

INTERNAL REVENUE SERVICE

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Distributing =

Controlled 1 =

Controlled 2 =

Controlled 3 =

F =

M =

C1 =

C2 =

C3 =

State X =

Manufacturer =

License =

Business B =

PLR-118975-98

Date A =

Date B =

a =

b =

c =

d =

f =

g =

h =

Z =

This letter responds to your request dated October 2, 1998, for rulings on the federal income tax consequences of a proposed transaction. You submitted additional information in letters dated November 19, 1998, December 17, 1998, and December 31, 1998. The information submitted for consideration is summarized below.

Distributing, a State X corporation, uses the accrual method of accounting and has a calendar tax year. Distributing has been a subchapter S corporation since Date A (which is prior to January 1, 1987). Distributing's only class of outstanding stock consists of a shares of common voting stock. F and F's wife, M, own b shares. F and M gifted the remaining shares equally to C1, C2, and C3 (their children) on Date B.

Distributing is engaged in the ownership and operation of c Manufacturer Licenses (Business A) and Business B. F is a licensed Z for each Manufacturer License currently owned by Distributing. C1, C2, and C3 are licensed Zs for each of their own Manufacturer Licenses. However, C1, C2, and C3 also work for Distributing in the operations of its Manufacturer Licenses but are not licensed Zs for the Manufacturer Licenses owned by Distributing. M is not active in the operations of the Manufacturer Licenses.

PLR-118975-98

We have received financial information which indicates that Business A and Business B 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.

Under Manufacturer's Z rules, if F does not remain active in Distributing's Manufacturer License operations, Distributing could not continue to own and operate the c Manufacturer Licenses. Further, the licensed Z must own not less than d% of each Manufacturer License. F is experiencing very serious health problems which is seriously undermining his ability to actively manage and operate Distributing's Manufacturer Licenses. Furthermore, Manufacturer will not license C1, C2, or C3 as to all the c Licenses owned by Distributing.

Accordingly, to enable satisfaction of Manufacturer's Z requirements and maintain ownership of Distributing's Manufacturer Licenses in light of F's serious health conditions and inability to work, the following has been proposed:

- (i) F and M will gift f% of the stock of Distributing to each of C1, C2, and C3. Immediately after this step, F and M will own g% of Distributing and C1, C2, and C3 will each own h% of Distributing.
- (ii) Distributing will form Controlled 1, Controlled 2, and Controlled 3 (each a "Controlled Corporation" and together the "Controlled Corporations") as wholly owned subsidiaries. The Controlled Corporations will be State X corporations, use the accrual method of accounting, and have a calendar taxable year.
- (iii) Distributing will contribute each of its c Manufacturer Licenses, including associated business assets, to one of the Controlled Corporations in exchange for all of the stock of the respective Controlled Corporation and the assumption by each of certain liabilities. The Manufacturer Licenses will be allocated among the Controlled Corporations so that each Controlled Corporation has the same value.
- (iv) Distributing will distribute (A) g% of the stock of each Controlled Corporation to F and M, (B) d% of the stock of Controlled 1 to C1, (C) d% of the stock of Controlled 2 to C2, and (D) d% of the stock of Controlled 3 to C3. The division of the Manufacturer Licenses among the Controlled Corporations in step (iii), above, will be made based on C1's, C2's or C3's involvement in that Manufacturer License. Each Controlled Corporation will elect subchapter S status.

PLR-118975-98

Following the proposed transaction, Manufacturer will approve C1, C2, and C3 as a licensed Z for the Manufacturer Licenses held by their respective Controlled Corporation that each received in step (iv), above. Distributing will continue operating Business B.

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

- (a) 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.
- (b) The five years of financial information submitted on behalf of Distributing is representative of its present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (c) Following the transaction, each Controlled Corporation will continue, independently and with its separate employees, the active conduct of its share of all the integrated activities of Business A conducted by Distributing prior to the consummation of the transaction. Distributing will continue the active conduct of Business B, independently and with its separate employees.
- (d) The distribution of the stock of each Controlled Corporation is carried out for the following corporate business purposes: To enable satisfaction of Manufacturer's Z requirements and maintain ownership of Distributing's Manufacturer Licenses in light of F's serious health conditions and inability to work. The distribution of the stock of each Controlled Corporation is motivated, in whole or in substantial part, by this corporate business purposes.
- (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 Distributing or any Controlled Corporation after the transaction.
- (f) There is no plan or intention by Distributing or any Controlled Corporation, directly or through any subsidiary, to purchase any of its outstanding stock after the transaction, other than through stock purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696.
- (g) There is no plan or intention to liquidate Distributing or

PLR-118975-98

any Controlled Corporation, to merge any corporation with any other corporation, or to sell or otherwise dispose of the assets of Distributing or any Controlled Corporation after the transaction, except in the ordinary course of business.

