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February 12, 1999

Distributing =

Controlled =

State X =

State Y =

A =

B =

C ESOP =

D ESOP =

business a =

Date 1 =

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This letter replies to a request for rulings, dated August 6, 1998, on the federal income tax consequences of a proposed transaction concerning § 355 of the Internal Revenue Code. We received additional information in letters dated September 28, October 23, 1998, January 8, and February 5, 1999. The information submitted for consideration is summarized below.

Distributing is a State X company with voting and non-voting stock outstanding. The stock is held by two unrelated individuals and an ESOP: A, B, and D ESOP. D ESOP is an ESOP owned by Distributing employees. Over 50 percent of Distributing's voting stock and all of Distributing's non-voting stock is held by D ESOP. Distributing conducts business a on the accrual method of accounting. Distributing does not join in the filing of a consolidated income tax return.

We have received financial information indicating that Distributing's business a had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

The taxpayer wishes to completely separate the activities of its State Y division from the activities of its State X division. Dissension and jealousy have arisen between the employee/shareholders of the two divisions which are having an adverse effect on the day-to-day operations of Distributing. In order to eliminate the problems generated by this situation, and allow the employee/shareholders of each division to control the operations and profitability of their respective divisions, the following transaction has been proposed and partially consummated:

- (i) Distributing formed Controlled as a State Y accrual basis corporation on Date 1 with both voting and non-voting stock outstanding. Distributing will transfer assets of its State Y division to Controlled in exchange for all of the Controlled stock and the assumption of related liabilities.
- (ii) Distributing will distribute all of the Controlled stock to B, and C ESOP. B will surrender all of his Distributing voting stock and receive Controlled voting stock in exchange. D ESOP will surrender all shares of Distributing stock (voting and non-voting) beneficially owned by employees (and former employees) of Distributing who will become employees of Controlled and C ESOP will receive Controlled stock in exchange.

The taxpayer has made the following representations in connection with the proposed transaction (For purposes of the following representations and rulings, C ESOP will be considered a Distributing shareholder and treated as if it received Controlled stock in exchange for the Distributing stock held by D ESOP for the benefit of employees who will work for Controlled).

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- (a) The fair market value of the Controlled stock and other consideration to be received by each Distributing shareholder approximately equals the fair market value of the Distributing stock surrendered by the shareholder 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 five years of financial information submitted on behalf of Distributing are representative of the corporation's present operations, and 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 own separate employees, the active conduct of its share of all of the integrated activities of business a.
- (e) The distribution of stock of Controlled is being carried out for the following corporate business purpose: to enhance the morale of the employee/shareholders of Distributing by allowing the employee/shareholders to control the operations and profitability of the division in which each employee/shareholder works. Moreover, since there presently is dissension and jealousy between the State X and State Y divisions, it is anticipated that the transaction will totally eliminate such dissension. The distribution of the stock of Controlled is motivated in whole, or substantial part, by this corporate business purpose.
- (f) 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 subsequent to the proposed transaction other than sales by A or B to employees of their respective corporations upon A or B's retirement.
- (g) 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 § 4.05(1)(b) of Rev. Proc. 96-30.
- (h) 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.

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- (i) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing will each equal or exceed the sum of the liabilities assumed by Controlled plus any liabilities to which the assets transferred are subject. The liabilities to be 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.
- (j) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.
- (k) Payments made in connection with all continuing transactions 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.
- (l) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (m) Distributing is not an S corporation (within the meaning of § 1361(a)) and there is no plan or intention by Distributing or Controlled to make an S corporation election pursuant to §1362(a).
- (n) 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 combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.

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

- (1) The transfer by Distributing to Controlled of the State Y division solely in exchange for all of the stock of Controlled and the assumption of certain liabilities, as described above, followed by the distribution of all of the Controlled stock to the Controlled shareholders in exchange for all of their Distributing stock will be a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each be "a party to a reorganization" within the meaning of § 368(b).
- (2) Distributing will recognize no gain or loss upon the transfer of assets, subject to liabilities, to Controlled in exchange for Controlled stock, as described above (§§ 357(a) and 361(a)).

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- (3) Controlled will recognize no gain or loss on the receipt of the assets of the State Y division in exchange for Controlled stock (§ 1032(a)).
- (4) The basis of each asset received by Controlled will be the same as the basis of that asset in the hands of Distributing immediately prior to the transaction (§ 362(b)).
- (5) The holding period of the Distributing assets received by Controlled will include the period during which these assets were held by Distributing (§ 1223(2)).
- (6) Neither B nor C ESOP will recognize gain or loss (and no amount will be included in the income of B or C ESOP) upon the receipt of the Controlled stock in exchange for all of their Distributing stock, as described above (§ 355(a)(1)).
- (7) Distributing will recognize no gain or loss upon the distribution of all of its Controlled stock (§ 361(c)).
- (8) B and C ESOP's basis in their Controlled stock, in each instance, will equal the aggregate basis of their Distributing stock surrendered in the exchange (§ 358(a)(1)).
- (9) The holding period of the Controlled stock received by the Controlled shareholders will include the holding period of the Distributing stock surrendered in the exchange, provided that the Distributing stock is held as a capital asset on the date of the exchange (§ 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.
- (11) For purposes of determining net unrealized appreciation in Controlled stock, the trustees of C ESOP will have a basis in the Controlled stock equal to the basis of the trustees of D ESOP immediately prior to the exchange, allocated in accordance with the fair market value of the Controlled and Distributing stock on the date of the exchange.
- (12) Those Controlled shares which were received in exchange for employer securities of Distributing will be deemed to have been acquired by or contributed to the ESOP on or before December 31, 1986, for purposes of § 401(a)(28), and, consequently, will not be subject to the diversification requirements of that section.

We express no opinion about the tax treatment of the proposed transaction

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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 transaction that are not specifically covered by the above rulings.

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

Each affected taxpayer must attach a copy of this letter to the taxpayer's federal income tax return for the tax year in which the transaction covered by this ruling letter is consummated.

We have sent a copy of this letter to the taxpayer pursuant to the power of attorney on file in this office.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By Ken Cohen

Ken Cohen  
Senior Technician Reviewer, Branch 3