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Department of the Treasury

Washington, DC 20224

Person To Contact:

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Telephone Number:

Refer Reply To:

CC:CORP:B02 – PLR-126887-03

Date:

October 15, 2003

LEGEND:

Distributing =

Controlled =

LLC =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

Key Employee 1 =

Executive =

State A =

Date 1 =

Date 2 =

Business D =

Business E =

Business F =

R =

S =

T =

U =

V =

W =

X =

Y =

Z =

Type X =

Dear

This letter responds to your letter of March 24, 2003, requesting rulings on behalf of Distributing regarding certain Federal income tax consequences of a proposed transaction. The information submitted for consideration in your request, and in additional submissions, is substantially as set forth below.

Distributing was incorporated in State A on Date 1. Distributing has authorized W shares of common stock class with V shares outstanding. At the present time, the shares of Distributing are owned as follows: Shareholder 1 owns X shares; Shareholder 2 owns Y shares; Shareholder 3 owns Y shares. Distributing's taxable year ends September 30.

Distributing is engaged in Business D. Distributing also holds a U percent membership interest in LLC. Partner owns the remaining T percent membership interest in LLC. LLC is engaged in Business E and Business F. Shareholder 1, who is the chief executive officer of Distributing, and Partner manage LLC's businesses. Financial information has been received indicating that Distributing has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Distributing has an existing key employee ("Key Employee") who was hired with the understanding that after S months of employment, and upon meeting certain performance expectations, he would be allowed to obtain an equity interest in Distributing. Distributing is also negotiating with a prospective employee ("Executive") to manage Business D. Executive wants to acquire an equity interest in Business D. Neither Key Employee nor Executive will have any part carrying out the operations of Businesses E or F. In order to retain the services of Key Employee and obtain the services of Executive, Distributing wishes to allow them to acquire an interest in Business D. The transfer of Distributing stock to Key Employee and Executive will accomplish a real and substantial business purpose germane to Distributing's Business D.

To accomplish these objectives, the following transaction is proposed:

- i. Distributing will transfer its membership interest in LLC to Controlled in exchange for Z shares of Controlled common stock. (Controlled was incorporated in State A for the purpose of carrying out this transaction on Date 2. From the time of its incorporation and up until the time of the transfer of the LLC interest to Controlled, Controlled will not engage in any business activities. Controlled has W shares of authorized common stock. Its taxable year will end on September 30.)
- ii. Distributing will distribute the Z shares of Controlled to Shareholder 1, Shareholder 2, and Shareholder 3 in proportion to their shareholdings in Distributing.
- iii. Within 12 months of the proposed distribution of the stock of Controlled, Key Employee and if employed by Distributing, Executive, will each purchase at least five percent of the common stock of Distributing. Distributing will finance each employee's purchase, allowing each employee to pay for the stock over a R year term.
- iv. Controlled will make an election to be treated as an S corporation on the first available date after the distribution.

Taxpayer has provided information that the objective of allowing Key Employee and Executive to purchase an equity interest in Business D cannot be accomplished by an alternative transaction to the one proposed without substantial additional costs.

In addition, Distributing states that the proposed transaction will allow Businesses E and F a reduction of risk. A claim ("Claim") against Distributing has been reduced to judgment. Distributing has appealed the judgment. Distributing does not currently have insurance to cover the judgment. Unless there is a separation of ownership of Businesses E and F from Business D, Distributing will not be able to obtain insurance for any future Type X claims involving Businesses E and F unless and until the current Claim against Distributing is resolved in Distributing's favor.

In connection with the proposed transaction, Distributing has made the following representations:

- (a) No part of the consideration distributed by Distributing is being received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing. No shareholder of Distributing shall transfer or surrender any property, stock, or securities in the course of the transaction.
- (b) The five years of financial information submitted on behalf of Distributing and LLC is representative of each entity's present operations, and with regard to each such entity there have been no substantial operational changes since the date of the last financial statements submitted.
- (c) Following the transaction, Distributing and Controlled will each continue, the active conduct of its businesses independently and with separate employees.
- (d) The distribution of the stock of Controlled is carried out to allow a key employee and a person who will become an employee of Distributing to acquire an equity interest in Business D. The distribution of the stock, or stock and securities, of Controlled is motivated in whole or substantial part by this business purpose.
- (e) There is no plan or intention by the shareholders or security holders of Distributing to sell, exchange, transfer by gift or otherwise dispose of any of their stock in, or securities of, either Distributing or Controlled after the transaction.
- f There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation to purchase any of its outstanding stock after the transaction other than through stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30.
- g 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 after the transaction, except in the ordinary course of business.

