

## Internal Revenue Service

## Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:DOM:CORP: 1- PLR-112770-98  
Date:  
March 2, 1999

Re:

Distributing =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Shareholder E =

Shareholder F =

Shareholder G =

Shareholder H =

Shareholder I =

Controlled =

Risk Business =

m =

n =

o =

r =

u =

v =

w =

x =

Old Business =

Dear :

This responds to a letter dated June 16, 1998, requesting rulings concerning the federal income tax consequences of proposed transactions. The information submitted for consideration is summarized below.

Distributing, a State X corporation, engaged in Risk Business and Old Business is an S corporation that uses the accrual method of accounting and a calendar year. Distributing has outstanding a single class of voting common stock, all of which is held by Shareholders A through I. Shareholders A, B, C, and D ("A Group") hold approximately 45 percent, Shareholders E and F ("E Group") hold approximately 45 percent, and Shareholders G, H, and I ("G Group") hold approximately 10 percent of Distributing's outstanding common stock.

Controlled is a corporation being formed in State X that will have outstanding solely common stock. All the stock in Controlled will initially be held by Distributing.

Subsequent to the proposed transaction, it is anticipated that Controlled will elect to be an S corporation.

Distributing's Risk Business involves the purchase, shipment by road and rail, manufacture, storage, distribution, and sale of materials that are, or can become, highly toxic and/or explosive. Some of the Risk Business products sold by Distributing are manufactured by Distributing. Other products are purchased by Distributing from other manufacturers. Distributing exercises care with regard to its Risk Business operations and products. Nonetheless, there have been a number of minor accidents, one of which was barely prevented from becoming catastrophic. In addition to concern about the possibility of a catastrophic accident, Distributing is also concerned that changes in scientific thinking and /or in regulatory interpretations may result in Risk Business incurring liabilities from product suitability litigation (as has happened to some similar companies) and from unpredictable costs for waste product containment facilities and site remediation.

In order to protect Old Business from the potential liabilities of Risk Business, it is desired to completely separate Old Business from Risk Business. In addition, it is desired to make various changes to the amount of stock held by the various shareholders in Risk Business while keeping the holdings of the three groups unchanged with regard to Old Business. Shareholder A, the father of Shareholders B, C and D, is over 70 years old and does not want to hold stock in either Old Business or Risk Business. Shareholders B, C, and D, the remaining A Group shareholders wish to continue to hold approximately 45 percent of Old Business and to increase their holding in Risk Business. E Group wishes to continue their approximately 45 percent holding in Old Business but to hold no stock in Risk Business. G Group wants to have an increased interest in Risk Business, while continuing to hold approximately 10 percent of Old Business. Accordingly, the following steps are proposed:

- (I) Shareholder A will sell nearly all his Distributing stock (m shares) to Distributing for \$ n cash. The remainder of his Distributing stock (o shares) will be sold by Shareholder A to the other members of the A Group for \$ r, 10 percent in cash and 3-year 5.6% secured promissory notes for the balance.
- (II) Shareholders E and F will sell over 90 percent of their Distributing stock (u shares each) to Distributing for \$ y each, 25 percent in cash and a 4-year 8% note for the balance ("Distributing Notes").
- (III) Distributing will transfer to Controlled assets and liabilities of Old Business. The assets transferred to Controlled will include land, buildings, equipment and inventory.
- (IV) Distributing will distribute all the outstanding stock in Controlled to its

shareholders (except Shareholder A), with the E Group surrendering all their remaining stock in Distributing in exchange for this stock in Controlled. The A Group shareholders other than shareholder A will receive Controlled stock primarily as a distribution on their Distributing stock, but also will exchange a small amount of Distributing stock (w shares) for x shares of Controlled stock.

- (V) In conjunction with the transaction, Distributing will make a change to its name (but, throughout this letter, will still be referred to as Distributing) and Controlled will take the name previously used by Distributing (but, throughout this letter, will still be referred to as Controlled).

Following step (IV) : Distributing will be held slightly over 25 percent each by Shareholders B, C and D and slightly less than 25 percent by the G Group. Controlled will be held approximately 45 percent by A Group (divided equally between Shareholders B, C, and D), 45 percent by E Group (divided equally between Shareholders E and F), and 10 percent by G Group.

Distributing has submitted financial and employee information that indicates that both Old Business and Risk Business had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past 5 years.

