

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Distributing =

Controlled 1 =

Controlled 2 =

Sub 3 =

Sub 4 =

Foreign Sub 5 =

Partnership =

Business A =

B =

C =

D =

E =

F =

G =

H =

I =

Buyer =

a =

b =

c =

d =

e =

Dear

We respond to your September 3, 1998 request for rulings on certain federal

income tax consequences of a proposed transaction.

Summary of Facts

Distributing and wholly owned subsidiaries Controlled 1, Controlled 2, Sub 3, and Sub 4 join in filing a consolidated federal income tax return (the "Distributing Group"). Distributing also owns the stock of Foreign Sub 5 and an a percent interest in Partnership. Each of the entities mentioned in this paragraph directly conducts Business A.

Distributing is owned b percent each by B and D, c percent each by G and I, and d percent each by C, E, F, and H (collectively, the "Shareholders"). B and C are husband and wife ("Couple 1"), as are D and E ("Couple 2"), F and G ("Couple 3"), and H and I ("Couple 4"). B, D, F, and I are siblings.

Financial information has been submitted indicating that Distributing, Controlled 2, Sub 3, and Sub 4 each has had gross income and operating expenses representing the conduct of an active business during each of the past five years.

Serious disputes have arisen between and among Couple 1, Couple 2, Couple 3, and Couple 4 that are having an adverse effect on the day-to-day operations of Distributing.

Proposed Transaction

To eliminate the shareholder disputes, the following transaction has been proposed:

(i) Distributing will transfer the stock of Sub 3, Sub 4, and Foreign Sub 5 to Controlled 1 (the "Contribution").

(ii) Controlled 1 will transfer Business A assets, including the Foreign Sub 5 stock, to Sub 3 in exchange for Sub 3 stock and the assumption by Sub 3 of related liabilities. Controlled 1 also will transfer Business A assets to a newly formed corporation ("Newco") in exchange for Newco stock and the assumption by Newco of related liabilities.

(iii) Distributing will distribute the Controlled 1 stock to B and C in exchange for their Distributing stock ("Distribution 1").

(iv) Distributing will distribute the Controlled 2 stock to D and E in exchange for their Distributing stock ("Distribution 2").

(v) F and G will sell e percent of their Distributing stock to Buyer and the rest of their Distributing stock to H and I (the "Sale").

(vi) Distributing will make an S corporation election under § 1362(a) of the Internal Revenue Code.

In addition, Distributing and the Shareholders have entered into an agreement providing for indemnification of contractual claims, corporate governance claims, and unanticipated liabilities against any Shareholder or member of the Distributing Group (the "Indemnity Obligations").

Contribution and Distribution 1 Representations

The taxpayer has made the following representations concerning the Contribution and Distribution 1:

(a) The fair market value of Controlled 1 stock received by each of B and C will approximately equal the fair market value of the Distributing stock surrendered in the exchange.

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

(c) The 5 years of financial information submitted on behalf of Distributing, Sub 3, and Sub 4 represents each corporation's present operations, and regarding each corporation, there have been no substantial operational changes since the date of the last financial statements submitted.

(d) Immediately after Distribution 1, at least 90 percent of the fair market value of the gross assets of Controlled 1 will consist of the stock and securities of controlled corporations that are engaged in the active conduct of a trade or business as defined in § 355(b)(2).

(e) Following Distribution 1, Distributing, Sub 3, and Sub 4 each will continue the active conduct of its business, independently and with its separate employees.

(f) Distribution 1 is carried out to resolve shareholder disputes over the operation of Business A. Distribution 1 is motivated, in whole or substantial part, by this corporate business purpose.

(g) Except for the Sale, there is no plan or intention by any shareholder or security holder of Distributing to sell, exchange, transfer by gift, or otherwise dispose of

any stock in, or securities of, either Distributing or Controlled 1 after Distribution 1.

(h) There is no plan or intention by Distributing or Controlled 1, directly or through any subsidiary corporation, to purchase any of its outstanding stock after Distribution 1.

(i) There is no plan or intention to liquidate either Distributing or Controlled 1, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation after Distribution 1, except in the ordinary course of business.

(j) The total adjusted basis and the fair market value of the assets transferred to Controlled 1 by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled 1, plus any liabilities to which the transferred assets are subject.

(k) 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.

(l) Except for the Indemnity Obligations, no intercorporate debt will exist between Distributing, on one hand, and any of Controlled 1, Sub 3, Sub 4, or Foreign Sub 5, on the other, at the time of, or after, Distribution 1.

(m) Immediately before Distribution 1, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable intercompany transaction regulations (see §§1.1502-13 and 1.1502-14 of the Income Tax Regulations as in effect before the publication of T.D. 8597, 1995-2 C.B. 147, and as currently in effect; § 1.1502-13 as published by T.D. 8597). Further, any excess loss account Distributing may have in the stock of Controlled 1, Sub 3, Sub 4, or Foreign Sub 5 will be included in income immediately before Distribution 1 (see § 1.1502-19).

(n) Payments made in all continuing transactions between Distributing, on one hand, and Controlled 1, Sub 3, Sub 4, or Foreign Sub 5, on the other, will in the aggregate be for fair market value based on terms and conditions arrived at the parties bargaining at arm's-length.

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

(p) The 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 of Distributing or Controlled 1, or stock possessing 50 percent or more of the total value of all classes of stock of Distributing or Controlled 1.

Distribution 2 Representations

The taxpayer has made the following representations concerning Distribution 2:

(q) The fair market value of Controlled 2 stock received by each of D and E will approximately equal the fair market value of the Distributing stock surrendered in the exchange.

