

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Legend:

Newco =

S1 =

S2 =

LLC =

Grantor
Trust =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Shareholder E =

State X =

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Business W =

Business Y =

Business Z =

Source A =

Source B =

Dear :

We respond to your August 3, 1999 request for rulings as to the federal income tax consequences of a proposed transaction. Additional information was received on September 22, 1999 and September 29, 1999. The information submitted is substantially as set forth below.

S1, an S corporation incorporated in State X, conducts Business Y. S1 wholly owns LLC, which conducts Business W. S2, an S corporation incorporated in State X, conducts Business Z. S1 is owned by Grantor Trust and eighteen individual shareholders. S2 is owned by the same eighteen individual shareholders. Shareholders A, B, D, and E are individuals who were shareholders of S1 and S2. Shareholder C remains a shareholder of S1 and S2. During the three years prior to the proposed transaction below, S1 and S2 redeemed stock of Shareholders A, B, C, D, and E. Each redemption was made pursuant to a redemption agreement with an employee.

Pursuant to what the taxpayer represents are valid business reasons, the taxpayers propose the following transaction:

- (i) The shareholders of S1 and S2 will form Newco, and will elect to treat Newco as an S corporation effective as of the first day of its taxable year. The shareholders of S1 will transfer to Newco, in exchange for Newco stock, all their stock in S1. The shareholders of S2 will transfer to Newco, in exchange for Newco stock, all their stock in S2.

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The taxpayers represent to the best of their knowledge and belief, that the proposed stock transfers qualify under § 351.

(ii) Newco will elect under §1361(b)(3)(B) of the Code to treat S1 and S2 as Qualified Subchapter S Subsidiaries ("QSubs").

The taxpayers have made the following representations with respect to the proposed transfers:

- (a) No stock or securities will be issued for services rendered to or for the benefit of Newco in connection with the proposed transaction, and no stock or securities will be issued for indebtedness of Newco or for interest on indebtedness of Newco.
- (b) No liabilities of the shareholders of S1 and S2 will be assumed by Newco in connection with the transfer of such stock.
- (c) The transfers are not the result of the solicitation by a promoter, broker, or investment house.
- (d) The transferors will not retain any rights in the property transferred to Newco.
- (e) Any debt to which the S1 stock is subject was incurred to acquire such stock and was incurred when such stock was acquired, and each transferor is transferring all of the stock to which such debt was incurred.
- (f) The adjusted basis and fair market value of the assets to be transferred by the transferors to Newco will, in each instance, be equal to or exceed the sum of the liabilities to be assumed by Newco plus any liabilities to which the transferred assets are subject.
- (g) There is no indebtedness between Newco and the transferors and there will be no indebtedness created in favor of the transferors as a result of the transaction.
- (h) The transfers and exchanges will occur under a plan agreed upon before the transaction in which the rights of the parties are defined.
- (i) All exchanges will occur on approximately the same date.

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- (j) There is no plan on the part of Newco to redeem or otherwise reacquire any stock or indebtedness issued in the transfer. However, certain stock of both S1 and S2 held by employees is subject to redemption agreements. These redemption agreements will be amended to apply to Newco stock. If an employee should retire or otherwise terminate his employment from either company, his stock would be redeemed at book value per share.
- (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; a public offering of Newco stock; and the sale, exchange, transfer by gift, or other disposition of any of the stock of Newco to be received in the exchange, the transferors will be in control of Newco within the meaning of § 368(c).
- (l) Newco will remain in existence and will retain and use the property transferred to it in a trade or business.
- (m) There is no plan or intention by Newco to dispose of transferred property other than in the normal course of business operations.
- (n) Each of the parties to the transaction will pay his or her own expenses, if any, incurred in connection with the proposed transaction.
- (o) 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.
- (p) None of the transferors are under the jurisdiction of a court in a title 11 case 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 such debtor.
- (q) Newco will not be a personal service corporation within the meaning of § 269A.

With respect to the QSub elections, the taxpayers have made the following representations:

- (r) Newco, on the date of filing the QSub elections, will be the owner of 100% of the single outstanding class of both S1 and S2 stock.

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- (s) The fair market value of the assets of each S1 and S2 will exceed their respective liabilities at the time of the QSub elections.
- (t) Newco will not be an organization that is exempt from federal income tax under § 501 or any other provision of the Code.
- (u) The fair market value of the Newco stock received by the S1 shareholders will be approximately equal to the fair market value of the S1 stock surrendered in the exchange.
- (v) The fair market value of the Newco stock received by the S2 shareholders will be approximately equal to the fair market value of the S2 stock surrendered in the exchange.
- (w) Newco will acquire at least ninety percent of the fair market value of the net assets and at least seventy percent of the fair market value of the gross assets held by S1 immediately prior to the transaction. For purposes of this representation, amounts used by S1 to pay its reorganization expenses, and any redemptions and distributions (excluding regular, normal dividends) made by S1 immediately preceding the transfer will be included as assets of S1 held immediately before the transaction.
- (x) Newco will acquire at least ninety percent of the fair market value of the net assets and at least seventy percent of the fair market value of the gross assets held by S2 immediately prior to the transaction. For purposes of this representation, amounts used by S2 to pay its reorganization expenses, and any redemptions and distributions (excluding regular, normal dividends) made by S2 immediately preceding the transfer will be included as assets of S2 immediately before the transaction.
- (y) After the transaction, the former shareholders of S1 and S2 will be in control of Newco within the meaning of § 368(a)(2)(H).
- (z) Newco has no intention to reacquire any of its stock issued in the proposed transactions.
- (aa) Newco has no plan or intention to sell or otherwise dispose of any of the assets of S1 acquired in the proposed transactions, except for dispositions made in the ordinary course of business.