The following representations have been made in connection with the entire transaction described in steps (I) through (IV) above.

- (a) Distributing, Controlled, and each of the shareholders will each pay their own expenses in the transactions.
- (b) There is no plan or intention for any Distributing shareholder to transfer any assets to Distributing, Controlled, or any related corporation (except for the shareholders' transfers of Distributing stock to Distributing).

The following representations have been made in connection with steps (I) and (II) (the "redemptions:):

- (aa) There are no outstanding options or warrants to purchase Distributing stock, nor are there any outstanding debentures or other obligations that are convertible into Distributing stock or that would be considered Distributing stock.
- (bb) In no event will the last payment on either of the Distributing Notes, or on any other obligation issued to the redeemed shareholders, be made more than 15 years after the date of issuance of the note or other obligation.

- (cc) None of the consideration from Distributing, including interest, consists entirely or partly of Distributing's promise to pay an amount that is based on, or contingent on, future earnings of Distributing, an amount that is contingent on working capital being maintained at a certain level, or any other similar contingency.
- (dd) The Distributing Notes and any other note or other obligation to be issued to a redeemed shareholder will not be subordinated to the claims of general creditors of Distributing.
- (ee) In the event of default on either of the Distributing Notes or on any other obligation, no shares of stock in Distributing, Controlled, or any related corporation will revert to E Group or any related person or entity nor will any member of E Group or any related person or entity be permitted to purchase such stock at any public or private sale. The notes to be received by E Group will specifically provide that, in event of default, no stock will revert to the shareholders.
- (ff) No shareholder of Distributing has been or will be obligated to purchase any of the stock to be redeemed.
- (gg) The proposed transactions described in steps (I) through (IV) above are an isolated group of transactions and are not related to any other past or future transactions.
- (hh) There have been no redemptions, issuances, or exchanges by Distributing of its stock in the past 5 years, except for the issuance of less than two percent to Shareholder G under a Distributing stock bonus plan. Shareholder G is not related, within the meaning of § 318(a), to Shareholders A, E, and F.
- (ii) Neither Distributing nor Controlled has any plan or intention to issue, redeem, or exchange any shares of its stock except for the transactions described in steps (I) through (IV) above and except for the possible issuance of an amount of stock that is less than 3 percent of its outstanding stock to Shareholder G under the Distributing stock bonus plan.
- (jj) None of the stock to be redeemed from Shareholder A was acquired by Shareholder A within the 10-year period preceding the redemption from a person whose stock would be attributed under section 318(a) of the Code to Shareholder A at the time of redemption.
- (kk) No person whose stock would be attributed to Shareholder A under

§ 318(a) will own stock in Distributing, except Shareholders B, C, and D, Shareholder A's children, who received gifts of Distributing stock from Shareholder A more than 6 years ago. These gifts, made as part of Shareholder A's long-term plan to share the family enterprise with his children, were intended to promote an orderly transition in corporate management and to accomplish estate planning, and were similar to the gifts of equal amounts of stock to each of the children made on several previous occasions starting nearly 30 years ago. The sales by Shareholder A of approximately 4 percent of his Distributing stock to each of Shareholders B, C and D in step (I) above (13.4 percent of his stock in total) are being made so these shareholders will have the desired amounts of stock in Distributing and Controlled at the end of step (IV). At that time, each of these shareholders will hold over 25 percent of the stock in Distributing and will be active in directing the affairs of Distributing. Neither the gifts nor the sales were made in order to provide Shareholder A with a post-redemption economic interest in, or influence over, either Distributing or Controlled. Neither the gifts nor the sales had as one of their principal purposes the avoidance of federal income tax.

