

Internal Revenue Service

Department of the Treasury

Number: **200207025**

Release Date: 2/15/2002

Index Number: 0355.01-01, 368.04-00

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CC:CORP:B05-PLR-142072-01

Date:

November 21, 2001

LEGEND:

Distributing =

Controlled =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

A =

State X =

State Y =

Date 1 =

Date 2 =

Date 3 =

Dear :

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This letter responds to your July 30, 2001 request submitted on behalf of Distributing, Shareholder 1 and Shareholder 2, for rulings on certain federal income tax consequences of a proposed transaction. Additional information was received in letters dated October 2, 2001, October 25, 2001, and November 15, 2001. The rulings in this letter are based on the facts and representations submitted under penalties of perjury in support of the request. Verification of that information may be required as part of the audit process. The material information is summarized below.

Distributing is a State X corporation that was incorporated on Date 1 (more than 5 years ago). Distributing has two geographic divisions, one in State X and one in State Y, both of which are engaged in the A business. The State X division has been engaged in the A business since Date 1. The State Y division has been engaged in the A business since it was established more than 5 years ago. Distributing computes its federal income tax liability using an accrual method of accounting and files its federal income tax returns on a calendar year basis.

From Date 2 until Date 3, the stock of Distributing was owned equally by Shareholder 1, Shareholder 2, and Shareholder 3. On Date 3 (less than 5 years ago), Shareholder 1 and Shareholder 2 each purchased half of the outstanding shares of Distributing stock owned by Shareholder 3, a non-resident alien. Since Date 3, Distributing has been owned equally by Shareholder 1 and Shareholder 2. Both Shareholder 1 and Shareholder 2 are individuals who compute their federal income tax liability using a cash method of accounting and file their federal income tax returns on a calendar year basis. Since the establishment of the State Y division of Distributing's A business, Shareholder 1 has assumed primary managerial duties and responsibilities for the State X division and Shareholder 2 has assumed primary managerial duties and responsibilities for the State Y division.

Controlled is to be formed as a State Y corporation. Controlled will compute its federal income tax liability using an accrual method of accounting and will file its federal income tax returns on a calendar year basis.

Financial documentation has been submitted which indicates that the A business conducted by Distributing has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Shareholder 1 and Shareholder 2 wish to concentrate their attention on the specific division of Distributing's A business which is of the most interest to each of them as differences of opinion have arisen concerning the operation and future direction of the State X and State Y divisions.

In order to allow Shareholder 1 and Shareholder 2 to separately operate the State X and State Y divisions, it is proposed that Distributing's A business be divided as follows:

- (i) Distributing will form Controlled as a wholly-owned subsidiary incorporated

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in State Y by contributing the assets of its State Y division to Controlled solely in exchange for all of Controlled's issued and outstanding stock and the assumption by Controlled of related liabilities.

- (ii) Distributing will retain its State X division.
- (iii) Distributing will distribute all of the Controlled stock to Shareholder 2 in exchange for all of Shareholder 2's Distributing stock.

In connection with the transaction, it has been represented that:

- (a) The fair market value of the Controlled stock and other consideration to be received by Shareholder 2 will be approximately equal to the fair market value of the Distributing stock surrendered by Shareholder 2 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 the corporation.
- (c) The 5 years of financial information submitted on behalf of Distributing are representative of the corporation's present operations, and with regard to such corporation, 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, independently and with its separate employees, the active conduct of its share of all the integrated activities of the business conducted by Distributing prior to consummation of the transaction.
- (e) The distribution of the stock of Controlled will be carried out for the following business purpose: to allow Shareholder 1 and Shareholder 2 to go their separate ways in order to enable the shareholders to concentrate on the specific geographic market which is of most interest to each of them, to remedy their inability to agree on the growth and direction of the business, to resolve issues related to appropriate levels of shareholder compensation and employee stock options/profit-sharing arrangements, and to segment the risks associated with debt guarantees pertaining to borrowing for business expansion. The distribution of the stock of Controlled is motivated, in whole or substantial part, by one or more of these corporate business purposes.
- (f) Distributing is not an S Corporation (within the meaning of § 1361(a)), but immediately before the distribution, Distributing will be eligible to make an S corporation election pursuant to § 1362(a) of the Internal Revenue Code. Distributing and Controlled will elect to be S corporations pursuant

