

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

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Date:

December 14, 2000

Distributing =

Controlled =

Sub 1 =

Sub 2 =

Sub 3 =

Sub 4 =

Sub 6 =

Sub 7 =

Sub 8 =

Business A =

Business B =

Business C =

D =

E =

Month M =

Month N =

Y Corp =

Shared Services =

Z =

This letter replies to your June 28, 2000 request for rulings on certain federal income tax consequences of a proposed transaction.

The rulings contained in this letter are based on facts and representations submitted by the taxpayer accompanied by a penalty of perjury statement executed by an appropriate party. Verification of these facts and representations may be required as part of the audit process.

Summary of Facts

Distributing is a holding company that conducts Business A, Business B, and Business C through subsidiaries. Sub 1 conducts Business A; Sub 2 performs administrative services for Distributing subsidiaries, and Sub 3 and Sub 4 hold intangible property used in Business A. Controlled conducts Business B, and Sub 6 holds intangible property used by Controlled. Business C is conducted by Sub 7 and Sub 8 and produces only a *de minimis* proportion of Distributing's net income. Effective Month M, Distributing elected to be an S corporation under § 1362 of the Internal Revenue Code and also elected to treat Controlled and Sub 1, Sub 2, Sub 3, Sub 4, and Sub 6, all of which are wholly owned by Distributing, as qualified subchapter S subsidiaries ("QSubs") under § 1361(b)(3)(B). As a result of the QSub elections, the QSubs are not treated as corporations separate from Distributing for federal income tax purposes. Sub 7 and Sub 8, which are not wholly owned by Distributing, are C corporations. Distributing has Class A voting common stock and Class B nonvoting common stock outstanding. The two classes are identical except for voting rights.

We have received financial information indicating that Business A and Business B each has had gross income and operating expenses representing the conduct of an active business during each of the past five years.

Individuals D and E are the president and vice president, respectively, of Distributing and are planning to retire. D and E spend substantially all of their time coordinating the activities of Business A and Business B. This includes considering strategic options that exist only because Businesses A and B are in the same corporate group, allocating resources and resolving disputes between those businesses, and reporting to Distributing's board of directors and its shareholders regarding the interplay of the two businesses. Significant executive coordination of Business A and Business

C is not required because Business C is small. Each operating subsidiary of Distributing is managed separately by its own executives.

The taxpayer and an independent management consulting firm (in a detailed opinion) state that, by separating Controlled from Distributing, the services performed by D and E would become unnecessary and therefore could be eliminated at significant cost saving. They further state that positioning the two businesses beneath a holding company would not solve the problem because the same level of business coordination would still be required.

Proposed Transaction

To accomplish this separation, the taxpayer proposes the following transaction:

- (i) Distributing will transfer the stock of Sub 6 to Controlled.
- (ii) Controlled will recapitalize by issuing Class A voting stock and Class B nonvoting common stock in exchange for its present single class of voting common stock (the "Recapitalization").
- (iii) Distributing will distribute the stock of Controlled to its shareholders pro rata, with the Distributing shareholders receiving one Class A share of Controlled on each Class A share of Distributing and one Class B share of Controlled on each Class B share of Distributing (the "Distribution").

Distributing also intends to cause Sub 4 to merge into Sub 3 for non-federal income tax purposes.

Representations

The taxpayer has made the following representations based on the characterization of steps (i) through (iii) above by ruling (1) below:

- (a) Distributing, Controlled, and their respective shareholders will each pay their own expenses, if any, incurred in connection with the transaction.
- (b) Any indebtedness owed by Controlled to Distributing after the Distribution will not constitute stock or securities.
- (c) No part of the consideration distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.
- (d) The five years of financial information submitted on behalf of Business A and

Business B represents each business's present operations, and with regard to each business, there have been no substantial operational changes since the date of the last financial statement submitted. During Month N, a member of Distributing's former consolidated group sold to an unrelated buyer a majority of its stock in Y Corp, which was not engaged in Business A, Business B, or Business C.

(e) Following the transaction, Distributing and Controlled each will continue the active conduct of its business, independently and with its separate employees, except that Controlled will lease office space at fair rental value in a building owned by Distributing, and Distributing employees will provide the Shared Services to Controlled.