- (II) After the redemption of his Distributing stock, Shareholder A will have no interest in either Distributing or Controlled, including an interest as an officer, director, or employee (other than an interest as a creditor as described in § 1.302-4(d) of the Income Tax Regulations, and constructive ownership under § 318(a)(1) of the Code). Under no circumstances will any of the Distributing stock sold by Shareholder A to his children revert back to Shareholder A, and the notes to be received by Shareholder A will specifically provide that in event of default, no stock in Distributing, Controlled, or any related entity will revert to Shareholder A.
- (mm) Shareholder A will elect to participate in Distributing's group health insurance for a period of 18 months, with Shareholder A being responsible for the payment of all premiums and other costs. This right to health insurance is being received by Shareholder A solely in his capacity as a retiring employee and is the same as the right available to all retiring employees pursuant to the provisions of the Consolidated Omnibus Budget Reconciliation Act of 1985, Act of April 7, 1986, Pub. L. No. 99-272.
- (nn) Shareholder A will execute and file the agreement required by § 302(c)(2)(a)(iii) with respect to the acquisition of any interest in Distributing within 10 years from the date of the redemption.
- (oo) There are no declared but unpaid dividends, or funds set apart for dividends, on any of the stock to be redeemed. (A dividend sufficient to

pay the shareholder's federal tax liability on income earned during the year has been declared; however, this dividend will be fully paid out prior to step (1) ).

- (pp) At the time of the redemptions, the amount of cash and the fair market value of any other consideration to be received from Distributing by Shareholders A, E, and F will, for each shareholder, approximately equal the fair market value of the Distributing stock to be surrendered by such shareholder in exchange therefor. The redemption price was reached through arms-length bargaining between Distributing and the redeemed shareholders.
- (qq) With regard to each redemption, the price to be paid for the Distributing stock will not result in a loss with respect to the shares of stock redeemed.
- (rr) Except for the transfer of \$ n cash from Distributing to Shareholder A in exchange for Distributing stock as described in step (I), there is no plan or intention for Distributing to transfer any assets to Shareholder A or for his benefit.
- (ss) Following the step (II) redemption by Distributing of the stock held by E Group, these shareholders will each hold approximately 3 percent of the outstanding Distributing stock and they will have reduced their interest in Distributing such that, for each of them, the ratio of the stock they hold after the redemption to all the then outstanding Distributing stock will be less than 80 percent of the same ratio prior to the redemption. Subsequent to step (IV), the E Group shareholders will hold no stock in Distributing.
- (tt) Each of the Distributing Notes received by E Group will be a debt and not an equity interest. Each of the notes will be for a term of no more than 5 years.
- (uu) Under the terms of the Distributing Notes, the rights the shareholders will receive with respect to Distributing will be no greater or broader in scope than necessary for enforcement of the shareholders' claim for payment of the notes.

The following representations have been made in connection with steps (III) and (IV) (the "spin-off"):

- (aaa) With regard to each shareholder who exchanges Distributing stock for Controlled stock (E Group who exchange all their remaining Distributing stock and A Group who exchange a small amount of their Distributing

stock), the fair market value of the Controlled stock received by such shareholder will be approximately equal to the fair market value of the Distributing stock surrendered by such shareholder in exchange therefor.

- (bbb) For each of the A Group and G Group shareholders, the total of the fair market value of the Distributing stock and the fair market value of the Controlled stock held by the shareholder after the spin-off will be approximately equal to the fair market value of the Distributing stock held by such shareholder prior to the spin-off.
- (ccc) None of the consideration being received by any of Distributing's shareholders in the whole overall transaction (including the cash, notes and Controlled stock) is being received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.
- (ddd) The 5 years of financial information submitted on behalf of Distributing is representative of the corporation's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (eee) Following the spin-off of Controlled stock, Distributing will continue to be directly engaged in the active conduct of Risk Business independently and with its own separate employees. Risk Business will have been actively conducted (within the meaning of § 1.355-3(b) ) by Distributing independently and with its own employees at all times in the 5-year period prior to the distribution of Controlled stock. Following the spin-off, Distributing will have a minimum of 200 full-time employees who will continue to conduct the operational and managerial activities of Risk Business: approximately 60 employees primarily managerial and other employees primarily operational.
- (fff) Following the spin-off, Controlled will be directly engaged in the active conduct of Old Business, independently and with its own separate employees. Old Business will have been actively conducted (within the meaning of § 1.355-3(b) ) by Distributing independently and with its own employees throughout the 5-year period immediately preceding the spin-off. Following the spin-off, Controlled will have a minimum of 10 full-time employees who will continue to conduct the operational and managerial activities of Old Business: at least two employees primarily managerial and other employees primarily operational.
- (ggg) The distribution of Controlled stock is being carried out for the corporate business purpose of protecting Old Business from the potential liabilities



of Risk Business. The distribution of Controlled stock is motivated, in whole, or substantial part, by this corporate business purpose.

- (hhh) There is no plan or intention for any Distributing shareholder to sell, exchange, transfer by gift, have redeemed, or otherwise dispose of any stock in either Distributing or Controlled, except for dispositions as described in steps (I) through (IV) above.
- (iii) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock in conjunction with the transaction or after the transaction, except as described in steps (I) through (IV) above.
- (jjj) 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, except for dispositions of assets in the ordinary course of business and dispositions of assets in steps (I) through (IV) as described above.
- (kkk) 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 assumed by Controlled plus any liabilities to which the transferred assets are subject.
- (III) The liabilities of Distributing assumed by Controlled in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets transferred.
- (mmm) The property being transferred by Distributing to Controlled will not be subject to any investment tax credit capture.
- (nnn) No intercorporate debt will exist between Distributing and Controlled at the time of the spin-off, or subsequent thereto, except as described in the next two sentences. A small amount of debt owed by the Old Business division to the Risk Business division immediately before the transaction will, immediately following the transaction, be owed by Controlled to Distributing. In addition, other de minimis debt may arise from time to time as a result of transactions between Distributing and Controlled. Any debt between Distributing and Controlled will be short term and will be the result of normal business dealings between divisions or between Distributing and Controlled and at no time will exceed \$100,000. In no event will any debt between Distributing and Controlled constitute either an equity interest or a security.

- (ooo) If, after the spin-off, there are any transactions between Distributing and Controlled, all payments made in connection with such transactions will be for fair market value based on terms and conditions arrived at by the parties bargaining at arms length.
- (ppp) No two parties to the spin-off are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (qqq) The transaction will not constitute a disqualified distribution within the meaning of § 355(d).
- (rrr) The step (IV) distribution is not part of a plan or series of related transactions (within the meaning of § 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 in either Distributing or Controlled, or stock possessing 50 percent or more of the total value of all classes of stock in either Distributing or Controlled.
- (sss) Except for transfers to members of the same family as defined in § 267(c) (4), each of Shareholders B through I has represented that (i) he or she has no plan or intention to sell, give, redeem, transfer, receive, or in any way change his or her holding of stock in Distributing, and (ii) he or she has no plan or intention to take any action that would result in any other shareholder changing their holding of Distributing stock. The sole exception to the prior sentence is the possible receipt of up to 3 percent of the outstanding Distributing stock by Shareholder G pursuant to the stock bonus plan.

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

- (1) Neither the gifts of Distributing stock by Shareholder A to his children some 6 years ago nor the proposed sales to the children, as described above, have as one of their principal purposes the avoidance of federal income tax within the meaning of § 302(c)(2)(B). See Rev. Rul. 77-293, 1977-2 C.B. 91, Rev. Rul. 57-387, 1957-2 C.B. 225, and Rev. Rul. 56-556, 1956-2 C.B. 177. Thus, these gifts and sales from Shareholder A to his children will not prevent Shareholder A from using the § 302(c)(2)(A) waiver of attribution provision.
- (2) Shareholder A's sale of the remainder of his Distributing stock subsequent to the redemption will be considered part of the same overall transaction as the redemption so that, at the time the redemption is completed, Shareholder A will be considered as ceasing to directly hold any

Distributing stock. See Zenz v. Quinlivan, 213 F.2d 914 (6<sup>th</sup> Cir. 1954), Rev. Rul. 55-745, 1955-2 C.B. 223.

