

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

December 9, 1998

Distributing =

Business X =

Business Y =

Key Employee =

a =

Dear

We are responding to your June 5, 1998 request for rulings as to the federal income tax consequences of a proposed transaction. The information submitted in that ruling request and subsequent correspondence is set forth below.

Distributing is a closely held S corporation actively engaged in Business X and Business Y.

Financial information has been received indicating that Distributing's Business X and Business Y each has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Key Employee of Business Y wishes to acquire stock in a corporation operating only Business Y. Distributing has provided information showing that transferring Business Y to a limited liability company or partnership is impractical. Accordingly, to

accommodate Key Employee, the following transaction has been proposed:

- (i) Distributing will transfer the Business X assets to newly formed Controlled in exchange for the stock of Controlled (the "Exchange").
- (ii) Distributing will distribute the Controlled stock pro rata to its shareholders (the "Distribution").
- (iii) Within one year of the Distribution, Distributing will issue to Key Employee an amount of stock equal to at least a percent of the outstanding stock of Distributing. Key Employee will pay for some of the stock with a note and will receive some of the stock as compensation.

The taxpayers have made the following representations in connection with the proposed transaction:

- (a) No part of the consideration distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a Distributing shareholder.
- (b) The five years of financial information submitted on behalf of Distributing's Business X and Business Y represent the present operations of each business, and, regarding each business, there have been no substantial operational changes since the date of the last financial statements submitted.
- (c) Following the transaction, Distributing and Controlled will each continue the active conduct of their respective businesses, independently and with their separate employees.
- (d) The Distribution is carried out to assure that Key Employee remains in employ of Controlled. The Distribution is motivated, in whole or in part, by this corporate business purpose.
- (e) 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 in either Distributing or Controlled after the transaction.
- (f) 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 stock purchases meeting the requirements of section 4.05(1)(b) of Revenue Procedure 96-30.
- (g) There is no plan or intention to liquidate Distributing or Controlled, to

merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation subsequent to the transaction, except in the ordinary course of business.

- (h) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the stock of Controlled.
- (i) 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.
- (j) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (k) 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 election of either Distributing or Controlled.

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

- (1) The Exchange and the Distribution together will qualify as a reorganization under § 368(a)(1)(D). Distributing and Controlled will each be a "party to a reorganization" under § 368(b).
- (2) No gain or loss will be recognized by Distributing on the Exchange (§§ 361(a) and 357(a)).
- (3) No gain or loss will be recognized by Controlled on the Exchange (§ 1032(a)).
- (4) The basis of each Business X asset received by Controlled will equal the basis of that asset in the hands of Distributing immediately before its transfer (§ 362(b)).
- (5) The holding period of each Business X asset received by Controlled will include the period during which that asset was held by Distributing (§ 1223(2)).
- (6) No gain or loss will be recognized by Distributing on the Distribution (§ 361(c)(1)).

- (7) No gain or loss will be recognized by (and no amount will be included in the income of) the shareholders of Distributing upon the receipt of Controlled stock in the Distribution (§ 355(a)(1)).
- (8) The aggregate basis of Distributing and Controlled stock in the hands of its shareholders after the Distribution will equal, in each instance, the aggregate basis of the Distributing stock immediately before the Distribution, allocated between the Distributing and Controlled stock in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) of the Income Tax Regulations.
- (9) The holding period of the Controlled stock received by the shareholders of Distributing will include, in each instance, the holding period of the Distributing stock on which the Distribution is made, provided that the shares are held by them 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).
- (11) Controlled is subject to the built-in-gain tax of § 1374 with respect to the built-in-gain assets it receives from Distributing. For purposes of the built-in-gain tax, Controlled's recognition period is reduced by the portion of Distributing's recognition period that expires before Distributing's transfer of these assets to Controlled.

The Internal Revenue Service expresses no opinion about the tax treatment of the transaction under other provisions of the Code and regulations, or the tax treatment of any conditions existing at the time of, or effects resulting from, the completed transaction that are not specifically covered by the above rulings.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. It is important that a copy of this letter be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

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

Sincerely yours,  
Assistant Chief Counsel (Corporate)

By \_\_\_\_\_  
Debra Carlisle  
Chief, Branch 5