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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 Shareholder 1 or Shareholder 2 to sell, exchange, transfer by gift, or otherwise dispose of any stock in either Distributing or Controlled after the transaction, other than by gifts to family members within the annual exclusion allowed under § 2503(b). Further, Distributing or Controlled may grant stock options to their respective employees. However, in no case will such gifts of stock or stock option grants equal or exceed $16 \frac{2}{3}$ percent of the stock owned in either Distributing or Controlled and in no case will either Shareholder 1 or Shareholder 2 own $83 \frac{1}{3}$ percent or less in Distributing or Controlled, respectively.
- (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.
- (i) 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 transaction, except in the ordinary course of business.
- (j) The total adjusted bases and the fair market value of the assets to be transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities to be assumed (as determined under § 357(d)) by Controlled.
- (k) The liabilities to be 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.
- (l) No investment tax credit under the Internal Revenue Code has been, or will be, claimed with respect to any of the assets of the State Y division being transferred by Distributing to Controlled.
- (m) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (n) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock.
- (o) 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.

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- (p) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (q) Distributing, Controlled, Shareholder 1, and Shareholder 2 will each pay their own expenses, if any, incurred in connection with the transaction.
- (r) The distribution of Controlled stock 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 either Distributing or Controlled entitled to vote, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.
- (s) Immediately after the distribution, no person will hold "disqualified stock" in Distributing or Controlled, which constitutes a 50 percent or greater interest in such corporations within the meaning of § 355(d).
- (t) The cash and investment assets held by Distributing and to be held by Controlled are related to the reasonable needs of the conduct of the active trade or business of each corporation.

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

- (1) The contribution of the State Y division assets to Controlled solely in exchange for all the outstanding stock of Controlled and the assumption by Controlled of related liabilities, followed by the distribution by Distributing of all the Controlled stock to Shareholder 2 in exchange for all of Shareholder 2's stock in Distributing, will be a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled each will each be "a party to a reorganization" within the meaning of § 368(b).
- (2) No gain or loss will be recognized by Distributing on the contribution of the State Y assets to Controlled in exchange for Controlled stock and Controlled's assumption of related liabilities (§§ 361(a) and 357(a)).
- (3) No gain or loss will be recognized by Controlled on the receipt of the State Y assets of Distributing in exchange for Controlled stock and Controlled's assumption of related liabilities (§ 1032(a)).
- (4) The basis of the assets received by Controlled from Distributing will be the same as the basis of such assets in the hands of Distributing immediately prior to the transaction (§ 362(b)).

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- (5) The holding period of the assets received by Controlled from Distributing will include the period during which Distributing held such assets (§1223(2)).
- (6) No gain or loss will be recognized by Distributing upon the distribution of all of its stock in Controlled to Shareholder 2 in exchange for all of Shareholder 2's Distributing stock (§ 361(c)(1)).
- (7) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) Shareholder 2 on receipt of Controlled stock in exchange for all of Shareholder 2's Distributing stock (§ 355(a)(1)).
- (8) The basis of the Controlled stock in the hands of Shareholder 2 will equal the basis of the Distributing stock surrendered in exchange therefor (§ 358(a)(1)).
- (9) The holding period of the Controlled stock received by Shareholder 2 will include the holding period of the Distributing stock surrendered in exchange therefor, provided the Distributing stock is held as a capital asset on the date of the distribution (§ 1223(1)).
- (10) 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.

No opinion is expressed about the tax treatment of the transaction under any other provision of the Code or 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 in the above rulings.

A copy of this letter must be attached to the federal income tax return of each taxpayer involved for the taxable year in which the transaction covered by this ruling letter is consummated.

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

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to the second representative listed on that power of attorney and to Distributing.

Sincerely,
John Moriarty
Assistant to the Branch Chief, Branch 5
Office of Associate Chief Counsel