- h. The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject.
- i. The liabilities assumed in the transaction (as determined under section 357(d)) and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.
- j. The income tax liability for the taxable year in which investment credit property (including any building to which Code section 47(d) applies) is transferred will be adjusted pursuant to Code Section 50(a)(1) or (a)(2) or Code Section 47 as in effect before the amendment of Public Law 101-508, Title 11, 104 Stat. 1388,536 (1990), if applicable, to reflect an early disposition of the property.
- k. No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled Stock. To the extent that any continuing transactions occur between Distributing and Controlled, payments will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's-length
- l. No two parties to the transaction are investment companies as defined in Code section 368(a)(2)(F)(iii) and (iv).
- m. For purposes of Code section 355(d), immediately after the Distribution, no person (determined after applying Code section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in Code section 355(d)(5) and (8)) during the five year period (determined after applying Code section 355(d)(6)) ending on the date of the distribution.
- n. For purposes of Code section 355(d), immediately after the distribution, no person (determined after applying Code section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Controlled stock, that was either: (i) acquired by purchase (as defined in Code section 355(d)(5) and (8)) during the five year period (determined after applying Code section 355(d)(6)) ending on the date of the distribution or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in Code section 355(d)(5) and (8)) during the five year period

(determined after applying Code section 355(d)(6)) ending on the date of the distribution.

- . o The Distribution is not part of a plan or series of related transactions (within the meaning of Code 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 The gross assets of the portion of the business directly conducted by Distributing immediately after the distribution will have a fair market value that is greater than 5 percent of the total fair market value of Distributing's gross assets at that time.
- . q The gross assets of the portion of the business to be conducted by Controlled immediately after the distribution will have a fair market value that is greater than 5 percent of the total fair market value of Controlled's gross assets at that time.
- . r Distributing is an S corporation within the meaning of section 1361(a). Controlled will elect to be an S corporation pursuant to section 1362(a) on the first available date after the distribution and there is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

Based solely on the information submitted and on the representations set forth above, we rule as follows:

- . 1 The transfer by Distributing to Controlled of Business E and Business F, solely in exchange for all of the outstanding stock of Controlled and the assumption by Controlled of certain liabilities associated with the Business E and Business F assets transferred, followed by the pro-rata distribution of all of the stock of Controlled to Shareholder 1, Shareholder 2, and Shareholder 3 will be a reorganization within the meaning of section 368(a)(1)(D) of the Code. Distributing and Controlled will each be a "party to a reorganization" within the meaning of section 368(b).
- . 2 Distributing will recognize no gain or loss upon the transfer of assets to Controlled in exchange for controlled stock and the assumption of liabilities. Sections 361(a) and 357(a).

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- (3) Controlled will recognize no gain or loss on the receipt of the assets of Distributing in exchange for all of the shares of Controlled. Section 1032(a).
- (4) Controlled's basis in the assets it receives from Distributing will be the same as the basis of such assets in the hands of Distributing immediately prior to the proposed transaction. Section 362(b).
- (5) Controlled's holding period for the assets received from Distributing will include the period during which such assets were held by Distributing. Section 1223(2).
- (6) Distributing will recognize no gain or loss upon the distribution of all its Controlled stock to Shareholder 1, Shareholder 2, and Shareholder 3. Section 361(c).
- (7) Shareholder 1, Shareholder 2, and Shareholder 3 will recognize no gain or loss upon the receipt of Controlled stock in the proposed transaction. Section 355(a)(1).
- (8) Shareholder 1, Shareholder 2, and Shareholder 3's basis in the stock of Distributing and Controlled immediately after the proposed transaction will be the same as their respective basis in the Distributing stock immediately before the proposed transaction, allocated between Distributing and Controlled in proportion to their fair market values. Section 358(a) and (b) and Treas. Reg. Section 1.358-2(a)(2).
- (9) Shareholder 1, Shareholder 2, and Shareholder 3's holding period in the stock of Controlled immediately after the proposed transaction will include the holding period of the Distributing stock with respect to which the distribution was made provided that the Distributing stock was held as a capital asset by Shareholder 1, Shareholder 2, and Shareholder 3 on the date of the distribution. Section 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 in accordance with Treas. Reg. Section 1.312-10(a).
- (11) Provided that Controlled meets the requirements of section 1361(b) and provided that Distributing immediately distributes the stock of Controlled, Distributing's ownership of the stock of Controlled will not cause Controlled to have an ineligible shareholder under section 1361(b)(1)(B),

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and Controlled is eligible to make a timely election, without the consent of Distributing, to be an S corporation for the first taxable year.

No opinion is expressed about the tax treatment of the proposed 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 proposed transaction that are not specifically covered by the above rulings.

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

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Marlene P. Oppenheim

Marlene P. Oppenheim
Senior Counsel, Branch 2
Office of Office of Associate Chief Counsel
(Corporate)

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cc: