

## Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Re:

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**March 16, 1999**

Distributing =

Controlled One =

Controlled Two =

S-1 =

S-2 =

S-3 =

S-4 =

S-5 =

S-6 =

S-7 =

LLC =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Shareholder E =

Shareholder F =

Shareholder G =

Business 1 =

Business 2 =

Business 3 =

Business 4 =

Business 5 =

Business 6 =

Business 7 =

State W =

Dear \_\_\_\_\_ :

This letter responds to your letter of April 14, 1998, requesting rulings as to the federal income tax consequences of the proposed transaction described below. You submitted additional information in letters dated June 22, September 25 and 29, October 22, and November 13, 1998, and February 16, 1999. The information submitted for our consideration is summarized hereafter.

The rulings contained in this letter are predicated 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 material submitted in support of the rulings request. Verification of the factual information, representations and other data may be required as part of the audit process.

Distributing is a closely held State W corporation. It has one class of voting common stock outstanding held, as follows: Shareholder A, 145.43 shares; Shareholder B, 3 shares; Shareholder C, 8.5 shares; Shareholder D, .5 of a share; Shareholders E, F and G, each own 3.69 shares. It is an accrual basis taxpayer on a calendar year. Distributing elected S corporation status in March 1997. At that time, the following wholly-owned subsidiaries, S-1, S-2, S-3, S-4, S-5, and S-6 each elected to be a Qualified Subchapter S Subsidiary ("QSS"). Distributing also owns more than 80 percent of the stock of S-7, which owns a majority interest in LLC, engaged in Business 7.

Financial information has been received that reflects that Businesses 1-6 operated through a QSS have had gross receipts and operating expenses representative of the conduct of an active trade or business for each of the past 5 years.

Shareholder F has been the general manager of Business 1 for more than 10 years. Shareholder G has been the general manager of Business 2 for at least 10 years. Shareholders F and G have each established key contacts in their respective business and each is responsible for most of the major business decisions and for the success of their operations. Shareholders F and G have each indicated that they only want to have a direct and substantial interest in the business each manages and not as part of a multi-faceted entity.

In order to satisfy the desire of each shareholder-general manager, the following proposed steps has or will be undertaken:

(1) Distributing has organized Controlled One and will transfer all of the assets related to Business 1 to it together with certain related liabilities to be assumed by Controlled One.

(2) Distributing will organize Controlled Two and will transfer to it all of the assets related to business 2 together with certain related Business 2 liabilities to be assumed by Controlled Two.

(3) Distributing will then distribute shares of Controlled One and Controlled Two to the shareholders of Distributing, other than Shareholders F and G. Shareholder F will exchange all of his stock in Distributing for approximately 26 percent of the stock in Controlled One. Shareholder G will exchange all of his stock in Distributing for approximately 36 percent of the stock of Controlled Two. Following this step, the stock of Distributing, Controlled One and Controlled Two will be held as follows:

<u>Shareholder</u>	<u>Distributing</u>	<u>Controlled One</u>	<u>Controlled Two</u>
A	145.33	145.33	145.33
B	3	3	3
C	8.5	8.5	8.5
D	.5	.5	.5
E	3.69	3.69	3.69
F	-	56.6	-
G	-	-	90.63

Following the proposed transactions, a nominal portion of Controlled One's sales will be to Distributing and will be on a market rate arm's length basis. In addition, Controlled One and Controlled Two will continue to lease certain equipment to Distributing, also at an arm's length market rate. Further, Controlled One and Controlled Two will share the services of a Comptroller and an accounting department for a transition period of up to one year with all shared employees being paid directly the fair market value for these services by each corporation. Except as just described, the three corporation will not have any officers, employees or directors in common following the transactions. The only intercorporate debt which will exist between Distributing and Controlled One and/or Controlled Two will be for accounts payable related to accounts receivables transferred and for services or supplies purchased in the ordinary course of business.