- (3) Provided that (i) Shareholder A files the agreement described in § 302(c)(2)(A)(iii) of the Code in accordance with § 1.302-4(a) of the regulations, and (ii) the conditions stated in § 302(c)(2)(A)(i) and (ii) are satisfied, § 318(a)(1) will not apply and the redemption by Distributing of its stock held by Shareholder A, as described above, will constitute a “complete termination” of Shareholder A’s interest within the meaning of § 302(b)(3). The amount distributed to Shareholder A by Distributing in the redemption will be treated as a distribution in full payment for the stock surrendered as provided in § 302(a).
- (4) The distributions of cash and Distributing Notes by Distributing to the E Group in exchange for some of their Distributing stock, as described more fully above, which for each of the shareholders will result in the ratio of the Distributing stock held by the shareholder after the transaction to all the outstanding stock being less than 80 percent of that same ratio before the transaction, will each constitute a substantially disproportionate redemption of stock within the meaning of § 302(b)(2). The cash and notes distributed to the E Group by Distributing will be treated as distributions in full payment for the stock surrendered as provided in § 302(a).
- (5) As provided by § 1001, Shareholder A and the E Group will realize and recognize gain or loss on the redemption of the Distributing stock. For each share of stock surrendered, gain or loss will be recognized to the extent of the difference between the redemption price (the amount of cash plus the fair market value of the portion of the Distributing Notes received in exchange for such share) and the adjusted basis of such share as determined under § 1011. Provided that § 341 (relating to collapsible corporations) is not applicable and that the Distributing stock is a capital asset in the hands of such shareholder, gain or loss, if any, will be considered capital gain or loss subject to the provisions and limitations of Subchapter P of Chapter 1.
- (6) No gain or loss will be recognized to Distributing on the distribution to its shareholders of solely cash and its own notes.
- (7) The transfer in step (III) by Distributing to Controlled of Old Business assets, in exchange for all the stock in Controlled and the assumption by Controlled of liabilities associated with the assets and business transferred followed by the distribution in step (IV) of all the Controlled stock to the Distributing shareholders constitutes a reorganization within

the meaning of §§ 368(a)(1)(D) and 355. Distributing and Controlled are each a “party to a reorganization” within the meaning of § 368(b).

- (8) No gain or loss is recognized to Distributing on the transfer of assets, subject to liabilities, to Controlled in exchange for all the stock in Controlled and the assumption of liabilities (§§ 361(a) and 357(a) ).
- (9) No gain or loss is recognized by Controlled on its receipt of assets in exchange for Controlled stock (§ 1032(a) ).
- (10) Controlled’s basis in the assets received from Distributing equals the basis of such assets in the hands of Distributing immediately prior to the transfer (§ 362(b) ).
- (11) Controlled’s holding period for the assets received from Distributing includes the period during which Distributing held such assets (§ 1223(2) ).
- (12) No gain or loss will be recognized to Distributing upon the distribution to Shareholders B through I of all the stock in Controlled (§ 361(c)(1) ).
- (13) No gain or loss will be recognized to (and no amount will be included in the income of ) Shareholders B through I upon the receipt of Controlled stock (§ 355(a)(1) ).
- (14) With regard to all the Controlled stock received by the E Group and with regard to x shares of Controlled received by the A Group in exchange for w shares of Distributing stock, the shareholder’s basis in the Controlled stock received will equal the basis in the Distributing stock surrendered in exchange therefore (§358(a)(1) ).
- (15) For the G Group and the A Group (except for the shares exchanged as provided in ruling (14) above), the total basis of the Controlled stock and the Distributing stock held by each shareholder after the distribution will be the same as the basis of the Distributing stock held by such shareholder immediately before the distribution. The total basis will be allocated in proportion to the relative fair market values of the Controlled stock and Distributing stock in accordance with § 1.358-2(a)(2).
- (16) The holding period of the Controlled stock received by the shareholders will include the period during which the shareholders held the Distributing stock exchanged therefor, or the Distributing stock with regard to which the Controlled stock is received, provided that the Distributing stock is a capital asset in the hands of the shareholders on the date of the spin-off

(§ 1223(1) ).

- (17) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a).
- (18) As provided by § 1.1368-2(d)(3), the “accumulated adjustments account” (as defined in § 1368(e)(1) ) of Distributing immediately prior to the spin-off will be allocated between Distributing and Controlled in a manner similar to the manner in which the earnings and profits of Distributing are allocated (see ruling (17) above).

No opinion is expressed about the tax treatment of the redemptions or the spin-off 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, these transactions that are not specifically covered by the above rulings. Further, no opinion is expressed or implied regarding the validity of Distributing’s S corporation election under § 1362(a) or the eligibility of Controlled under § 1361(b) to elect S corporation status.

Nor is any opinion requested or expressed as to whether the transfer of any trade name, trademark, know-how, or similar items from Distributing to Controlled constitutes the transfer of property. See Rev. Rul. 69-156, 1969-1 C.B. 101.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

It is important that a copy of this letter be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transactions covered by this letter are consummated.

Sincerely yours.  
Assistant Chief Counsel (Corporate)

By \_\_\_\_\_  
Alfred C. Bishop  
Chief, Branch 1