

Internal Revenue Service

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Person to Contact:

Telephone Number:

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Date:

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Legend:

Parent =

Subsidiary =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Shareholder E =

State X =

Business Y =

s =

t =

u =

Dear

This responds to your October 26, 1998 request for rulings as to the federal income tax consequences of a proposed transaction. The information submitted in that request and in subsequent correspondence is substantially as set forth below.

Parent, a C corporation incorporated in State X, assists Subsidiary in Subsidiary's business through the furnishing of consulting services exclusively to Subsidiary. Subsidiary, a C corporation incorporated in State X, is engaged in Business Y.

Parent has a single class of stock outstanding that is owned equally by two family trusts (the "Family Trusts"). Subsidiary has voting common stock, nonvoting common stock, and nonvoting preferred stock outstanding. Parent owns s percent of each of the classes of Subsidiary stock outstanding. Shareholder A and Shareholder B are two grantor trusts ("the Grantor Trusts") that each own t percent of Subsidiary's voting common stock, t percent of Subsidiary's nonvoting common stock, and u percent of Subsidiary's nonvoting preferred stock. Shareholder C owns less than 5 percent of each of the classes of Subsidiary stock outstanding. Shareholders D and Shareholder E own less than 5 percent of the nonvoting preferred stock of Subsidiary combined.

The grantors of the Grantors Trusts and the beneficiaries of the Family Trusts are "members of a family" within the meaning of § 318(a)(1) of the Internal Revenue Code.

For what the taxpayer represents are valid business reasons, the following transaction is proposed:

(i) Subsidiary will redeem all of the stock owned by Shareholder D and Shareholder E.

(ii) The Family Trusts will form Newco with a nominal amount of cash, and will elect to treat Newco as an S corporation commencing as of the first day of its first taxable year. The Family Trusts will transfer their Parent stock to Newco in exchange for Newco stock, and the Grantor Trusts will transfer their Subsidiary stock to Newco in exchange for Newco stock (collectively, the "Stock Transfers.")

(iii) Each of the Family Trusts holding stock of Newco will elect under § 1361(e)(1)(A)(iii) to be an "electing small business trust" within the meaning of § 1361(e)(1)(A).

(iv) The Family Trusts will transfer to Newco, in exchange for Newco stock, interests in a limited liability company (LLC) (the "LLC Interest Transfers").

(v) Newco will elect under § 1361(b)(3)(B) to treat each of Parent and Subsidiary as a qualified subchapter S subsidiary (a "QSub").

The following representations have been made with respect to the proposed transaction:

I. With respect to the Stock Transfers:

- (a) To the best of the taxpayers' knowledge and belief, the Stock Transfers qualify under § 351.

II. With respect to the LLC Interest Transfers:

- (b) No stock or securities will be issued for services rendered to or for the benefit of Newco in connection with the transactions; and no stock or securities will be issued for indebtedness of Newco that is not evidenced by a security or for interest on indebtedness of Newco accrued on or after the beginning of the holding period of the transferor of the debt.
- (c) The transactions will not be the result of a solicitation by a promoter, broker, or investment house.
- (d) The transferors will not retain any rights in the properties that are transferred to Newco.
- (e) The adjusted basis and the fair market value of the assets to be transferred to Newco will, in each instance, be equal to or will exceed the sum of the liabilities assumed by Newco plus any liabilities to which the transferred liabilities will be subject.
- (g) The liabilities assumed by Newco, if any, will have been incurred in the ordinary course of business and will be associated with the assets transferred.
- (h) There is no indebtedness between the transferors and Newco, and no indebtedness will be created in favor of the transferors as a result of the transfer.
- (i) All exchanges will occur on approximately the same date.
- (j) There is no plan or intention on the part of Newco to redeem or otherwise acquire any stock or indebtedness issued in the transaction.
- (k) Taking into account any issuance of additional shares of Newco stock; any issuance of stock for services; the exercise of any Newco stock rights, warrants, or subscriptions; and the sale, exchange, transfer by gift, or other disposition of any of the stock of Newco received in the exchange, the transferors will be in "control" of Newco within the meaning of §

368(c).