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- (bb) Newco has no plan or intention to sell or otherwise dispose of any of the assets of S2 acquired in the proposed transactions, except for dispositions made in the ordinary course of business.
- (cc) The liabilities of S1 and S2 assumed by Newco in the proposed transactions and the liabilities to which the transferred assets are subject were incurred in the ordinary course of their businesses.
- (dd) Following the proposed transactions, Newco will continue the historic business of S1 or use a significant portion of S1's historic business assets in a business.
- (ee) Following the proposed transactions, Newco will continue the historic business of S2 or use a significant portion of S2's historic business assets in a business.
- (ff) 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 S1 and S2 within the meaning of § 368(a)(2)(H).
- (gg) Newco, S1, and S2 will pay their respective expenses, if any, incurred in connection with the transactions.
- (hh) No two parties to the transaction are investment companies within the meaning of § 368(a)(2)(F)(iii) and (iv).
- (ii) Except with respect to the redemption of stock of S1 held by Shareholder A, Shareholder B, Shareholder C, Shareholder D, and Shareholder E, no shares of S1 will have been redeemed during the three years preceding the adoption of the plan of liquidation of S1.
- (jj) Except with respect to the redemption of stock of S2 held by Shareholder A, Shareholder B, Shareholder C, Shareholder D, and Shareholder E, no shares of S2 will have been redeemed during the three years preceding the adoption of the plan of liquidation of S2.
- (kk) Other than the formation of new subsidiary entities, to the best of the knowledge of S1's and S2's management, neither S1 nor S2 will have

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acquired assets in any nontaxable transactions except for acquisitions occurring more than three years prior to the date that Newco makes QSub elections for S1 and S2, respectively.

- (ll) No assets of S1 or S2 have been, or will be, disposed of by either S1 or S2 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 S1 and S2 respectively.
- (mm) The deemed liquidations of S1 and S2 will not be preceded by, nor will they be followed by, reincorporation in, or transfer or sale to, a recipient corporation ("Recipient") of any of the businesses or assets of S1 or S1, if persons holding, directly or indirectly, more than 20% in value of the stock of S1 or S2 also held, directly or indirectly, more than 20% 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).
- (nn) Prior to making the QSub elections with respect to S1 and S2, no assets of S1 or S2 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 S1 and S2.

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

- (1) Newco, S1, S2, Grantor Trust, and the Individual Shareholders recognize no gain or loss as a result of the deemed transfer of assets from S1 and S2, respectively, to Newco pursuant to Newco's QSub elections with respect to S1 and S2.
- (2) The tax years of S1 and S2, 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 S1 and S2 described in § 381(c), subject to the provisions and limitations specified in §§ 381, 382, 383, and 384, if applicable, and the regulations thereunder.
- (4) The basis of the assets of S1 and S2 in the hands of Newco will be the same as the basis of such assets in the hands of S1 and S2 immediately prior to

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transaction.

(5) The holding period of the assets of S1 and S2 in the hands of Newco will include the period during which S1 and S2, respectively, held the assets.

(6) Newco will succeed to the Accumulated Adjustments Accounts of S1 and S2.

(7) Neither S1 nor S2 will be treated as a C corporation for any period solely because of the transfer of their respective stock to Newco.

(8) The inventories of S1 deemed transferred to Newco under the proposed transaction will be taken into account by Newco on the same basis and methods on which such inventories were taken into account by S1. Newco will not be required to treat the inventory received in the proposed transaction as separate from otherwise identical inventory subsequently acquired or produced.

(9) Section 1363(d) will not require S1 to include in its gross income any LIFO recapture amount for the inventory deemed transferred to Newco.

(10) Section 1374(d)(8) will not subject any assets that are transferred from S1 or S2 to Newco in the proposed transaction to the built-in gain provisions of § 1374, to the extent that the assets are not presently subject to the built-in gain provisions.

(11) Rental income received by S2 from Business Y will not be considered passive investment income for purposes of § 1362(d)(3)(C) or § 1375.

(12) Income received by LLC from Source A will not be considered passive investment income for purposes of § 1362(d)(3)(C) or § 1375. We express no opinion on income from Source B.

No opinion is expressed concerning the federal income tax treatment of the transactions under other provisions of the Code or Income Tax Regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions that are not covered by the above rulings.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code 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 letter

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ruling is consummated.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to your authorized representatives.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By: _____
Christopher W. Schoen
Assistant to the Chief, Branch 1