

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

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Refer Reply To:  
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Date:  
April 27, 2000

Re:

Distributing =

Controlled =

State X =

State Y

State Z =

Business A =

Business B =

Business C =

A =

B =

C =

D =

E =

Dear :

This is in reply to a letter dated November 17, 1999, in which rulings were requested as to the federal income tax consequences of a proposed transaction.

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Addition information has been submitted in and with a letter dated April 20, 2000. The information submitted for consideration is substantially as set forth below.

Distributing is an accrual basis State Y corporation actively engaged in Business A, Business B, and Business C. Distributing is an S corporation. Business A is located in State X. Business B is located in State Y. Business C is located in State Z. As of November 17, 1999, Distributing has outstanding 34,087 shares of no par value voting common stock that were owned by A (10,701 shares; about 31.4%), B (11,073 shares; about 32.5%), C (9,313 shares; about 27.3%), D (1,500 shares; about 4.4%), and E (1,500 shares; about 4.4%).

Controlled is an accrual basis State X corporation formed to effectuate the proposed transaction. Controlled will elect S corporation status. Controlled will have issued and outstanding 100,000 shares of voting common stock, all of which initially will be held by Distributing.

Financial information has been received which indicates that Business A, Business B, and Business C of Distributing 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.

A, B, C, D, and E have decided to split up the businesses of Distributing due to ongoing and unreconcilable disputes on how the businesses of Distributing should be conducted. Specifically, the Distributing shareholders disagree on the management, acquisition, expansion and development of goals for Distributing. Accordingly, they propose the following transaction:

- (i) Distributing will transfer to the newly-formed Controlled all of the assets and liabilities pertaining to the operation of Business A. In exchange, Distributing will receive all of the 100,000 issued and outstanding shares of Controlled voting common stock.
- (ii) Then, Distributing will distribute all 100,000 shares of Controlled stock to A solely in exchange for all of A's shares of Distributing stock.
- (iii) Controlled will elect to be an S corporation immediately after the proposed transaction effective for its first tax year.

The taxpayer has made the following representations in connection with the proposed transaction:

- (a) The fair market value of the stock of Controlled received by A, described in step (ii) above, will approximately equal the fair market value of the Distributing stock surrendered by A in the exchange.

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- (b) No part of the consideration to be distributed by Distributing is being received by a shareholder as a creditor, employee, or in any capacity other than as a shareholder of the corporation.
- (c) The five years of financial information submitted on behalf of Distributing is 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 proposed transaction, Distributing and Controlled will each continue, independently and with their separate employees, the active conduct of the businesses previously conducted solely by Distributing.
- (e) The distribution of the stock of Controlled is carried out for the following corporate business purpose: management disagreements between shareholders which have an unfavorable effect on the operations of Distributing. The distribution of the stock of Controlled is motivated in whole 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 Distributing or Controlled subsequent to the transaction.
- (g) There is no plan or intention by either Distributing or Controlled, 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.
- (h) 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 subsequent to the transaction, except in the ordinary course of business.
- (i) The income tax liability for the taxable year in which investment credit property (including any building to which §47(d) applies) is transferred will be adjusted pursuant to § 50(a)(1) or (a)(2) (or §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.
- (j) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (k) No intercorporate debt will exist between Distributing and Controlled at the

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time of or subsequent to the proposed distribution.

- (l) Any 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.
- (m) No two parties to the transaction are "investment companies" as defined in § 368(a)(2)(F)(iii) and (iv).
- (n) 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.
- (o) 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 directly associated with the assets being transferred.
- (p) 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.
- (q) The distribution of the Controlled stock 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 total 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 on the representatives set forth above, we hold as follows:

- (1) The transfer by Distributing to Controlled of the assets and liabilities of Business A as described in step (i) above, solely in exchange for all of the outstanding stock of Controlled, followed by the distribution of the Controlled stock by Distributing to A in exchange for all of their Distributing stock will be a reorganization within the meaning of §368(a)(1)(D). Distributing and Controlled each 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 assets and

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liabilities to Controlled in exchange for Controlled stock (§361(a) and 357(a)).

- (3) Controlled will recognize no gain or loss on the receipt of assets and liabilities in exchange for the Controlled stock (§ 1032(a)).
- (4) Controlled's basis in the assets received will be the same as the basis of such assets in the hands of Distributing immediately prior to the transaction (§362(b)).
- (5) Controlled's holding period for the assets received from Distributing will include the period during which such assets were held by Distributing (§1223(2)).
- (6) Distributing will recognize no gain or loss upon the distribution of all of its Controlled stock in exchange for their Distributing stock (§361(c)(1)).
- (7) No gain or loss will be recognized to (and no amount will be included in the income of A) upon the receipt of the Controlled stock in exchange for all of their shares of Distributing stock (§355(a)(1)).
- (8) A's basis in the Controlled stock after the distribution will be the same as A's basis in the Distributing stock surrendered in exchange therefor (§358(a)(1)).
- (9) A's holding period in the Controlled stock received will include the holding period of the Distributing stock surrendered in exchange therefor, provided that the Distributing stock is held as a capital asset by the shareholder 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) The provisions of Rev. Rul. 74-101, 1974-1C.B. 7, will be applied, where applicable, to any "§38 property" covered by this ruling letter.
- (12) The momentary affiliation by Distributing of the stock of Controlled in connection with the reorganization will not, in and of itself, make Controlled ineligible to elect to be an S corporation for its first tax year, provided that Controlled otherwise meets the other requirements under §1361(b).
- (13) The S election to be made by Controlled immediately following the

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distribution of Controlled's stock by Distributing will not subject Controlled's assets to be taxed under §1374.

We express no opinion about the tax treatment of the 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 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) 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 returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

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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 L. Carlisle

Chief, Branch 5