

Internal Revenue Service

Number: 200419020

Release Date: 5/7/04

Index Number: 355.00-00;368.04-00

Department of the Treasury
Washington, DC 20224

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Refer Reply To:

CC:CORP:B02 – PLR-146039-03

Date:

January 23, 2004

Legend:

Distributing =

Controlled =

Business X =

Family A =

Family B =

Family C =

Individual D =

PLR-146039-03

Asset A =

Asset B =

Asset C =

Asset D =

Activity A =

Activity B =

a =

Dear

This is in response to a letter dated August 5, 2003, submitted on behalf of Distributing, requesting rulings under §§ 355 and 368 of the Internal Revenue Code (the "Code") with respect to a proposed transaction. Additional information was received in letters dated September 24, 2003, November 13, 2003, November 20, 2003, and January 22, 2003.

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

PLR-146039-03

Distributing is an S corporation engaged in Business X. Distributing has supplied information indicating that Business X has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years. Distributing's stock is owned by members of Family A, Family B, and Family C, and by trusts for the benefit of members of Family A, Family B, and Family C.

Disputes have arisen between the members of Family B on the one hand and the members of Family A and of Family C on the other. The disputes have impaired the ability of Distributing to operate efficiently. The disputes do not involve the management and operation of Asset A. Furthermore, the members of Family B, who have not so far been actively involved in the day-to-day management and operation of the business, wish to be involved. The members of Family B intend to pursue growth more aggressively than have the members of Family A and of Family C. Specifically, Individual D, a member of Family B, intends to undertake Activity A with respect to Asset B, will be significantly involved in all planning and development aspects of such activity and will bear primary responsibility for the completion of such activity. In connection with that undertaking, Individual D will perform Activity B on behalf of Controlled. In order to resolve the disputes, the following series of transactions is proposed:

1. Distributing will form a new limited liability company ("LLC"). Distributing will contribute certain assets (including Asset A) in exchange for all of the membership interests in LLC and the assumption by LLC of certain liabilities.
2. Distributing will form a new corporation, Controlled, to which it will contribute Asset B, Asset C, Asset D, and an a% interest in LLC, as well as certain non-business assets, in exchange for all the Controlled stock and the assumption by Controlled of certain liabilities
3. Distributing will distribute all of the stock of Controlled to members of Family B and trusts for the benefit of members of Family B (the "Family B Shareholders") in exchange for all of their Distributing stock (the "Distribution").

Distributing has made the following representations with respect to the proposed transactions:

- (a) The fair market value of the stock of Controlled to be received by each of the Family B Shareholders will be approximately equal to the fair market value of the stock of Distributing surrendered by each such shareholder in the exchange.
- (b) No part of the consideration to be distributed by Distributing will be received by a shareholder of Distributing as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.

PLR-146039-03

- (c) The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operation and there have been no substantial operational changes since the date of the last financial statements submitted.
- (d) Following the Distribution, Distributing and Controlled each will continue, independently and with its separate employees, the active conduct of its share of all of the integrated activities of Business X conducted by Distributing prior to the consummation of the Distribution.
- (e) The Distribution is being carried out for the following corporate business purpose: to resolve disputes between the Family B Shareholders and the other shareholders of Distributing that have impaired Distributing's ability to operate efficiently.
- (f) 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.
- (g) 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 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 purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30.
- (i) Distributing and Controlled had no accumulated earnings and profits at the beginning of their respective tax years.
- (j) Distributing and Controlled will have no current earnings and profits as of the date of the Distribution.
- (k) No distribution of property by Distributing immediately before the Distribution would require recognition of gain resulting in current earnings and profits for the taxable year of the Distribution.

PLR-146039-03

- (l) Distributing is not aware of, nor is Distributing planning or intending, any event that will result in Distributing or Controlled having positive current or accumulated earnings and profits after the Distribution.
- (m) 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 Distribution, except in the ordinary course of business.
- (n) The Distribution is not part of a plan or series of related transactions (within the meaning of Code § 355(e)) pursuant to which one or more persons will acquire directly or indirectly stock possessing 50% 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% or more of the total value of all classes of stock of either Distributing or Controlled.
- (o) The total adjusted basis 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.
- (p) 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.
- (q) No intercorporate debt will exist between Distributing and Controlled at the time of or subsequent to the distribution of the Controlled stock.
- (r) 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. LLC will be governed by and operated pursuant to a limited liability company operating agreement negotiated at arm's length between Distributing and Controlled.
- (s) No two parties to the Distribution are investment companies as defined in Code § 368(a)(2)(F)(iii) and (iv).
- (t) LLC will not file an election to be treated as an association (and therefore a corporation).

PLR-146039-03

- (u) LLC is an eligible entity, as defined in Reg. § 301.7701-3(a), that will be treated as a partnership for federal tax purposes when Controlled becomes a member.
- (v) If incorporated, LLC would not be treated as an investment company for purposes of § 351(e) immediately after the transfer or after contribution of any assets pursuant to a plan in existence at the time of the contributions by Distributing and Controlled

Law and Analysis

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(b)(1) provides that, unless a domestic eligible entity elects otherwise, the entity is classified as a partnership if it has two or members and disregarded as an entity separate from its owner if it has a single owner.

Section 721(a) provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Based solely on the information submitted and the representations made, we have concluded that:

(1) The transfer by Distributing of part of its assets in exchange for all of the common stock of Controlled, followed by the distribution of all the Controlled stock to the Family B shareholders, will constitute a reorganization within the meaning of section 368(a)(1)(D) of the Code. Distributing and Controlled will each be "a party to a reorganization" within the meaning of section 368(b) of the Code.

(2) Distributing will recognize no gain or loss upon the transfer of assets to Controlled in exchange for Controlled stock and the assumption of liabilities, as described above (sections 361(a) and 357(a)).

(3) Controlled will recognize no gain or loss on the receipt of the assets in exchange for all the shares of Controlled (section 1032(a)).

PLR-146039-03

(4) Controlled's basis in the Distributing assets received by Controlled in the transaction will be the same as the basis of such assets in the hands of Distributing immediately prior to the transaction (section 362(b)).

(5) Controlled's holding period of the Distributing assets received by Controlled in the transaction will include the period during which such assets were held by Distributing (section 1223(2)).

(6) The Family B Shareholders will recognize no gain or loss (and no amount will be included in the income of the Family B Shareholders upon the receipt of Controlled stock in exchange for their Distributing stock, as described above (section 355(a)(1)).

(7) The basis of the Controlled stock in the hands of the Family B Shareholders will in each instance be the same as the basis of the Distributing stock held immediately before the exchange by each such shareholder (section 358(a)).

(8) The holding period of the Controlled stock to be received by the Family B Shareholders, as described above, will in each instance include the period of the Distributing stock surrendered in the exchange, provided that such stock is held as a capital asset by each such shareholder on the day of the exchange (section 1223(1)).

(9) No gain or loss will be recognized to Distributing upon the distribution of all its Controlled stock (section 361(c)).

(10) Except as provided in § 752, neither Controlled nor Distributing nor the partnership will recognize gain or loss upon the contribution of the assets of LLC to the partnership in exchange for interests in the partnership.

No opinion is expressed as to the tax treatment of the transactions under other provisions of the Code (including § 707) or regulations, or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions that are not specifically covered by the above ruling.

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.

Sincerely yours,

Marlene P. Oppenheim

Marlene P. Oppenheim

Senior Counsel, Branch 2

Office of Associate Chief Counsel (Corporate)

cc: