

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

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Refer Reply To:

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Date:

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**LEGEND:**

Distributing =

Controlled =

LLC =

Shareholder A =

Shareholder B =

Shareholder C =

Trust D =

Trust E =

Trust F =

Trust G =

Trust H =

Trust I =

Trust J =

Trust K =

State L =

State M =

Business X =

Business Y =

Operation Z =

Dear

We respond to your letter dated December 5, 2001, in which you requested rulings as to the federal income tax consequences of a proposed transaction. Specifically, you requested rulings under sections 355 and 1361 of the Internal

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Revenue Code. Additional information was received in a letter dated March 29, 2002. The information submitted for consideration is summarized below.

Distributing is an S corporation incorporated in State L. Distributing is a calendar year taxpayer and utilizes the accrual method of accounting for book and tax purposes. Distributing has outstanding voting common stock and non-voting common stock. Shareholder A and Trust D, a trust for the benefit of Shareholder A's children, own 50% of the outstanding voting and nonvoting Distributing stock. Shareholders B and C, together with Trusts E, F, G, H, I, J, and K, which are trusts for the benefit of Shareholder B's and Shareholder C's children, own 50% of the outstanding voting and nonvoting Distributing stock.

Distributing is principally engaged in Business X and also conducts Business Y. Distributing conducts Business X at several sites, including Operation Z, which possesses certain features that the other sites at which Distributing conducts Business X do not possess.

Distributing has submitted financial information indicating that Business X, as operated by 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 wholly owns Controlled, a qualified subchapter S subsidiary (QSub) incorporated in State M for the purpose of consummating the proposed transaction. Controlled has two classes of outstanding common stock, voting and nonvoting, all of which is owned by Distributing. Controlled will file its federal income tax returns on a calendar year basis and will use the accrual method of accounting. Distributing also wholly owns LLC, a State M limited liability company formed for the purpose of consummating the proposed transaction.

Shareholders A, B and C have disagreed on a number of fundamental business matters, including the allocation of corporate resources to Operation Z. The conflicts between the shareholders are having an adverse effect on the day-to-day operations of Distributing. Distributing has proposed the transaction described below, which will allow Shareholder A to focus on Business X at Operation Z, thus eliminating the shareholder disputes.

## PROPOSED TRANSACTION

1. Distributing will contribute to LLC the Operation Z assets and liabilities, as well as an additional amount for use as working capital in Operation Z, which will be determined by a formula apportioning Distributing's working capital between Operation Z and its other operations. Distributing will transfer its ownership interest in LLC to Controlled, along with certain other assets and liabilities (the "Transfers").
2. Distributing will distribute all the Controlled stock to Shareholder A and Trust D in exchange for all of their Distributing stock (the "Distribution").

Within 60 days following the Distribution, Distributing will prepare its consolidated balance sheet effective as of the date of the Distribution. Within 100 days after the Distribution, Distributing may transfer additional assets to LLC, or LLC may return assets to Distributing, as necessary to comply with the formula in Step 1 above ("True-up Provision"). Distributing, Controlled, and LLC generally will agree to indemnify each other for certain liabilities that include (1) tax liabilities for periods up to and including the tax year of the Distribution, as specified in the Tax Matters Agreement and Plan of Reorganization, and (2) certain non-tax liabilities specified in the Plan of Reorganization (this provision is hereinafter referred to as "Indemnification Agreement"), including liabilities created by shareholder breaches under the Plan of Reorganization, certain environmental liabilities, liabilities assumed as part of the proposed transaction, and other shared contingent liabilities.

## REPRESENTATIONS

The taxpayer has made the following representations concerning the Transfers and the Distribution.

- (a) The fair market value of Controlled stock and other consideration to be received by Shareholder A and Trust D in the Distribution will be approximately equal to the fair market value of Distributing stock surrendered by Shareholder A and Trust D in the exchange.
- (b) No part of the consideration to be distributed by Distributing will be received by Shareholder A or Trust D as a creditor, employee, or in any other capacity other than that of a shareholder of Distributing.
- (c) The five years of financial information submitted on behalf of Distributing is representative of Distributing'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.
- (d) Following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees, the active conduct of its share of all the integrated activities of Business X conducted by Distributing prior to consummation of the transaction.
- (e) The distribution of the stock of Controlled is carried out for the following corporate business purpose: to enable the corporation to resolve management, systemic and other problems that are exacerbated by Distributing's operation of its current businesses under unified ownership. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (f) 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.

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- (g) 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.
- (h) 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.
- (i) 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.
- (j) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the liabilities assumed (as determined under section 357(d)) by Controlled. The liabilities assumed (as determined under section 357(d)) 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. For purposes of this representation, the contingent liabilities under the True-Up Provision and the indemnification provisions included in the Plan of Reorganization and the Tax Matters Agreement are not treated as assumed liabilities.
- (k) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock, except for the True-Up Provision, the contingent indemnification obligations that appear in the Plan of Reorganization and the Tax Matters Agreement, and the continuing transactions between Distributing and Controlled.
- (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 section 368(a)(2)(F)(iii) and (iv).
- (n) No Distributing shareholder will hold immediately after the distribution disqualified stock within the meaning of section 355(d)(3) which constitutes a 50 percent or greater interest in Distributing or Controlled.
- (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 combined voting power of all classes of stock entitled to vote 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.