- (h) The total adjusted bases and the fair market value of the assets transferred to each Controlled Corporation by Distributing each equals or exceeds the sum of the liabilities assumed by each Controlled Corporation plus any liabilities to which the transferred assets are subject. The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.
- (i) There is no property for which any investment credit has been taken and to which recapture applies because the recapture period has expired.
- (j) No intercorporate debt will exist between Distributing and any Controlled Corporation at the time of, or subsequent to, the distribution of each Controlled Corporation.
- (k) Payments made in connection with all continuing transactions, if any, between Distributing and any Controlled Corporation will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length. Payments made in connection with all continuing transactions, if any, between any of the Controlled Corporations will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (l) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv) of the Internal Revenue Code.
- (m) Distributing is an S corporation (within the meaning of § 1361(a)). Each Controlled Corporation 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 intention to revoke or otherwise terminate the S corporation election of Distributing or any Controlled Corporation.
- (n) The distributions are 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% or more of the total combined voting power of all classes of stock of

PLR-118975-98

Distributing or any Controlled Corporation, or stock possessing 50% or more of the total value of all classes of stock of Distributing or any Controlled Corporation.

- (o) At no time during the period that Distributing has been an S corporation did it acquire any asset in a transaction in which Distributing's basis in such asset was determined (in whole or in part) by reference to a C corporation's basis in the asset (or any other property).

Based solely on the information submitted and representations made, we hold as follows:

- (1) The transfer by Distributing of the Manufacturer Licenses (including associated business assets) to each Controlled Corporation, in exchange for all the stock of each Controlled Corporation, and the assumption of certain liabilities, as described above, followed by the distribution of (A) g% of the stock of Controlled 1 to F and M and d% of the stock of Controlled 1 to C1 (B), g% of the stock of Controlled 2 to F and M and d% of the stock of Controlled 2 to C2, and (C) g% of the stock of Controlled 3 to F and M and d% of the stock of Controlled 3 to C3, will each be a reorganization within the meaning of § 368(a)(1)(D), respectively. Distributing and each Controlled Corporation, respectively, will be "a party to a reorganization" within the meaning of § 368(b).
- (2) Distributing will recognize no gain or loss upon the transfer of the Manufacturer Licenses (including associated business assets), subject to liabilities, to each Controlled Corporation in exchange for all the stock of each Controlled Corporation, as described above (§ 361(a) and § 357(a)).
- (3) Each Controlled Corporation will recognize no gain or loss on the receipt of the respective Manufacturer Licenses (including associated business assets) in exchange for its stock, as described above (§ 1032(a)).
- (4) Each Controlled Corporation's basis in the assets received from Distributing will equal the basis of such assets in the hands of Distributing immediately prior to the transaction (§ 362(b)).
- (5) Each Controlled Corporation's holding period in the assets received in the transaction will include the period during which Distributing held such asset (§ 1223(2)).
- (6) Distributing will recognize no gain or loss on the distribution of each Controlled Corporation to the

PLR-118975-98

Distributing shareholders, as described above (§ 361(c)).

- (7) The Distributing shareholders will recognize no gain or loss (and no amount will be included in their income) upon the receipt of the Controlled Corporations' stock, as described above (§ 355(a)(1)).
- (8) The basis of the stock of each Controlled Corporation and Distributing in the hands of the Distributing shareholders after the distribution will, in each instance, be the same as the aggregate basis of the Distributing stock held immediately before the distribution allocated in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) (§§ 358(a) & 358(b)(1)).
- (9) A Distributing shareholder's holding period of the Controlled Corporation(s)' stock received in the transaction will, in each instance, include the holding period of the Distributing stock with respect to which the distribution is made, provided that they held their Distributing stock 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 each Controlled Corporation will be made under § 1.312-10(a).
- (11) The momentary ownership by Distributing of the stock of each Controlled Corporation in connection with the reorganization will not, in and of itself, make each Controlled Corporation ineligible to elect to be an S corporation for its first taxable year, provided that each Controlled Corporation meets the other requirements under § 1361(b). Distributing's consent to each Controlled Corporation's election to be an S corporation is not required.
- (12) The S corporation election to be made by each Controlled Corporation immediately following the respective distribution of each Controlled Corporation will not subject each Controlled Corporation to be taxed under § 1374 because, for purposes of this determination, each Controlled Corporation and Distributing (the predecessor of each Controlled Corporation) are to be treated as one corporation, and such corporation made its S election before January 1, 1987 (§ 1374(c)(1) and § 633(b) of Pub. L. No. 99-514).

We express no opinion 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

PLR-118975-98

transaction that are not specifically covered by the above rulings. Specifically, no opinion is expressed concerning the tax consequences of step (i).

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

The affected taxpayers must attach a copy of this letter to their federal income tax returns for the taxable year in which the transaction covered by this ruling letter is consummated.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By *Ken Cohen*

Ken Cohen

Senior Technician Reviewer, Branch 3