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Department of the Treasury

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Person to Contact:

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Refer Reply To:

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Date:

May 16, 2001

Re:

Distributing =

Controlled =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Business A =

Date A =

a =

b =

c =

d =

Distributing Note =

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This is in response to a letter dated October 31, 2000, in which rulings are requested regarding the federal income tax consequences of a proposed transaction. The information submitted in the request and in subsequent correspondence is summarized below.

Distributing is a domestic corporation that made a subchapter S election on Date A. Distributing is engaged in Business A and has a single class of voting common stock outstanding. The Distributing shares are presently held in the following proportions: Shareholder A owns a percent, Shareholder B owns b percent, Shareholder C owns c percent and Shareholder D owns d percent.

To resolve irreconcilable shareholder disagreements over the management of Business A, a separation of Distributing is proposed. It is intended that, after the distribution, Shareholder A and Shareholder B will own collectively 100 percent of the outstanding stock of Controlled and Shareholder C and Shareholder D will own collectively 100 percent of the outstanding stock of Distributing. Accordingly, Distributing proposes the following transaction:

- (i) Distributing will form Controlled as a wholly owned subsidiary. Distributing will transfer a portion of the assets of Business A to Controlled solely in exchange for shares of Controlled voting common stock and the assumption of Controlled liabilities.
- (ii) Distributing will distribute all of its Controlled stock to Shareholder A and Shareholder B in exchange for all of their Distributing stock.

The taxpayer has made the following representations with respect to the proposed transaction:

- (a) The fair market value of the Controlled stock and other consideration to be received by Shareholder A and Shareholder B will be approximately equal to the fair market value of the Distributing stock surrendered by each shareholder in the exchange.
- (b) No part of the consideration to be 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.
- (c) The 5 years of financial information submitted on behalf of Distributing is representative of Distributing's present operations, and with regard to Distributing, 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,

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independently and with separate employees, the active conduct of its share of all of the integrated activities of the business conducted by Distributing prior to the consummation of the transaction.

- (e) The distribution of the stock of Controlled is carried out for the following corporate business purpose: to allow the separation of the business conducted by Distributing in a manner consistent with the business objectives of each shareholder. The distribution of stock of Controlled is motivated, in whole or substantial part, by this business purpose.
- (f) 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, except for small gifts of shares within the family.
- (g) 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.
- (h) There is no plan or intention to liquidate Distributing or Controlled, to merge either corporation with any other corporation after the transaction, or to sell or otherwise dispose of the assets of either corporation after the transaction, except in the ordinary course of business.
- (i) The total adjusted tax bases and fair market values of the assets transferred to Controlled by Distributing equals or exceeds the sum of the liabilities assumed (as determined under § 357(d) of the Internal Revenue Code) by Controlled.
- (j) 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.
- (k) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the stock of Controlled, except that Distributing will contribute to Controlled the Distributing Note to equalize the value of the stock of 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 the 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 § 368(a)(2)(F)(iii) and (iv).

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- (n) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (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 total combined voting power of all classes of stock of Distributing or Controlled or stock possessing 50 percent or more of the total value of all classes of stock of Distributing or Controlled.
- (p) Distributing, Controlled and their respective shareholders will each pay their own expenses, if any, incurred in connection with the proposed transaction.
- (q) 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.

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

- (1) The transfer by Distributing to Controlled of a portion of the assets associated with Business A solely in exchange for all of the outstanding Controlled stock, and the assumption of liabilities, followed by the distribution of all of the Controlled stock to Shareholder A and Shareholder B in exchange for their stock in Distributing will be a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each be “a party to a reorganization” within the meaning of § 368(b).
- (2) No gain or loss will be recognized by Distributing upon its transfer of the assets to Controlled in exchange for stock and Controlled’s assumption of liabilities ((§§ 361(a) and 357(a)).
- (3) No gain or loss will be recognized by Controlled upon the receipt of the assets of Distributing in exchange for the stock of Controlled and the assumption of liabilities (§ 1032(a)).
- (4) The basis in the assets to be received by Controlled will be the same as the basis of such assets in the hands of Distributing immediately prior to the transaction (362(b)).
- (5) The holding period of the Distributing assets to be received by Controlled

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will include the period during which such assets were held by Distributing (§ 1223(2)).

- (6) No gain or loss will be recognized to (and no amount will be included in the income of) Shareholder A or Shareholder B upon their receipt of the stock of Controlled in exchange for their Distributing stock (§ 355(a)(1)).
- (7) The holding period of the Controlled stock received by Shareholder A and Shareholder B will include the holding period of their Distributing stock surrendered in the exchange, provided that such Distributing stock is held as a capital asset on the date of the distribution (§ 1223(1)).
- (8) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a) of the Income Tax Regulations.
- (9) No gain or loss will be recognized to Distributing upon the distribution of its stock in Controlled to Shareholder A and Shareholder B (§ 361(c)(1)).
- (10) The basis of the Controlled stock in the hands of each member of Shareholder A and Shareholder B will be the same as the basis of the Distributing stock surrendered by each such member in exchange therefor (§ 358(a)(1)).
- (11) Distributing's momentary ownership of stock of Controlled as part of a reorganization under § 368(a)(1)(D) will not cause Controlled to have an ineligible shareholder for any portion of its taxable year under § 1361(b)(1)(B). Therefore, assuming 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 taxable year.

No opinion is expressed about the tax treatment of the transaction under other provisions of the Code and the regulations or about 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 concerning whether Distributing or Controlled is otherwise eligible to be an S corporation.

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 letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

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

Sincerely yours,
Associate Chief Counsel (Corporate)

By Debra Carlisle

Chief, Branch 5