

Internal Revenue Service

Department of the Treasury

Index Number: 355.03-00: 368.09-00

Washington, DC 20224

Number: **199917052**

Person to Contact:

Release Date: 4/30/1999

Telephone Number:

Refer Reply To:

CC:DOM:CORP:1-PLR-116128-98

Date:

February 1, 1999

Legend

Distributing =

Controlled =

Subsidiary =

Division 1 =

Division 2 =

State A =

Date T =

Date U =

Date V =

Date W =

Date X =

Date Y =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

Agreement P =

Q =

License =

Dear :

We respond to your letter dated August 11, 1998, in which you requested rulings as to the federal income tax consequences of a proposed transaction. Additional information was provided in a letter dated November 20, 1998 and submitted on November 30, 1998. Specifically, you requested rulings under section 355 of the Internal Revenue Code. The facts as submitted, are as follows.

Distributing is a State A corporation incorporated on Date X that is engaged in the sale and delivery of alcoholic beverages. In particular, Distributing is currently engaged in the Division 1 and Division 2 businesses. Distributing is a calendar year, accrual method taxpayer and has been conducting the Division 1 and Division 2 businesses for more than five years. Distributing is a sub-chapter C corporation, although it is qualified to elect sub-chapter S status. Distributing has 250 shares of voting common stock outstanding. Shareholder 1 is an individual. Shareholders 2 and 3 are both trusts with the same individual beneficiary. Therefore, All 250 outstanding shares are held for or by two individuals. Shareholder 2 owns 125 shares (50%), Shareholder 2 owns 72 shares (28.8%), and Shareholder 3 owns 53 shares (21.2%). Shareholder 2 is an irrevocable trust that can elect to be a “small business trust” under Section 1361(e) of the Code and therefore can be a qualified shareholder of a sub-chapter S corporation. Shareholder 3 is a revocable trust that is deemed to be owned by the beneficiary and therefore can be a qualified shareholder of a sub-chapter S corporation.

Controlled is a State A corporation incorporated on Date Y. Controlled is a calendar year accrual method taxpayer . Currently, Controlled has \$Q and a license but conducts no activities.

Controlled has 1000 shares of voting common stock outstanding which are fully owned by Distributing. Controlled was created in anticipation of the distribution of Controlled in the proposed transaction. Controlled filed for sub-chapter S tax status on Date V . However, assuming the sub-chapter S election is invalid, Controlled will file for the election again after Controlled is distributed. Additionally, in order to lessen the Service's concern about a potential non-Corporate Business Purpose, Distributing and Controlled agreed that each would make or refrain from making elections to cause or continue status as an S corporation if the Service believes such is necessary and appropriate to prevent the potential avoidance of federal taxes or other non-Corporate Business Purpose.

Subsidiary is a State A corporation incorporated on Date W. Subsidiary is an accrual method taxpayer that is wholly owned by Distributing. Subsidiary is a service corporation that has no assets but has payroll activity.

On Date U, Distributing entered into Agreement P with one of its suppliers. Agreement P provides certain requirements which have resulted in conflicts regarding the operations and directions of Division 1 and Division 2. As a result of Agreement P, one of the two divisions will have to change its operations and business philosophies if both Divisions are not separated. Additionally, P Agreement requires that one of the shareholders obtain control of Distributing. Neither shareholder is willing to give up control. As a result, Shareholder 1, on the one hand, and Shareholder 2 and 3 (controlled by one individual) cannot agree as to the conflicts created by agreement P. To resolve the conflicts created by Agreement P, shareholder 1, and Shareholder 2 and 3, have taken several steps and will take additional steps in accordance with the requested ruling in order to sever their interests.

The steps already taken and the additional steps that will be taken are as follows:

- 1) On Date Y, Distributing created Controlled and on Date T, all the stock of Controlled was distributed to Distributing in exchange for \$1000 cash.
- 2) On Date V, Controlled filed for sub-chapter S tax status.
- 3) Distributing will transfer Division 2 and Subsidiary along with all the liabilities associated with such businesses to Controlled and will keep Division 1. Thereafter, Distributing will distribute all 1000 shares of Controlled stock to shareholder 1 in exchange for all of Shareholder 1's shares in Distributing. As a result, Distributing will be owned by Shareholder 2 and 3, and Controlled will be solely owned by Shareholder 1. Distributing will retain its sub-chapter C tax status. Assuming Controlled's sub-chapter S status filed on Date V is invalid, Controlled will file for election again after the distribution.

After the distribution, only one employee will be shared by Distributing and Controlled.

That employee will be the current Controller of Distributing and he will perform accounting, financial, and other services typically provided by the Controller of a Division 1 and Division 2 business. The Controller will be shared for a period of six months immediately after the distribution. He will work an equal amount of time for Distributing and Controlled and his compensation will be shared equally by them. The services of the Controller will be shared by Distributing and Controlled to facilitate the smooth transition of the Division 2 business to Controlled and the adaptation of both Distributing and Controlled to the separate operations of their separate active businesses.

