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LEGEND

Distributing =

Controlled 1 =

Controlled 2 =

State X =

Year 1 =

Year 2 =

Business Y =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Individual E =

Individual F =

g =

h =

i =

j =
k =
L =
m =

We respond to your letter dated December 4, 2001, requesting rulings on the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated January 10, 2002, January 23, 2002, February 4, 2002 and February 22, 2002. The information submitted for consideration is summarized below.

SUMMARY OF FACTS

Distributing, a calendar year taxpayer, is a State X corporation that was incorporated in Year 1. Distributing is engaged in Business Y and elected to be taxed as an S corporation, within the meaning of §1361(a) of the Internal Revenue Code (the "Code"), effective on the first day of Year 2.

Distributing has outstanding g shares of voting common stock, which are owned by Shareholder A (h shares representing i% of outstanding Distributing voting common stock), Shareholder B (h shares representing i% of outstanding Distributing voting common stock), Shareholder C (j shares representing k% of outstanding Distributing voting common stock), Shareholder D (j shares representing k% of outstanding Distributing voting common stock). Shareholder A, Shareholder B, and Shareholder C are siblings. Shareholder C and Shareholder D are husband and wife.

The above shareholders are each engaged full-time in the activity of Business Y. Shareholder C is currently the President of Distributing. Shareholder B is currently the Secretary-Treasurer of Distributing.

After the distribution set forth below: Shareholder C will remain the President of Distributing and Shareholder D will serve as Secretary-Treasurer for Distributing; Shareholder A will serve as the President of Controlled 1 and Individual E, the spouse of Shareholder A, will serve as Secretary-Treasurer for Controlled 1; Shareholder B will serve as the President of Controlled 2 and Individual F, the spouse of Shareholder B, will serve as Secretary-Treasurer for Controlled 2.

Financial information has been received that indicates that Business Y has had gross receipts and operating expenses of the active conduct of a trade or business for each of the past 5 years.

Serious disputes have arisen among the shareholders, which have adversely affected the business operations of Distributing. In order to alleviate the problems caused by the disputes among the shareholders, the following transaction is proposed:

- (i) Distributing will form Controlled 1 and Controlled 2 (each known as a “Controlled Corporation” and collectively referred to as the “Controlled Corporations”) as wholly owned subsidiaries. The Controlled Corporations will be State X corporations and have a calendar tax year. Each Controlled Corporation will have 100,000 shares outstanding.
- (ii) Distributing will transfer a portion of the operating assets of Business Y and, in order to equalize the value of the corporations, “other assets” to Controlled 1 in exchange for all of the outstanding stock of Controlled 1 and the assumption of liabilities by Controlled 1. The “other assets” include a portion of a note receivable from Shareholder A.

Distributing will transfer a portion of the assets of Business Y and, in order to equalize the value of the corporations, “other assets” to Controlled 2 in exchange for all of the stock of Controlled 2 and the assumption of liabilities by Controlled 2. The “other assets” include the remaining portion of the note receivable from Shareholder A, a note receivable from Shareholder C, and a note receivable from Individual F.

- (iii) Thereafter, Shareholder A will exchange all of his shares of Distributing stock for all of the outstanding shares of Controlled 1 and Shareholder B will exchange all of her shares of Distributing stock for all of the outstanding shares of Controlled 2; and
- (iv) Each of the Controlled Corporations will elect S status immediately after the distribution.

Immediately after this transaction, Shareholder A will own L% of the outstanding stock of Controlled 1, Shareholder B will own L% of the outstanding stock of Controlled 2, Shareholder C will own m% of the outstanding stock of Distributing, and Shareholder D will own m% of the outstanding stock of Distributing.

REPRESENTATIONS

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

- (a) The fair market value of the stock of each Controlled Corporation and other consideration received by each shareholder of Distributing will be approximately equal to the fair market value of the Distributing stock surrendered by each of the shareholders 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 5 years of financial information submitted on behalf of Distributing is representative of the corporation's present operations, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statement submitted.
- (d) Following the transaction, Distributing and each of the Controlled Corporations will continue, independently and with its separate employees, the active conduct of its share of all of the integrated activities of the business conducted by Distributing prior to the consummation of the transaction.
- (e) The distribution of the stock of each of the Controlled Corporations is carried out for the following corporate business purposes: to resolve the conflict in management and allow each of the three shareholders to manage their share of the assets of Distributing in the manner they see best fit to accomplish their objective as well as coordinate that activity with their individual farming businesses. The distribution of the stock of each Controlled Corporation is motivated, in whole or substantial part, by that corporate business purpose.
- (f) Distributing is an S corporation (within the meaning of §1361(a) of the Code). 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 intent to revoke or otherwise terminate the S corporation election of Distributing or the Controlled Corporations.
- (g) There is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift, have redeemed, or otherwise dispose of any of their stock in Distributing or in either of the Controlled Corporations after the transaction.
- (h) There is no plan or intention by Distributing or either of the Controlled Corporations, directly or through any subsidiary corporation, to purchase any of their 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.
- (i) The distribution of Controlled 1 to Shareholder A and Controlled 2 to Shareholder B would qualify as an exchange under §302 (a) of the Code in the event it did not qualify under §355.
- (j) The notes receivable from Shareholder A, Individual F, and Shareholder C comprise all of the investment assets of Distributing prior to the transfer of assets to the Controlled Corporations. These notes were incurred in arms length