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

(s) The 5 years of financial information submitted on behalf of Distributing and Controlled 2 represents each corporation's present operations, and regarding each corporation, there have been no substantial operational changes since the date of the last financial statements submitted.

(t) Following Distribution 2, Distributing and Controlled 2 each will continue the active conduct of its business, independently and with its separate employees.

(u) Distribution 2 is carried out to resolve shareholder disputes over the operation of Business A. Distribution 2 is motivated, in whole or substantial part, by this corporate business purpose.

(v) Except for the Sale, there is no plan or intention by any shareholder or security holder of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any stock in, or securities of, either Distributing or Controlled 2 after Distribution 2.

(w) There is no plan or intention by Distributing or Controlled 2, directly or through any subsidiary corporation, to purchase any of its outstanding stock after Distribution 2.

(x) There is no plan or intention to liquidate either Distributing or Controlled 2, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation after Distribution 2, except in the ordinary course of business.

(y) Except for the Indemnity Obligations, no intercorporate debt will exist between Distributing and Controlled 2 at the time of, or after, Distribution 2.

(z) Immediately before Distribution 2, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable intercompany transaction regulations (see §§1.1502-13 and 1.1502-14 as in effect before the

publication of T.D. 8597, 1995-2 C.B. 147, and as currently in effect; § 1.1502-13 as published by T.D. 8597). Further, any excess loss account Distributing may have in the stock of Controlled 2 will be included in income immediately before Distribution 2 (see § 1.1502-19).

(aa) Payments made in all continuing transactions between Distributing and Controlled 2 will in the aggregate be for fair market value based on terms and conditions arrived at the parties bargaining at arm's-length.

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

(cc) The 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 of Distributing or Controlled 2, or stock possessing 50 percent or more of the total value of all classes of stock of Distributing or Controlled 2.

Contribution and Distribution 1 Rulings

Based solely on the information submitted and the representations set forth above, we rule as follows on the Contribution and Distribution 1:

(1) The Contribution, followed by Distribution 1, will be a reorganization under § 368(a)(1)(D). Distributing and Controlled 1 each will be "a party to a reorganization" under § 368(b).

(2) No gain or loss will be recognized by Distributing on the Contribution (§§ 357(a) and 361(a)).

(3) No gain or loss will be recognized by Controlled 1 on the Contribution (§ 1032(a)).

(4) The basis of each asset received by Controlled 1 will equal the basis of that asset in the hands of Distributing immediately before the transfer (§ 362(b)).

(5) The holding period of each asset received by Controlled 1 in the Contribution will include the period during which Distributing held the asset (§ 1223(2)).

(6) No gain or loss will be recognized by Distributing on Distribution 1 (§§ 361(c) and 355(e)).

(7) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) B and C on their receipt of Controlled 1 stock in Distribution 1

(§ 355(a)(1)).

(8) The basis of the Controlled 1 stock in the hands of B and C will in each case equal the basis of the Distributing stock surrendered in exchange therefor (§ 358(a)(1)).

(9) The holding period of the Controlled 1 stock received by B and C will in each case include the holding period of the Distributing stock exchanged therefor, provided the Distributing stock is held as a capital asset on the date of Distribution 1 (§ 1223(1)).

(10) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled 1 will be made under § 1.312-10(a).

Distribution 2 Rulings

Based solely on the information submitted and the representations set forth above, we rule as follows on Distribution 2:

(11) No gain or loss will be recognized by Distributing on Distribution 2 (§§ 355(c) and 355(e)).

(12) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) D and E on their receipt of Controlled 2 stock in Distribution 2 (§ 355(a)(1)).

(13) The basis of the Controlled 2 stock in the hands of D and E will in each case equal the basis of the Distributing stock surrendered in exchange therefor (§ 358(a)(1)).

(14) The holding period of the Controlled 2 stock received by D and E will in each case include the holding period of the Distributing stock exchanged therefor, provided the Distributing stock is held as a capital asset on the date of Distribution 2 (§ 1223(1)).

(15) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled 2 will be made under § 1.312-10(b).

International Rulings

(16) The earnings and profits of Foreign Sub 5, to the extent attributable to such stock under § 1.1248-2 or § 1.1248-3 (whichever is applicable), which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, during the period Distributing held Foreign Sub 5 stock (or was considered as

holding it by reason of the application of § 1223) while Foreign Sub 5 was a controlled foreign corporation shall be attributable to the Foreign Sub 5 stock in the hands of Controlled 1 (§ 1.1248-1(a)(1)).

(17) Provided the transfer of Foreign Sub 5 stock from Controlled 1 to Sub 3 qualifies for nonrecognition treatment under § 351, then the earnings and profits of Foreign Sub 5, to the extent attributable to such stock under § 1.1248-2 or § 1.1248-3 (whichever is applicable), which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, during the period Controlled 1 held Foreign Sub 5 stock (or was considered as holding it by reason of the application of § 1223) while Foreign Sub 5 was a controlled foreign corporation shall be attributable to the Foreign Sub 5 stock in the hands of Sub 3 (§ 1.1248-1(a)(1)).

Caveats

We express no opinion about the tax treatment of the proposed transaction under any other section of the Code or regulations or the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered in the above rulings. In particular, no opinion is expressed on (a) whether the transfers described above in step (ii) will qualify under § 351 or (b) whether the election referred to above in step (vi) will qualify under § 1362(a).

Procedural Statements

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

A copy of this ruling letter should be attached to the federal income tax return of each taxpayer involved for the taxable year in which the transaction is completed.

In accordance with the power of attorney on file in this office, the taxpayer and a second authorized representative each will receive a copy of this letter.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By: _____
Wayne T. Murray
Senior Technician/Reviewer
Branch 4