The following representations have been made with respect to the transactions described above:

- (A) The indebtedness owed by Controlled One and/or Controlled Two to Distributing after the distribution of the stock of each will not constitute stock or securities.
- (B) The fair market value of the shares of Controlled One stock to be received by Shareholder F, and the fair market value of the shares of stock of Controlled Two to be received by Shareholder G will be, in each instance, approximately equal to the fair market value of the shares of stock of Distributing to be surrendered by each shareholder in the exchange.
- (C) 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 the corporation.
- (D) The five years of financial information submitted on behalf of the businesses of the Distributing corporation are representative of the present operations of the corporation, and with regard to such corporation there have been no substantial operational changes since the date of the last financial statements submitted.
- (E) Following the proposed transaction, except as described above, Distributing, Controlled One and Controlled Two will each continue the active conduct of their respective businesses, independently and with their separate employees.
- (F) The distributions of the stock of Controlled One and Controlled Two, respectively, are carried out for the corporate business purpose of providing the two key employees with an equity interest in the business each manages. The distributions of the stock of Controlled One and Controlled Two are motivated, in whole or substantial part, by this corporate business purpose.
- (G) There is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock of either the distributing or either controlled corporation after the transaction.
- (H) Except for the possible future sale of Distributing's interest in LLC or its purchase of the outstanding minority interest pursuant to certain options or a possible sale of the stock of Subsidiary 7 to its president, there is no plan or intention to liquidate Distributing, Controlled One or Controlled Two, to merge any of the corporations with any other corporation, or to sell or otherwise to dispose of the assets of any of these corporations subsequent to the proposed transaction, except in the ordinary course of business.
- (I) There is no plan or intention by Distributing, Controlled One or Controlled Two, directly or through any subsidiary corporation, to purchase any of its outstanding

stock after the transaction, other than stock purchases meeting the requirements of Section 4.05(1)(b) of Rev. Proc. 96-30.

- (J) The total adjusted basis and the fair market value of the assets to be transferred to Controlled One and to Controlled Two, respectively, by Distributing will each equal or exceed the sum of the liabilities assumed by Controlled One, and by Controlled two, respectively, plus any liabilities to which the assets transferred to each corporation are subject.
- (K) The liabilities to be assumed by Controlled One, and by Controlled Two, respectively, and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and will be associated with the assets being transferred.
- (L) The income tax liability for the taxable year in which investment credit property (including any building to which § 47(d) applies) is transferred will be adjusted pursuant to § 50(a)(1) or (a)(2) (or § 47, as in effect before amendment by Public Law 101-508, Title 11, 104 Stat. 1388, 536 (1990)), is applicable to reflect an early disposition of the property.
- (M) Distributing neither accumulated nor made extraordinary payment of payables in anticipation of the proposed transaction.
- (N) No intercorporate debt will exist between Distributing and Controlled One or Controlled Two at the time or, or subsequent to, the distribution of the stock of Controlled One and Controlled Two.
- (O) Payments made in connection with all continuing transactions between Distributing, Controlled One, and Controlled Two, will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (P) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (Q) Distributing is an S corporation (within the meaning of § 1361 (a) of the Internal Revenue Code. Controlled One and Controlled Two each 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 elections of Distributing, Controlled One or Controlled Two.
- (R) The gross assets of the trades or businesses relied on to satisfy the active trade or business requirement of § 355(b) for Distributing, Controlled One, and Controlled Two, will, in each case, have a fair market value that is at least 5

percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.

- (S) 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, Controlled One, or Controlled Two.

