

Internal Revenue Service

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Date:

May 16, 2001

Distributing =

Controlled =

A =

B =

State X =

Business Y =

Date 1 =

Date 2 =

Store 1 =

Store 2 =

Store 3 =

This letter responds to your November 29, 2000 request for rulings on certain federal income tax consequences of a proposed transaction. Additional information was requested and submitted in letters dated January 24, February 27, and May 9, 2001. The information submitted for consideration is summarized below.

Summary of Facts

Distributing, a State X Subchapter S corporation, files its federal income tax return on a calendar year basis and uses the accrual method of accounting. Distributing has outstanding voting common stock and non-voting common stock. Two brothers, A and B, own an equal number of voting shares and an equal number of non-voting shares.

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Distributing has engaged directly in Business Y through three stores located in State X: Store 1, Store 2 and Store 3. Generally, A has operated and managed Store 1 while B has operated and managed Store 2. A and B have shared operational and management responsibilities over Store 3. Distributing sold nearly all of the assets of Store 3 on Date 1. Distributing used the proceeds from such sale to pay off liabilities.

Distributing has submitted financial information indicating that Business Y, 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.

Controlled is a State X qualified subchapter S subsidiary ("Qsub") and was formed on Date 2 for the purpose of consummating the proposed transaction described below. Controlled has one class of outstanding common stock, 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.

A and B have disagreed on a number of fundamental business matters. The conflicts between A and B are having an adverse effect on the day-to-day operations of Distributing. Distributing has proposed the transaction described below, which will allow A and B to each engage in Business Y independently, thus eliminating the shareholder disputes. Under the proposal, A will continue to operate Store 1 while B will continue to operate Store 2.

Proposed Transaction

To effect the separation of Store 1, Distributing has proposed the following series of steps (collectively, the "Proposed Transaction"):

(i) Distributing will transfer its Store 1 assets to Controlled in exchange for all of Controlled's issued and outstanding stock and the assumption by Controlled of the liabilities associated with the Store 1 assets (the "Transfer"); and

(ii) Distributing will distribute all of the stock of Controlled to A in exchange for all of his Distributing stock (the "Distribution").

Representations

The taxpayer has made the following representations regarding the Transfer and Distribution:

(a) The fair market value of Controlled stock and other consideration to be received by A in the Distribution will be approximately equal to the fair market value of Distributing stock surrendered by A in the exchange.

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(b) No part of the consideration to be distributed by Distributing will be received by A 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 operations 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 the business 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 purposes: (i) resolution of shareholder disputes, and (ii) allowing the individual shareholders to separately manage their respective businesses. The distribution of the stock of Controlled is motivated, in whole or substantial part, by one or more of these corporate business purposes.

(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.

(g) There is no plan or intention by the shareholders 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) (i) 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.

(ii) 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

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associated with the assets being transferred.

(k) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.

(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.

Rulings

Based solely on the facts submitted and representations made, we rule as follows on the Proposed Transaction:

(1) The Distribution will cause the termination of the Qsub election of Controlled because Controlled will cease to be a 100 percent subsidiary of Distributing. As a result, Controlled will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the Distribution from Distributing in exchange for stock of Controlled (the "Transfer") (Treas. Reg. § 1.1361-5(b)(1)(i)).

(2) The Transfer and the Distribution will constitute a reorganization within the meaning of section 368(a)(1)(D). Distributing and Controlled will each be a party to a reorganization within the meaning of section 368(b).

(3) No gain or loss will be recognized by Distributing on the Transfer (sections 361(a) and 357(a)).

(4) No gain or loss will be recognized by Controlled on the Transfer (section 1032(a)).

(5) Controlled's basis in each of the Store 1 assets received from Distributing will equal the basis of such asset in the hands of Distributing immediately prior to the

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Transfer (section 362(b)).

(6) The holding period for each asset received by Controlled from Distributing will include the period during which Distributing held such asset (section 1223(2)).

(7) No gain or loss will be recognized by Distributing upon the Distribution (section 361(c)(1)).

(8) No gain or loss will be recognized by A upon his receipt of Controlled stock in the Distribution (section 355(a)(1)).

(9) The basis of the stock of Controlled in the hands of A will be the same as the basis of the Distributing stock surrendered by A in exchange therefor (section 358(a)(1)).

(10) The holding period of the Controlled stock received by A will include the period during which A held the Distributing stock with respect to which the Distribution is made, provided that such Distributing stock is held as a capital asset on the date of the Distribution (section 1223(1)).

(11) Proper allocation of Distributing's earnings and profits will be made under Treas. Reg. § 1.312-10(a).

Caveats

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

No opinion is expressed about the tax treatment of the Proposed Transaction under other provisions of the Code or regulations, or 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.

Procedural Statements

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.

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

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A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,
Associate Chief Counsel (Corporate)
By: Stephen P. Fattman
Assistant to the Chief
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