

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:

, ID No.

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Refer Reply To:

CC:CORP:2 – PLR-147307-03

Date:

December 10, 2003

Legend

Distributing =

State X =

Date 1 =

Business A =

Business B =

Business C =

Z =

Shareholder 1 =

Shareholder 2 =

Dear Mr

This letter responds to your August 7, 2003 letter requesting rulings on certain federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated October 3, 2003, December 6, 2003 and December 10, 2003. The information submitted in such request and subsequent correspondence is summarized below.

Summary of Facts

Distributing, an "S" corporation, was incorporated in State X on Date 1. Distributing is a calendar year taxpayer using the cash method of accounting. Distributing is engaged in Business A, Business B, and Business C (collectively, the "Businesses").

Distributing has Z shares outstanding of common voting stock, which are owned equally by Shareholder 1 and Shareholder 2.

Financial information has been submitted which indicates that Distributing has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

The Proposed Transaction

A series of disputes have arisen between Shareholder 1 and Shareholder 2 regarding fundamental business matters affecting the operations of the Businesses. The conflicts between the shareholders are impeding the development and expansion of the Businesses. To eliminate these disputes, the following transaction is proposed (the "Transaction"):

(i) Distributing will form a wholly-owned subsidiary ("Controlled"), which will elect "S" corporation status under § 1361(a). Distributing will contribute the assets and liabilities of Business A to Controlled in exchange for 100 percent of the stock of Controlled (the "Contribution").

(ii) Distributing will distribute all of the Controlled shares of stock to Shareholder 1. Shareholder 1 will surrender all of his shares of Distributing stock in exchange for the Controlled shares ("the Distribution").

Representations

The taxpayer has made the following representations concerning Distributing and the Transaction:

- (a) The indebtedness owed by Controlled to Distributing after the distribution of Controlled stock will not constitute stock or securities.
- (b) The fair market value of the stock of Controlled received by Shareholder 1 will be approximately equal to the fair market value of the Distributing stock surrendered by Shareholder 1 in the exchange.
- (c) No part of the consideration to be distributed by Distributing will be received by a Distributing 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 the Businesses of Distributing represents their present operations, and with regard to Distributing, there have been no substantial operational changes since the date of the last financial statement submitted.
- (e) Following the Transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees.
- (f) The Transaction will be carried out to eliminate shareholder disputes that, if permitted to continue, would impede the development and expansion of the Businesses. The Transaction is motivated, in whole or substantial part, by this corporate business purpose.
- (g) There is no plan or intention by the shareholders of either Distributing or Controlled to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in either Distributing or Controlled after the Distribution.
- (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 § 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696, 705.
- (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 sum of the liabilities assumed by Controlled 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) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the Transaction.

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

(m) 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.

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

(o) Shareholder 1 will not acquire any Distributing stock after the Transaction. Shareholder 1 will not be shareholders, employees, officers, or directors of Distributing after the Transaction. Shareholder 2 will not acquire any Controlled stock after the Transaction. Shareholder 2 will not be shareholders, employees, officers, or directors of Controlled after the Transaction.

(p) Following the Transaction, the gross assets of Business B and Business C that Distributing relies on to satisfy the active trade or business requirement of § 355(b) will have a fair market value that is equal to at least 5 percent of the total fair market value of the gross assets of Distributing.

(q) Following the Transaction, the gross assets of Business A that Controlled relies on to satisfy the active trade or business requirement of § 355(b) will have a fair market value that is equal to at least 5 percent of the total fair market value of the gross assets of Controlled.

(r) 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 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.

(s) For purposes of § 355(d), immediately after the Transaction, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in §§ 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

(t) For purposes of § 355(d), immediately after the Transaction, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote, or 50 percent or more of the total value of shares of all classes of

Controlled stock, that was either (i) acquired by purchase (as defined in §§ 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in §§ 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

(u) The Transaction 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 either Distributing or Controlled entitled to vote, 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 information submitted and representations made, we rule as follows:

- (1) The Contribution and Distribution will be a reorganization under § 368(a)(1)(D). Distributing and Controlled each will be "a party to a reorganization" under § 368(b).
- (2) No gain or loss will be recognized by Distributing on the Contribution (§§ 361(a) and 357(a)).
- (3) No gain or loss will be recognized by Controlled on the Contribution. (§ 1032(a)).
- (4) No gain or loss will be recognized by Distributing on the Distribution (§ 361(c)).
- (5) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) Shareholder 1 on the receipt of Controlled stock in exchange for his Distributing stock (§ 355(a)(1)).
- (6) The aggregate basis of the Controlled stock in the hands of Shareholder 1 will equal the aggregate basis of the respective Distributing stock surrendered by Shareholder 1 in the exchange (§ 358(a)(1)).

(7) The basis that Controlled has in each asset received from Distributing will equal the basis of that asset in the hands of Distributing immediately before the Contribution (§ 362(b)).

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

(9) The holding period of the Controlled stock received by Shareholder 1 will include the holding period of the respective Distributing stock surrendered by Shareholder 1, provided such stock is held as a capital asset on the date of the exchange (§ 1223(1)).

(10) Distributing's momentary ownership of stock of Controlled as part of the reorganization will not cause Controlled to be an ineligible corporation under § 1361(b)(2)(A).

(11) Assuming that Controlled will otherwise meet the requirements of a small business corporation under § 1361, Controlled will be eligible to make an S corporation election under § 1362(a) for its first taxable year.

(12) Distributing's accumulated adjustment account immediately before the transaction will be allocated between Distributing and Controlled in a manner similar to the manner in which Distributing's earnings and profits will be allocated under § 312(h).

Caveats and Procedural Statements

No opinion is expressed about the tax treatment of the 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 Transaction that are not specifically covered by the above rulings.

Specifically, no opinion is expressed regarding transactions involving any related corporations of Distributing.

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.

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

The rulings contained in this letter are based upon facts and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of this ruling request. Verification of the information, representations, and other data may be required as part of the audit process.

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,

Alison Burns
Senior Technician Reviewer, Branch 2
Office of Associate Chief Counsel
(Corporate)

cc: