

**Internal Revenue Service**

Department of the Treasury

Index Number: 355.01-00  
368.04-00

Washington, DC 20224

Number: **199947020**  
Release Date: 11/26/1999

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Telephone Number:

Refer Reply To:  
CC:DOM:CORP:3-PLR-109353-99  
Date:  
August 31, 1999

Distributing =

Controlled 1 =

Controlled 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Business 1 =

Business 2 =

Business 3 =

Business 4 =

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Business 5 =

Pool 1 =

Pool 2 =

Pool 3 =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

a =

b =

c =

This letter responds to a request dated May 17, 1999 for rulings about the federal income tax consequences of a proposed transaction. We have received additional information in letters dated July 28, 1999, August 18, 1999, August 19, 1999, August 26, 1999 and August 27, 1999. The information submitted for consideration is summarized below.

Distributing is an accrual basis taxpayer that maintains its books on the basis of a fiscal year ending Date 1. Distributing elected to be taxed as an S corporation effective Date 2 (a date before January 1, 1987). Distributing has two classes of common stock issued and outstanding: voting common stock and nonvoting common stock. Distributing has a shares of voting common and b shares of nonvoting common stock issued and outstanding.

Distributing is engaged in the Business 1. Distributing's products are divided into four separate product lines/businesses: (i) the Business 2; (ii) the Business 3; (iii) the Business 4; and (iv) the Business 5 (collectively the "Businesses").

Distributing has consistently accounted for its inventories under the LIFO method since its fiscal year ended on Date 7. Distributing uses the dollar-value, double-extension LIFO method. Distributing pools its inventories into three pools: Pool 1, Pool 2 and Pool 3.

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Shareholder 1 and Shareholder 2 started Distributing and the Business 2 in Date 3, the Business 3 in Date 5, the Business 4 in Date 4, and the Business 5 in Date 6. Financial information has been received which indicates that the Businesses each have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Information has been received indicating the existence of substantial differences in the managerial philosophies of the Businesses that have arisen among the shareholders in operating the Businesses under a single corporate umbrella. Statements from Distributing's representatives and investment banker indicate that in order to resolve shareholder conflicts that have impeded, and likely will continue to impede, the growth and profitability of Distributing, Distributing should be split up.

Information has also been received indicating the need to obtain capital to grow and expand the Business 5. In order to raise capital to effect its plans, Controlled 2, described below, proposes to undertake an initial public offering ("IPO") of approximately c percent of Controlled's total outstanding stock. Distributing has concluded, based upon documentation provided by its investment banker, that an IPO will be significantly more effective if the Business 5 is separated from Distributing.

To accomplish these objectives, the taxpayer has proposed the following transaction (the "Proposed Transaction"):

- (1) The assets and liabilities of the Business 2 will be transferred to Controlled 1 in exchange for all of its stock.
- (2) Distributing will then distribute the stock of Controlled 1 to Shareholder 1 and the Estate of Shareholder 2 in exchange for all of their stock in Distributing.
- (3) Following the distribution, Controlled 1 will elect the dollar-value LIFO method of valuing its inventory.
- (4) Following the distribution, Controlled 1 will elect to be an S corporation.
- (5) The assets and liabilities of the Business 5 will be transferred to Controlled 2 in exchange for all of its stock.
- (6) Distributing will distribute all of the shares of Controlled 2 that it receives in the exchange pro rata to its remaining shareholders.
- (7) Following the distribution, Controlled 2 will elect the dollar-value LIFO method of valuing its inventory.
- (8) Following the distribution, Controlled 2 will elect to be an S corporation for the period of time prior to the IPO.

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- (9) Prior to the public sale of stock, and while it is an S corporation, Controlled 2 will declare a dividend equal to the amount of the accumulated adjustment account (“AAA”) that is allocated to it under § 1.1368-2(d)(3). The dividend will be paid to the shareholders by the issuance of interest-bearing notes.
- (10) Following the distribution, Controlled intends to sell approximately c percent of its stock to the public in an underwritten offering.

With respect to the Proposed Transaction, the taxpayer has made the following representations:

- (a) The fair market value of the Controlled 1 stock to be received by Shareholder 1 and the Estate of Shareholder 2 will be approximately equal to the fair market value of the Distributing stock surrendered 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 Distributing.
- (c) The 5 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.
- (d) Following the distributions, Distributing, Controlled 1 and Controlled 2 will each continue the active conduct of its business, independently and with its separate employees except that following the distribution, Distributing will provide computer and data processing services to Controlled 1 and Controlled 2 pursuant to forthcoming agreements for an initial term of 5 years subject to renewal; and, Distributing may perform disbursement functions for Controlled 1.
- (e) The distribution of the stock of Controlled 1 is carried out for the following corporate business purpose: to resolve managerial and shareholder problems that have arisen. This will enable a significant shareholder group to concentrate on a particular business. The distribution of the Controlled 1 stock is motivated, in whole or substantial part, by this corporate business purpose.
- (f) The distribution of the stock of Controlled 2 is carried out for the following corporate business purposes: to raise additional capital needed to fund the expansion and operation of the business. The proposed distribution of Controlled 2 creates a company operating in a single segment, Business 5, which should enable Controlled 2 to raise capital in the IPO on a more cost effective basis. The distribution of the Controlled 2 stock is motivated, in whole

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or substantial part, by this corporate business purpose.