- (l) Each transferor will receive Newco stock approximately equal to the fair market value of the property transferred to Newco.
- (m) Newco will remain in existence and will use the property transferred to it in a trade or business.
- (n) There is no plan or intention by Newco to dispose of the transferred property other than in the normal course of business operations.
- (o) Each of the parties to the transaction will pay its own expenses, if any, incurred in connection with the proposed transaction.
- (p) Newco will not be an “investment company” within the meaning of § 351(e)(1) and § 1.351-1(c)(1)(ii) of the Income Tax Regulations.
- (q) The transferors are not under the jurisdiction of a court in a Title 11 or similar case (within the meaning of § 368(a)(3)(A)) and the stock or securities received in the exchange will not be used to satisfy the indebtedness of a debtor.
- (r) Newco will not be a “personal service corporation” within the meaning of § 269A.

III. With respect Newco’s QSub elections for Parent and Subsidiary:

- (s) On the date the QSub election is made with respect to Parent and Subsidiary, and at all times until the deemed liquidations of Parent and Subsidiary are completed, Newco will be the owner of at least 80 percent of the outstanding stock of Parent and Subsidiary, respectively.
- (t) Except with respect to the redemption of stock of Subsidiary held by Shareholder D and Shareholder E, no shares of Parent or Subsidiary will have been redeemed during the 3 years preceding the adoption of the respective plans of liquidation of Parent and Subsidiary.
- (u) Neither Parent nor Subsidiary will retain any assets following the deemed liquidations of Parent and Subsidiary.
- (v) Neither Parent nor Subsidiary will have acquired assets in any nontaxable transactions at any time after the date of its respective acquisition by Newco, and, to the best of the knowledge of Parent’s and Subsidiary’s management, neither Parent nor Subsidiary will have acquired assets in any nontaxable transactions except for acquisitions occurring more than

three years prior to the date that Newco makes the QSub elections for Parent and Subsidiary, respectively.

- (w) No assets of Parent or Subsidiary have been or will be disposed of by either Parent or Subsidiary except for dispositions in the ordinary course of business and dispositions occurring more than three years prior to Newco's QSub elections with respect to Parent and Subsidiary, respectively.
- (x) The deemed liquidations of Parent and Subsidiary will not be preceded by, nor will they be followed by, the reincorporation in, or transfer or sale to, a recipient corporation ("Recipient") of any of the businesses or assets of Parent or Subsidiary, if persons holding, directly or indirectly, more than 20 percent in value of the stock of Parent or Subsidiary also held, directly or indirectly, more than 20 percent in value of the stock in Recipient. For purposes of this representation, ownership is determined by application of the constructive ownership rules of § 318(a) as modified by § 304(c).
- (y) Prior to making the QSub elections with respect to Parent and Subsidiary, no assets of Parent or Subsidiary will be distributed in kind, transferred, or sold to Newco except for (i) transactions occurring in the normal course of business and (ii) transactions occurring more than three years prior to making the QSub elections with respect to Parent and Subsidiary.
- (z) Parent and Subsidiary will report all earned income represented by assets that were distributed to its shareholders, such as receivables being reported on a cash basis, unfinished construction contracts, commissions due, etc.
- (aa) The fair market value of the assets of Parent and Subsidiary will exceed their liabilities both on the date that the QSub elections are made and immediately prior to the time the deemed liquidations of Parent and Subsidiary, respectively, take place.
- (bb) There is no intercorporate debt existing between Newco and Parent or Newco and Subsidiary, and none has been canceled, forgiven, or discounted.
- (cc) Newco is not an organization that is exempt from federal income tax under § 501 or any other provision of the Code.
- (dd) The fair market value of the Newco stock received by the shareholders of Subsidiary will be approximately equal to the fair market value of the Subsidiary stock surrendered in the exchange.

- (ee) Newco will acquire at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by Subsidiary immediately prior to the transaction. For purposes of this representation, amounts used by Subsidiary to pay its reorganization expenses, and any redemptions and distributions (excluding regular, normal dividends) made by Subsidiary immediately preceding the transfer will be included as assets of Subsidiary held immediately before the transaction.
- (ff) After the transaction, the shareholders of Subsidiary will be in control of Newco within the meaning of § 368(a)(2)(H).
- (gg) Newco has no plan or intention to reacquire any of its stock issued in the proposed transactions.
- (hh) Newco has no plan or intention to sell or otherwise dispose of any of the assets of Subsidiary acquired in the proposed transactions, except for dispositions made in the ordinary course of business.
- (ii) The liabilities of Subsidiary assumed by Newco in the proposed transactions and the liabilities to which the transferred assets of Subsidiary are subject were incurred in the ordinary course of their businesses.
- (jj) Following the proposed transactions, Newco will continue the historic business of Subsidiary or use a significant portion of the Subsidiary's historic business assets in a business.
- (kk) At the time of the proposed transactions, Newco will not have outstanding any warrants, options, convertible securities, or any other type of right pursuant to which any person could acquire stock in Newco that, if exercised or converted, could affect the acquisition of "control" of Newco by the former shareholders of Subsidiary within the meaning of § 368(a)(2)(H).
- (ll) Newco, Parent and Subsidiary will pay their respective expenses, if any, incurred in connection with the transactions.
- (mm) No two parties to the transaction are investment companies within the meaning of § 368(a)(2)(F)(iii) and (iv).
- (nn) The fair market value of the assets of Subsidiary transferred to Newco will equal or exceed the sum of the liabilities assumed by Newco, plus the amount of liabilities, if any, to which the transferred assets are subject.