On the basis of the information submitted and the representations set forth above, it is held as follows:

- (1) The transfer of the assets and liabilities of Business One by Distributing to Controlled One, and the assets and liabilities of Business Two by Distributing to Controlled Two, respectively, followed by the Distribution of the stock of Controlled One and of Controlled Two, as described above, will constitute, in each instance, a reorganization within the meaning of § 368(a)(1)(D). Distributing, Controlled One and Controlled Two will each be “a party to a reorganization” within the meaning of section 368(b).
- (2) No gain or loss will be recognized to either Controlled One or Controlled Two on the receipt by each of the assets subject to liabilities of Distributing in exchange for the stock of each controlled corporation, respectively (§ 1032(a)).
- (3) No gain or loss will be recognized to Distributing on its transfer of assets to Controlled One, and to Controlled Two in exchange for the stock of each and the assumption by each controlled corporation of the liabilities associated with the assets transferred (§§ 361 (a) and 357(a)).
- (4) The basis of the assets received by Controlled One and by Controlled Two, respectively, will be the same as the basis of such assets in the hands of Distributing immediately before the transfer (§ 362(b)).
- (5) The holding period of the assets received by Controlled One, and by Controlled Two, respectively, will include the periods during which such assets were held by Distributing (§ 1223(2)).
- (6) No gain or loss will be recognized by Distributing on the distribution of the stock of Controlled One and Controlled Two, as described above (§ 361(c)).
- (7) No gain or loss will be recognized (and no amount of income will be included) by the shareholders of Distributing upon their receipt of shares of stock of Controlled One and/or Controlled Two, as described above (§ 355(a)(1)).

- (8) The basis of the stock of Controlled One and Controlled Two received by the shareholders of Distributing, other than Shareholders F and G, will be allocated between the Distributing stock and the stock of Controlled One and Controlled Two held by each shareholder after the transaction in proportion to their relative fair market values, as provided in § 1.358-2 (§ 358(a)(1) and (b)).
- (9) The basis of the shares of (a) Controlled One received by Shareholder F in exchange for his shares of Distributing stock, and (b) the shares of Controlled Two received by Shareholder G in exchange for his shares of Distributing stock will be, in each case, the same as the basis of the shares of Distributing stock surrendered in exchange therefor (§ 358(a)(1)).
- (10) The holding period of the stock of Controlled One and Controlled Two received by the Distributing shareholders, will include the holding period of the Distributing stock with respect to which the distribution or exchange was made, provided that the Distributing stock was held as a capital asset on the date of the exchange (§ 1223(1)).
- (11) Provided that Distributing immediately distributes the stock of Controlled One, and Controlled Two to qualified Subchapter S shareholders, Distributing's momentary ownership of the stock of each corporation in connection with a reorganization under § 368(a)(1)(D) will be disregarded for purposes of §§ 1361 and 1362, and, therefore, will not terminate Distributing's election to be taxed as an S corporation under § 1362 (d)(2).
- (12) Provided that Distributing immediately distributes the stock of Controlled One and Controlled Two, Distributing's momentary ownership of the stock will not cause Controlled One or Controlled Two to have an ineligible shareholder under § 1361(b)(1)(B). Therefore, Controlled One and Controlled Two are each eligible to make a timely election, without the consent of Distributing, to be an S corporation for the first taxable year of each, provided that Controlled One and Controlled Two each meet the requirements of § 1361(b).
- (13) Controlled One and Controlled Two each will be subject to § 1374 with respect to any asset transferred to it from Distributing to the same extent Distributing was subject to § 1374. Controlled One's and Controlled Two's recognition period will be reduced by the portion of Distributing's recognition period that expired prior to the transfer of the assets to each (Ann. 86-128, 1986-51 I.R.B. 22, and § 1374(d)(8)).

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Internal Revenue Code and 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, we



express no opinion regarding the validity of Distributing's past election or the intended elections under § 1362 by Controlled One, and by Controlled Two to be treated as an S corporation, or whether Controlled One or Controlled Two will each qualify as an S corporation. This ruling has no effect on any earlier transactions and is directed solely to the taxpayer who requested it. § 6110(k)(3) provides that it may not be used or cited as precedent.

Each affected taxpayer should attach a copy of this letter to such taxpayer's federal income tax return for the taxable year in which the proposed transaction is consummated.

Pursuant to the Power of Attorney filed in this matter, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

Assistant Chief Counsel  
(Corporate)

By: Howard W. Staiman  
Assistant to the Chief, Branch 1