(f) The Distribution will be carried out to achieve cost savings by eliminating the need for executives to coordinate Business A and Business B. The Distribution is motivated, in whole or substantial part, by this corporate business purpose. In this regard, the taxpayer represents that the eliminated coordination activity will not be reinstituted or duplicated elsewhere in Distributing, Controlled, or any of their affiliates.

(g) Some Distributing shareholders have made, and will continue making, inter vivos gifts of Distributing stock (and, after the Distribution, of Controlled stock). Also, minority shareholders holding less than five percent of Distributing and Controlled stock will possess put rights to sell their stock to Distributing or Controlled, subject to a right of first refusal by other shareholders. To the extent that any Distributing shareholder sells any Distributing stock to Distributing, the shareholder will sell an equal proportion of its, his, or her Controlled stock to Controlled within Z months of the stock sale to Distributing, and vice versa. Other than these items, 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 the stock of either Distributing or Controlled after the transaction.

(h) Apart from repurchases required to be made under the shareholder put rights described in the preceding representation, 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 § 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 basis and the fair market value of the assets transferred to Controlled by Distributing will equal or exceed the amount of the liabilities assumed (as determined under § 357(d)) by Controlled.

(k) The liabilities assumed (as determined under § 357(d)) in the transaction were incurred in the ordinary course of business and are associated with the assets being transferred.

(l) No property is being transferred between Distributing and Controlled to which an investment tax credit has been or will be claimed.

(m) After the Distribution, Controlled will purchase products for its business from Distributing. Also, Controlled will rent office space in a building owned by Distributing and use the Shared Services furnished by employees of Distributing. Payments made in any transactions 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.

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

(o) 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 combined voting power of all classes of stock of Distributing or Controlled eligible to vote, or 50 percent or more of the total value of shares of all classes of Distributing or Controlled stock.

(p) Distributing is an S corporation within the meaning of § 1361(a). Controlled will elect to be an S corporation pursuant to § 1362(a) on the date of the Distribution and will elect to treat Sub 6 as a QSub as of that date. There is no plan or intention to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

Rulings

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

(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 "Contribution") (§ 1.1361-5(b)(1)(i)). Because Sub 6 is a QSub of Distributing before the Distribution, and Controlled will elect to treat Sub 6 as a QSub of Controlled on the date of the Distribution, Sub 6 will not be treated as a separate corporation before or after the Distribution (see § 1.1361-5(b)(3), Example (9)).

(2) The Contribution, followed by the Distribution, will be a reorganization under

§ 368(a)(1)(D). Distributing and Controlled each will be a “party to a reorganization” under § 368(b).

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

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

(5) The basis of each asset deemed received by Controlled in the Contribution will equal the basis of that asset in the hands of Distributing (§ 362(b)).

(6) The holding period of each asset deemed received by Controlled will include the holding period of that asset in the hands of Distributing (§ 1223(2)).

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

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

(9) The aggregate basis of the Controlled stock and Distributing stock in the hands of each shareholder after the Distribution will equal the shareholder’s basis in the Distributing stock held immediately before the Distribution (§ 358(a)(1)). The basis will be allocated between the Controlled stock and Distributing stock in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) of the Income Tax Regulations (§ 358(b)(2) and (c)).

(10) The holding period of the Controlled stock received by Parent will include the holding period of the Distributing stock on which the Distribution is made, provided the stock is held as a capital asset on the date of the Distribution (§ 1223(1)).

(11) Earnings and profits will be allocated between Distributing and Controlled in accordance with §§ 312(h) and 1.312-10(a).

Caveats

We express no opinion on the federal income 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. In particular, no opinion is given regarding the Recapitalization or the merger of Sub 4 into Sub 3.

Procedural Statements

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

Each taxpayer involved in the transaction should attach a copy of this letter to the taxpayer's federal income tax return for the taxable year in which the transaction is completed.

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

Sincerely,
Associate Chief Counsel (Corporate)
By: Wayne T. Murray
Senior Technician Reviewer
Branch 4