Additionally, Distributing will rent office and warehousing space to Controlled under an existing lease that will end on April 30, 2000, and it will deliver part of Division's 2 products for which Controlled will pay a fee. The rent and delivery fee will be negotiated at arm's length. The part of Division's 2 products that will be warehoused and delivered by Distributing constitutes only 20% of Controlled's business. As to the warehouse, Controlled has ten one-year options to lease from Distributing warehouse space to store alcoholic beverage products which options may be exercised after the existing lease terminates. Controlled cannot at this time confirm an earlier date by which it will be financially able to build its own warehouse facilities or buy the required specialized delivery trucks, and thus cease using the facilities to be leased from Distributing.

An alternative transaction to the distribution of Controlled whereby distributing would transfer Division 1 And Division 2 into two separate subsidiaries of Distributing, thereby making Distributing a holding company could not be accomplished because of the following reasons:

- 1) P Agreement requires that an individual be in control of Division 1.
- 2) P Agreement requires that where there is a chain of corporations, one individual have control of the parent corporation.

The following representations have been made in connection with the proposed transaction:

- a) The fair market value of the controlled corporation stock and other consideration to be received by each shareholder of the Distributing corporation (specifically, Shareholder 1) will be approximately equal to the fair market value of the distributing corporation stock surrendered by the shareholder in the exchange.
- b) No part of the consideration to be distributed by the distributing corporation will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.
- c) No part of the consideration to be distributed by the distributing corporation will be received by a security holder as an employee or in any other capacity other than that of a

security holder of the corporation.

d) The 5 years of financial information submitted on behalf of the distributing corporation is representative of the corporation's present operations, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.

e) Following the transaction, the distributing and controlled corporations will each continue the active conduct of its business, independently and with its separate employees.

f) The distribution of the stock, or stock and securities, of the Controlled corporation is carried out for the following corporate business purpose: To separate the business interests of shareholders who disagree about the direction of the business of the controlled corporation. The distribution of the stock, or stock and securities, of the controlled corporation is motivated, in whole or substantial part, by this corporate business purpose.

g) There is no plan or intention by the shareholders or security holders of the distributing corporation to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in, or securities of, either the distributing or controlled corporation after the transaction.

h) There is no plan or intention by either the distributing corporation or the controlled corporation, 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.

i) There is no plan or intent to liquidate either the distributing or controlled corporation, 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.

j) The total adjusted bases and the fair market value of the assets transferred to the controlled corporation by the distributing corporation each equals or exceeds the sum of liabilities assumed by the controlled corporation plus any liabilities to which the transferred assets are subject and the liabilities assumed 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 being transferred.

k) No intercorporate debt will exist between the distributing corporation and the controlled corporation at the time of, or subsequent to, the distribution of controlled corporation stock.

l) Payments made in connection with all continuing transaction, if any, between the distributing and controlled corporations, 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 section 368(a)(2)(F)(iii) and (iv).

n) 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.

Based solely on the facts submitted and the representations made above, it is held as follows:

1) The transfer by Distributing to Controlled of the assets, followed by the distribution of Controlled stock to Shareholder 1, will qualify as a reorganization within the meaning of sections 368(a)(1)(D). Distributing and Controlled will each be a "party to the reorganization" within the meaning of section 368(b).

2) No gain or loss will be recognized by Distributing upon the transfer of assets and liabilities to Controlled in actual and constructive exchange for Controlled stock as described above. Sections 361(a) and 357(a) of the Code.

3) No gain or loss will be recognized by Controlled upon the receipt of assets and liabilities, in actual and constructive exchange for Controlled stock as described above. Section 1032(a) of the Code.

4) The basis of the assets received by Controlled 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) of the Code.

5) The holding period of the assets received by Controlled from Distributing in the transaction will include the holding period of Distributing in those assets immediately before the transaction. Section 1223(2) of the Code.

6) No gain or loss will be recognized by Distributing on the distribution of all of the stock of Controlled to Shareholder 1. Section 361(c) of the Code.

7) No gain or loss will be recognized and no amount will be included in the income of shareholder 1 on the receipt of Controlled stock. Section 355(a)(1).

8) The basis of the Controlled stock in the hand of shareholder 1 will be the same as shareholder 1's basis in his Distributing stock held immediately before the transaction. Section 358(a)(1) of the Code.

9) The holding period of the Controlled stock received by shareholder 1 in the transaction will include the holding period of the Distributing stock surrendered, by shareholder 1, in the exchange, provided that such stock is held as a capital asset on the date of the exchange. Section 1223(1) of the Code.

10) As provided in section 312(h), proper allocation of earnings and profits among Distributing and Controlled will be made pursuant to Treasury Regulations section 1.312-10(a).

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 directly covered by the above rulings.

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

Sincerely yours,

Assistant Chief Counsel (Corporate)

By _____
Alfred Bishop
Branch Chief, Branch 1