- (g) There is no noncorporate business purpose. A purpose of the transaction is not to facilitate personal shareholder planning.
- (h) Distributing is an S corporation (within the meaning of § 1361(a)). Controlled 1 and Controlled 2 will elect to be an S corporation pursuant to § 1362(a) on the first available date after the distribution. There is no plan or intention to revoke or otherwise terminate the S corporation election of either Distributing or Controlled 1. Controlled 2's S corporation status will be terminated pursuant to the IPO.
- (i) 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, or securities of, Distributing, Controlled 1 or Controlled 2 after the transaction, except that the Estate of Shareholder 2 will distribute his stock in Controlled 1 in accordance with his will.
- (j) There is no plan or intention by either Distributing, Controlled 1 or Controlled 2, 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, 1996-1 C.B. 696.
- (k) There is no plan or intention to liquidate Distributing, Controlled 1 or Controlled 2, to merge Distributing, Controlled 1 or Controlled 2 with any other corporation or to sell or otherwise dispose of the assets of Distributing, Controlled 1 or Controlled 2 after the transaction, except in the ordinary course of business.
- (l) The total adjusted bases and the fair market value of the assets transferred to Controlled 1 and Controlled 2, respectively, by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled 1 and Controlled 2, respectively, plus any liabilities to which the transferred assets are subject.
- (m) 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.
- (n) None of the property transferred from Distributing to Controlled 1 and Controlled 2, respectively, is property with respect to which any investment credit under § 46 has been, or will be, claimed or with respect to which any investment credit is required to be recaptured.
- (o) No intercorporate debt will exist between any of Distributing, Controlled 1 and Controlled 2 at the time of, or subsequent to, the distribution of the Controlled 1

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and Controlled 2 stock.

- (p) Payments made in connection with all continuing transactions, if any, between any of Distributing, Controlled 1 and Controlled 2 will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (q) Neither Distributing, Controlled 1 nor Controlled 2 are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (r) The distributions are not part of a plan or a 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 combined voting power of all classes of stock of Distributing, Controlled 1 or Controlled 2, or stock possessing 50% or more of the total value of all classes of stock of Distributing, Controlled 1 or Controlled 2.

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

- (1) The transfer of the assets of the Business 2 to Controlled 1 in exchange for Controlled 1 stock and the assumption of related liabilities followed by the distribution of the Controlled 1 stock will be a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled 1 will each be a "party to the reorganization" within the meaning of § 368(b).
- (2) No gain or loss will be recognized by Distributing on the transfer of the assets of the Business 2 to Controlled 1 in exchange for Controlled 1 stock and the assumption by Controlled 1 of related liabilities. Sections 361(a) and 357(a).
- (3) No gain or loss will be recognized by Controlled 1 on its receipt of the assets of the Business 2 in exchange for Controlled 1 stock. Section 1032(a).
- (4) The basis of the assets to be received by Controlled 1 will be equal to the basis of such assets in the hands of Distributing immediately before the transfer. Section 362(b).
- (5) The holding period for each asset received by Controlled 1 will include the period during which such asset was held by Distributing. Section 1223(2).
- (6) No gain or loss will be recognized by (and no amount will be included in the income of) Shareholder 1 or the Estate of Shareholder 2 upon the receipt of the stock of Controlled 1 in exchange for all of their stock of Distributing. Section 355(a)(1).

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- (7) The basis of the stock of Controlled 1 to Shareholder 1 and the Estate of Shareholder 2 will be the same as the basis of their Distributing stock exchanged therefor. Section 358(a).
- (8) The holding period of the Controlled 1 stock received by Shareholder 1 and the Estate of Shareholder 2 will include the holding period of their Distributing stock surrendered on the exchange, provided that the Distributing stock was held as a capital asset by them on the date of the exchange. Section 1223(1).
- (9) No gain or loss will be recognized by Distributing on the distribution of the Controlled 1 stock to Shareholder 1 and the Estate of Shareholder 2. Section 361(c).
- (10) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled 1 will be made under § 1.312-10(a). Under § 1.1368-2(d)(3), the AAA of Distributing will be allocated between Distributing and Controlled 1 in a manner similar to the manner in which Distributing will allocate its earnings and profits between itself and Controlled 1 under § 1.312-10(a).
- (11) The transfer of the assets of the Business 5 to Controlled 2 in exchange for Controlled 2 stock and the assumption of related liabilities followed by the distribution of the Controlled 2 stock will be a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled 2 will each be a “party to the reorganization” within the meaning of § 368(b).
- (12) No gain or loss will be recognized by Distributing on the transfer of the assets of the Business 5 to Controlled 2 in exchange for Controlled 2 stock and the assumption by Controlled 2 of related liabilities. Sections 361(a) and 357(a).
- (13) No gain or loss will be recognized by Controlled 2 on its receipt of the assets of the Business 5 in exchange for Controlled 2 stock. Section 1032(a).
- (14) The basis of the assets to be received by Controlled 2 will be equal to the basis of such assets in the hands of Distributing immediately before the transfer. Section 362(b).
- (15) The holding period for each asset received by Controlled 2 will include the period during which such asset was held by Distributing. Section 1223(2).
- (16) No gain or loss will be recognized by (and no amount will be included in the income of) the Distributing shareholders upon the receipt of the stock of Controlled 2 from Distributing. Section 355(a)(1).