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## RULINGS

- (1) For federal tax purposes, LLC will be disregarded as an entity separate from its owner, provided that no election will be made to treat the LLC as a corporation. Treas. Reg. § 301.7701-2 (a). All of the assets, liabilities and items of income, deduction, and credit of Controlled, a QSub, will be treated as assets, liabilities, and items of income, deduction, and credit of Distributing. Accordingly, the Transfers will be disregarded for federal income tax purposes. Treas. Reg. § 1.1361-4(a)(1).
- (2) The Transfers, followed by the Distribution, will be a reorganization within the meaning of section 368(a)(1)(D). Distributing and Controlled will each be a “party to the reorganization” within the meaning of section 368(b). Treas. Reg. § 1.1361-5(b)(3), Example 4.
- (3) Distributing will recognize no gain or loss upon the transfer of assets, subject to liabilities, to Controlled in exchange for the stock of Controlled. Sections 361(a) and 357(a).
- (4) No gain or loss will be recognized by Controlled upon the receipt of the assets from Distributing in exchange for the stock of Controlled. Section 1032(a).
- (5) The basis of each of the assets received by Controlled in the transaction will equal the basis of such assets in the hands of Distributing immediately prior to the Transfers. Section 362(b).
- (6) The holding period of each of the assets to be received by Controlled in the transaction will include the period during which such assets were held by Distributing. Section 1223(2).
- (7) No gain or loss will be recognized by Distributing upon the Distribution. Section 361(c).
- (8) No gain or loss will be recognized by Shareholder A or Trust D upon the Distribution. Section 355(a)(1).
- (9) The basis of the Controlled stock to be received by Shareholder A and Trust D will be the same as the basis of the Distributing stock surrendered by each in exchange therefor. Section 358(a)(1).
- (10) The holding period of the Controlled stock received by Shareholder A and Trust D will include the holding period of the Distributing stock surrendered in exchange therefor, provided that the Distributing stock is held as a capital asset on the date of the exchange. Section 1223(1).
- (11) Proper allocation of earnings and profits between Distributing and Controlled will be made under section 312(h) and Treas. Reg. § 1.312-10(a).

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- (12) Payments made by Distributing to Controlled or LLC, or by Controlled or LLC to Distributing under the True-Up Provision will be treated as occurring immediately before the Distribution at a time when Controlled was a QSub.
- (13) Payments made by Distributing to Controlled or LLC, or by Controlled or LLC to Distributing under the Tax Matters Agreement and Plan of Reorganization regarding tax liabilities that (i) have arisen or will arise for a taxable period ending on or before the Distribution or for a taxable period beginning before and ending after the Distribution, and (ii) will not become fixed or ascertainable until after the Distribution, will be treated as occurring immediately before the Distribution at a time when Controlled was a QSub.
- (14) Controlled will be subject to section 1374 with respect to any asset transferred to Controlled to the same extent Distributing was subject to section 1374 with respect to such asset. For purposes of section 1374, the recognition period for Controlled will be reduced by the portion of Distributing's recognition period that expired prior to the transfer of these assets to Controlled. Section 1374(d)(8) and Ann. 86-128, 1986-51 I.R.B. 22.
- (15) The Distribution of Controlled to Shareholder A and Trust D will terminate the QSub election with respect to Controlled. Section 1361(b)(3)(B); Treas. Reg. § 1361-5(a)(1)(iii). Controlled may, without requesting the Commissioner's consent, make an S election before the expiration of the five year period described in section 1361(b)(3)(D) and Treas. Reg. § 1361-5(c)(1), provided that: (i) immediately following the termination, Controlled is otherwise eligible to make an S election; and (ii) the election is made effective immediately following the termination of the QSub election. Treas. Reg. §§ 1.1361-5(c)(2) and 1.1361-5(c)(3), Example 1. Any momentary ownership by Distributing of the stock of Controlled on the day of termination of the QSub election, in connection with a corporate separation to which section 368(a)(1)(D) applies, will not require Distributing to consent to Controlled's S election, terminate Controlled's S election under section 1362(d)(2)(A), or prohibit Controlled from being eligible under section 1361(b) to make an S election under section 1362(a), provided Controlled satisfies the other requirements for making an election.

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. Specifically, we express or imply no opinion concerning whether Distributing is a valid S corporation or whether Controlled is otherwise eligible to be an S corporation. We express no opinion concerning the tax treatment of non-tax indemnification payments made under the Indemnification Agreement.

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

A copy of this letter must be attached to any income tax return to which it is relevant. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely yours,  
Mark S. Jennings  
Chief, Branch 1  
Office of Associate Chief Counsel (Corporate)

CC: