

Internal Revenue Service

Department of the Treasury

Index Number: 355.01-02

Washington, DC 20224

Number: **200020032**

Person to Contact:

Release Date: 5/19/2000

Telephone Number:

Refer Reply To:

CC:DOM:CORP:3 - PLR-115313-99

Date:

February 16, 2000

Distributing =

Controlled =

business m =

business n =

shareholder A =

shareholder B =

shareholder C =

shareholder D =

employee E =

employee F =

state R =

W =

PLR-115313-99

X =

Y =

Z =

This is in response to a letter dated September 14, 1999, in which rulings were requested on behalf of Distributing regarding certain federal income tax consequences of a proposed transaction. The information submitted in that request and in a letter dated December 10, 1999, is substantially as set forth below.

Distributing is a state R corporation engaged in business m and business n. Distributing has outstanding W shares of voting common stock, X shares of which are owned by shareholder A and X of which are owned by shareholder B. Shareholder C owns Y shares and shareholder D owns Z shares. Employee E is in charge of the operation of business m and employee F is in charge of the operation of business n. Financial information has been provided showing that each business has receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Employee E and employee F have expressed concern about their level of participation in the profitability and growth of their respective businesses within Distributing. These employees have demanded equity participation in business m and business n, respectively. Employee E and employee F are the primary contacts with clients for their respective lines of business. Each business requires personal relationships with each client in order to, among other things, procure repeat business. Shareholders C and D insist on retaining their current level of participation, therefore shareholders A and B will sell some of their stock to shareholders C and D in order to prevent dilution of the stock held by shareholders C and D caused by the proposed equity participation of employee E and employee F.

The following transaction has been proposed:

Distributing will form Controlled as a wholly owned subsidiary by transferring all of the assets of business n to Controlled in exchange for stock of Controlled. Immediately after the formation of Controlled and the transfer of the business n assets to Controlled, all of the outstanding stock of Controlled will be distributed by Distributing to its shareholders. Distributing uses the accrual method of accounting and has a tax year ending December 31, and after the transaction Controlled will also use the accrual method of accounting and will have a tax year ending December 31.

The following representations have been made in connection with the proposed

PLR-115313-99

transaction:

(a) No part of the consideration distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.

(b) The five years of financial information submitted on behalf of Distributing's business m and business n is representative of their present operation, and with regard to each such business, there have been no substantial operational changes since the date of the last financial statements submitted.

(c) Following the proposed transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with their separate employees, with the exception of certain management services that may be supplied by Distributing to Controlled.

(d) The distribution of stock of Controlled will be carried out for the following corporate business purpose: to retain key employees who have demanded that they be permitted to purchase equity interests in the businesses that they manage. The distribution of the stock of Controlled is motivated in whole or substantial part by this corporate business purpose.

(e) Distributing is an S corporation (within the meaning of § 1361(a)). Controlled will elect to be an S corporation pursuant to § 1362(a) on the first day of its first taxable year and there is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

(f) Other than the sale of stock from shareholders A and B to C and D, there is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift or otherwise dispose of any of their stock in either Distributing or Controlled after the transaction.

(g) There is no plan or intention by either Distributing or Controlled, directly or indirectly or through any subsidiary corporation to purchase any of its outstanding stock after Distributing's distribution of the Controlled stock.

(h) There is no plan or intention to liquidate either Distributing or Controlled, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation subsequent to the transaction, except in the ordinary course of business.

(i) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing will each equal or exceed the sum of the liabilities to be assumed by Controlled plus any liabilities to which the transferred assets are subject.

PLR-115313-99

The liabilities to be assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of the business and are associated with the assets being transferred.

(j) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.

(k) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled's stock, with the exception of any amounts owed to Distributing by Controlled in consideration for the continuing services provided to Controlled by Distributing.

(l) Payments made in connection with all continuing transactions, if any, between Distributing and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

(m) No two parties to the transaction are investment companies as defined in §§ 368(a)(2)(F)(iii) and (iv).

(o) The Distribution is not part of a plan or series of related transactions (within the meaning of section 355(e)) pursuant to which one or more persons will acquire directly or indirectly stock possessing 50 percent or more of the total combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.

(p) No Distributing shareholder or shareholders will hold immediately after the distribution disqualified stock within the meaning of § 355(d)(3), which constitutes a 50% or greater interest in Distributing or Controlled.

(q) Each of shareholder A and shareholder B will sell equal proportions of each of Distributing's and Controlled's stock to shareholder C and shareholder D.

Based solely on the information submitted and on the representations set forth above, it is held as follows:

(1) The transfer by Distributing to Controlled of the assets described above in exchange for all the stock of Controlled and the assumption of certain liabilities followed by the distribution of Controlled stock will qualify as a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each be "a party to a reorganization" within the meaning of § 368(b).

(2) No gain or loss will be recognized to Distributing upon the transfer of assets to Controlled in exchange for Controlled stock and the assumption of liabilities

PLR-115313-99

(§§ 361(a) and 357(a)).

(3) No gain or loss will be recognized to Controlled on the receipt of the assets in exchange for all the shares of Controlled (§ 1032(a)).

(4) The basis of the assets received by Controlled will be the same as the basis of such assets in the hands of Distributing immediately prior to the transaction (§ 362(b)).

(5) The holding period of each asset received by Controlled will include the period during which Distributing held the asset (§ 1223(2)).

(6) No gain or loss will be recognized by Distributing upon the distribution of its Controlled stock (§ 361(c)).

(7) No gain or loss will be recognized by Distributing shareholders (and no amount will be included in their income) upon receipt of Controlled stock (§ 355(a)(1)).

(8) The basis of the Distributing stock and the Controlled stock distributed in the transaction in the hands of the Distributing shareholders after the distribution will, in each instance, be the same as the aggregate basis of the Distributing stock held immediately before the distribution, allocated in proportion to the fair market value of each in accordance with Treasury Regulations § 1.358-2(a)(2) (§ 358(a)(1)).

(9) The holding period of the Controlled stock in the hands of the Distributing shareholders will include the period for which such shareholder held the Distributing stock, provided that such stock was held as a capital asset by such shareholder on the day of distribution (§ 1223(1)).

(10) As provided in section 312(h) of the Code, proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a).

(11) Controlled will be subject to § 1374 with respect to any asset transferred to Controlled from Distributing to the same extent Distributing was subject to § 1374 with respect to such asset. For purposes of § 1374, Controlled's recognition period will be reduced by the portion of Distributing's recognition period that expires prior to Distributing's transfer of these assets to Controlled.

No opinion is expressed about the tax treatment of the transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above rulings.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3)

PLR-115313-99

of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By *Victor Penico*

Victor Penico
Branch Chief, Branch 3