- (oo) The total adjusted basis of the assets of Subsidiary to be transferred to Newco will equal or exceed the sum of the liabilities, if any, to which the transferred assets are subject.
- (pp) The fair market value of the Newco stock received by the shareholders of Parent will be approximately equal to the fair market value of the Parent stock surrendered in the exchange.
- (qq) Newco will acquire at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by Parent immediately prior to the transaction. For purposes of this representation, amounts used by Parent to pay its reorganization expenses, and any redemptions and distributions (excluding regular, normal dividends) made by Parent immediately preceding the transfer will be included as assets of Parent held immediately before the transaction.
- (rr) After the transaction, the shareholders of Parent will be in control of Newco within the meaning of § 368(a)(2)(H).
- (ss) Newco has no plan or intention to reacquire any of its stock issued in the proposed transactions.
- (tt) Newco has no plan or intention to sell or otherwise dispose of any of the assets of Parent acquired in the proposed transactions, except for dispositions made in the ordinary course of business.
- (uu) The liabilities of Parent assumed by Newco in the proposed transactions and the liabilities to which the transferred assets of Parent are subject were incurred in the ordinary course of business.
- (vv) Following the proposed transactions, Newco will continue the historic business of Parent or use a significant portion of the Parent's historic business assets in a business.
- (ww) At the time of the proposed transactions, Newco will not have outstanding any warrants, options, convertible securities, or any other type of right pursuant to which any person could acquire stock in Newco that, if exercised or converted, could affect the acquisition of "control" of Newco by the former shareholders of Parent within the meaning of § 368(a)(2)(H).
- (xx) The fair market value of the assets of Parent transferred to Newco will equal or exceed the sum of the liabilities assumed by Newco, plus the amount of liabilities, if any, to which the transferred assets are subject.

- (yy) The total adjusted basis of the assets of Parent to be transferred to Newco will equal or exceed the sum of the liabilities, if any, to which the transferred assets are subject.

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

- (1) Parent, Subsidiary, Newco, the Grantor Trusts, the Family Trusts and Shareholder C recognize no gain or loss as a result of the deemed transfer of assets from Parent and Subsidiary, respectively, to Newco pursuant to Newco's QSub elections with respect to Parent and Subsidiary.
- (2) Newco and the Family Trusts recognize no gain or loss on the LLC Interest Transfers (§ 351 and § 1032).
- (3) Newco is subject to the built-in gains tax of § 1374 with respect to the assets it is deemed to receive from Parent and Subsidiary pursuant to the QSub elections for Parent and Subsidiary. See § 1.1374-8(b) (relating to the separate determination of tax for the assets of Parent and Subsidiary deemed received by Newco other than the stock of Parent and Subsidiary). For federal tax purposes, including the built-in gains tax of § 1374, Parent and Subsidiary shall not be treated as separate corporations, and all assets (other than the stock of Parent and Subsidiary), liabilities, and items of income, deduction, and credit of Parent and Subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of Newco (§1361(b)(3)(A)).
- (4) The taxable year of Parent and Subsidiary, respectively, will end at the close of the day before their QSub elections become effective (§ 1.381(b)-1(a)) and as provided in § 381(a) and § 1.381(a)-(1), Newco will succeed to and take into account those attributes of Parent and Subsidiary described in § 381(c), subject to the provisions and limitations specified in §§ 381, 382, 383, and 384, if applicable, and the regulations thereunder.

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about 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.

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

It is important to attach a copy of this letter to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling is consummated.

Pursuant to a power of attorney on file in this office, a copy of this letter has been sent to the taxpayer's authorized representative.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By _____
Debra Carlisle
Chief, Branch 5