

**Internal Revenue Service**

Department of the Treasury

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Distributing =

State X =

Shareholder 1 =

Shareholder 2 =

y =

ss =

Controlled =

This letter responds to your request dated November 23, 1998, for rulings concerning the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated March 23, 1999, April 8, 1999, April 28, 1999, June 28, 1999, June 30, 1999, July 1, 1999, July 6, 1999, and July 19, 1999. The information submitted for consideration is summarized below.

The rulings contained in this letter are based upon information and

representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Distributing is a closely held State X corporation engaged in the rental real estate business. It is a cash method taxpayer filing its returns on a calendar year. Distributing has one class of common stock outstanding. Shareholder 1 and Shareholder 2 each own y percent of the outstanding Distributing stock. Financial information has been received indicating that Distributing's business had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

The rental real estate business holds a number of residential and commercial rental properties. In addition, it holds unimproved multifamily residential properties. Distributing employees are actively engaged in the following regular business activities: advertising for tenants, speaking with potential tenants, showing properties to potential tenants, collecting rent, cleaning and maintaining common areas, receiving calls from tenants for repairs, paying utility, insurance and tax bills, and when necessary evicting tenants, including serving notices and processing through the courts. With respect to one property, in addition to the above activities, Distributing employees regularly clean and stock the unit. In addition, Distributing employees are periodically engaged in making major repairs, including renovations. The work required for these repairs is either personally performed by Distributing employees, or contracted for by Distributing employees.

Significant disagreements have developed between Shareholder 1 and Shareholder 2 concerning management and business objectives of Distributing. The shareholders differ on issues of repair and maintenance of the properties, alternatives for development of properties, employment of additional personnel, marketing and mortgaging of assets to obtain financing for development and acquisitions.

Accordingly, the shareholders have adopted a plan of reorganization to go their separate ways which will consist of the following steps (the proposed transaction):

- (i) Distributing will form Controlled, a State X corporation, as a wholly owned subsidiary by transferring certain of its residential and commercial properties and certain of its undeveloped properties to Controlled solely in exchange for ss shares of Controlled common stock.
- (ii) Distributing will distribute all of its Controlled stock to Shareholder 2 in exchange for all of Shareholder 2's Distributing stock.

In the 12 month period immediately following the proposed transaction,

Distributing and Controlled will be actively engaged in all the above mentioned rental real estate business activities with respect to properties held respectively by the two corporations. Distributing also plans to build a small apartment building on one property. Controlled also plans to substantially renovate one commercial rental property and build rental units on several unimproved multifamily residential properties or sell the properties and purchase improved rental properties with the proceeds.

Distributing has made the following representations concerning the proposed transaction:

- (a) Controlled will not be indebted to Distributing after the distribution of the Controlled stock.
- (b) The fair market value of the Controlled stock and the other consideration to be received by each shareholder of Distributing will be approximately equal to the fair market value of the Distributing stock surrendered by the 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) No part of the consideration to be distributed by Distributing will be received by a security holder.
- (e) The five years of financial information submitted on behalf of Distributing is representative of the corporation's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (f) Following the transaction, Distributing and Controlled will each continue, independently and with its separate employees, the active conduct of its business or businesses.
- (g) The distribution of the stock of Controlled is carried out for the following corporate purpose: To allow the rental real estate businesses to prosper by allowing Shareholder 1 and Shareholder 2 to separately operate and manage their own business thus ending their current deadlock with respect to business decisions. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (h) There is no plan or intention by the shareholders or security holders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in either Distributing or Controlled after the transaction.

- (i) There is no plan or intention by either Distributing or Controlled, directly or indirectly, to purchase any of its outstanding stock after the transaction.
- (j) 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.
- (k) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled 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.
- (l) The income tax liability for the taxable year in which investment credit property (including any building to which section 47(d) applies) is transferred will be adjusted pursuant to section 50(a)(1) or (a)(2) (or section 47, as in effect before amendment by Public Law 101-508, Title 11, 104 Stat. 1388, 536 (1990), if applicable) to reflect an early disposition of the property.
- (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.
- (p) No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).

Based solely on the information submitted and the representations made, we rule as follows concerning the proposed transaction:

- (1) The transfer by Distributing to Controlled of a portion of the assets of the rental real estate business, solely in exchange for all of the shares of Controlled stock, followed by the distribution of the Controlled stock in exchange for all of the Distributing stock owned by Stockholder 2, will be a reorganization within the meaning of section 368(a)(1)(D) of the Code. Distributing and Controlled will each be "a party to the reorganization" within the meaning of section 368(b).

- (2) No gain or loss will be recognized by Distributing upon the transfer of assets, subject to liabilities, if any, to Controlled in exchange for shares of Controlled stock (section 361(a) and 357(a)).
- (3) No gain or loss will be recognized by Controlled on the receipt of assets from Distributing in exchange for the shares of Controlled stock (section 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 (section 362(b)).
- (5) The holding period of the Distributing assets received by Controlled will include the period during which such assets were held by Distributing (section 1223(2)).
- (6) No gain or loss will be recognized by Distributing upon the distribution of all of the shares of Controlled to Shareholder 2 in exchange for all of Shareholder 2's Distributing stock (section 361(c)).
- (7) No gain or loss will be recognized by (and no amount will be included in the income of) Shareholder 2 on the receipt of Controlled stock in exchange for all of Shareholder 2's Distributing stock (section 355(a)).
- (8) The basis of the Controlled stock received by Shareholder 2 will be the same as the basis of the Distributing stock surrendered in exchange therefor (section 358(a)).
- (9) The holding period of the Controlled stock received by Shareholder 2 will include the holding period of the Distributing stock exchanged therefor, provided that such stock is being held as a capital asset on the date of the exchange (section 1223(1)).
- (10) As provided in section 312(h) of the code, proper allocation of earnings and profits between Distributing and Controlled will be made under section 1.312-10(a) of the regulations.

No opinion is expressed about the tax treatment of the transactions 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 transaction that are not specifically covered by the above rulings.

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

A copy of this letter should 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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By: *Mark S. Jennings*

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Branch 1