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- (17) The aggregate basis of Distributing and Controlled 2 stock in the hands of a Distributing shareholder after the distribution will equal the aggregate basis of the Distributing stock held immediately before the distribution, allocated between the Distributing stock and Controlled 2 stock in proportion to the relative fair market value of each in accordance with § 1.358-2(a)(2). Section 358(a), (b) and (c).
- (18) The holding period of the Controlled 2 stock received by a Distributing shareholder will include the holding period of the Distributing stock on which the distribution will be made, provided that the Distributing stock is held as a capital asset by them on the date of the distribution. Section 1223(1).
- (19) No gain or loss will be recognized by Distributing on the distribution of the Controlled 2 stock to the shareholders. Section 361(c).
- (20) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled 2 will be made under § 1.312-10(a). Under § 1.1368-2(d)(3), the AAA of Distributing will be allocated between Distributing and Controlled 2 in a manner similar to the manner in which Distributing will allocate its earnings and profits between itself and Controlled 2 under § 1.312-10(a).
- (21) Provided that Distributing immediately distributes the stock of Controlled 1 and Controlled 2, Distributing's momentary ownership of their stock will not cause either Controlled 1 or Controlled 2 to have an ineligible shareholder under § 1361(b)(1)(B). Therefore, Controlled 1 and Controlled 2 are each eligible to make a timely election, without the consent of Distributing, to be an S corporation for their first taxable year, provided that Controlled 1 and Controlled 2 each satisfy the other requirements under § 1361(b).
- (22) Neither Controlled 1 nor Controlled 2 will be subject to § 1374 of the Tax Reform Act of 1986.
- (23) Assuming Controlled 2 is eligible to be an S corporation under § 1361(b) and properly makes an election under § 1362(a), Controlled 2 will remain an S corporation until Controlled 2's S corporation election terminates under § 1362(d).
- (24) Controlled 1 and Controlled 2 each may elect to use the LIFO inventory method for their initial taxable year by timely filing an appropriate Form 970 with its respective federal income tax return and otherwise complying with the requirements of § 472 and the regulations thereunder. Whether or not Controlled 1 and Controlled 2's applications for the adoption and use of the LIFO inventory method should be approved will be determined by the Commissioner in

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connection with the examination of Controlled 1 and Controlled 2's federal income tax returns. See § 1.472-3(d).

- (25) The Business 2 inventory transferred by taxpayer to Controlled 1 shall be treated by Controlled 1 as its opening inventory for LIFO purposes.
- (26) The Business 5 inventory transferred by taxpayer to Controlled 2 shall be treated by Controlled 2 as its opening inventory for LIFO purposes.
- (27) Controlled 1 and Controlled 2 each must determine the cost of its opening inventory by the average cost method as provided by § 472(b)(3).
- (28) Distributing must compute its basis in the inventories transferred using a pro rata (vertical) division of the base-year and subsequent yearly incremental costs in accordance with the procedures established in § 1.472-8(g)(2). See Rev. Rul. 85-176, 1985-2 C.B. 159.
- (29) Controlled 1 and Controlled 2 must determine the total current-year cost of items making up a pool by use of one of the methods described in § 1.472-8(e)(2)(ii)(a) through (d).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed as to the propriety of Distributing's LIFO inventory method, the valuation of Distributing's inventory by Distributing or the timeliness and validity of any past, present or future elections under § 472 by Distributing, Controlled 1 or Controlled 2. In addition, we express no opinion as to the validity of Distributing's S corporation election, whether Controlled 1 and Controlled 2 are eligible to elect S corporation status or whether the elections will be valid under § 1362. Moreover, we express no opinion as to the estate or gift tax consequences of any of the transactions.

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.

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

A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon facts and representations submitted in your request for a ruling. The facts and representations were accompanied by a penalty of perjury statement that the taxpayer executed. This office

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has not verified any of the facts and representations. Verification of the facts, representations and other data may be required as part of a future audit of Distributing, Controlled 1 and Controlled 2's federal income tax returns.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By *Ken Cohen*

Ken Cohen  
Senior Technical Reviewer, Branch 3