bargaining transactions. The notes are held for collection in the normal course of business under the terms of the original contract. After the distribution of the stock of the Controlled Corporations, these notes will continue to be held for collection in the normal course of business under the terms of the original contract.

- (k) There is no plan or intention to liquidate Distributing or either of the Controlled Corporations, to merge any of these corporations with any other corporation, or to sell or otherwise dispose of the assets of any of the corporations after the transaction, except in the ordinary course of business.
- (l) The total adjusted basis 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 were incurred in the ordinary course of business and are associated with the assets being transferred.
- (m) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (n) No indebtedness has been or will be cancelled in connection with the transaction. No intercorporate debt will exist between Distributing and either of the Controlled Corporations at the time of, or subsequent to, the distribution of the stock of each Controlled Corporation.
- (o) Payments made in connection with all continuing transactions, if any, will be for fair market value based on the terms and conditions arrived at by the parties bargaining at arm's length.
- (p) None of the parties to the transaction are investment companies as defined in §368(a)(2)(F)(iii) and (iv) .
- (q) For purposes of §355(d), immediately after the distribution, no person (determined after applying §355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in §355(d)(5) and (8)) during the five-year period (determined after applying §355(d)(6)) ending on the distribution date.

For purposes of §355(d), immediately after the distribution, no person (determined after applying §355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled 1 and Controlled 2 stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Controlled 1 and Controlled 2 stock, that was either (i)

acquired by purchase (as defined in §355(d)(5) and (8)) during the five-year period (determined after applying §355(d)(6)) ending on the distribution date, or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in §355(d)(5) and (8)) during the five-year period (determined after applying §355(d)(6)) ending on the distribution date.

- (r) The distribution is not part of a plan or series of related transaction 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 Distributing or the Controlled Corporations stock entitled to vote or stock possessing 50 percent or more of the total value of all classes of stock of Distributing or the Controlled Corporations.

RULINGS

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

- (1) The transfer by Distributing to each Controlled Corporation of a portion of its assets in exchange for all the stock of each Controlled Corporation and the assumption of liabilities by each Controlled Corporation, as described above, followed by the distribution of all of the stock of Controlled 1 to Shareholder A and Controlled 2 to Shareholder B in exchange for all of the stock of Distributing owned by such shareholders will qualify as reorganizations within the meaning of §368(a)(1)(D) . Distributing, Controlled 1 and Controlled 2 each will be a “party to a reorganization” within the meaning of §368(b) .
- (2) No gain or loss will be recognized by Distributing upon the transfer of its assets to the Controlled Corporations solely in exchange for stock of the Controlled Corporations and the assumption of liabilities (§§361(a) and 357(a)).
- (3) No gain or loss will be recognized by each Controlled Corporation upon the receipt of its designated portion of Distributing assets in exchange for the stock of each Controlled Corporation (§1032(a)).
- (4) No gain or loss will be recognized by Distributing upon the distribution of all of the stock of Controlled 1 to Shareholder A and all of the stock of Controlled 2 to Shareholder B as described above (§361(c)(1)).
- (5) The basis of the assets received by each Controlled Corporation will be the same as the basis of such assets in the hands of Distributing immediately before their transfer to each Controlled Corporation (§362(b)).
- (6) The holding period of the assets transferred to each Controlled Corporation will include the period during which such assets were held by Distributing (§1223(2)).

- (7) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) Shareholder A and Shareholder B upon receipt of Controlled 1 and Controlled 2 stock in exchange for their Distributing stock as described above (§355(a)(1)).
- (8) The basis of Controlled 1's stock in the hands of the Shareholder A will be the same as the basis of the Distributing stock surrendered by Shareholder A in exchange therefor (§358(a)(1)). The basis of Controlled 2's stock in the hands of the Shareholder B will be the same as the basis of the Distributing stock surrendered by Shareholder B in exchange therefor (§358(a)(1)).
- (9) The holding period of the Controlled 1 and Controlled 2 stock received by Shareholder A and Shareholder B will include the holding period of the Distributing stock surrendered by each of them, provided such stock is held as a capital asset on the date of the transaction (§1223(1)).
- (10) As provided in §312(h), following distribution of the stock of each Controlled Corporation, proper allocation of earnings and profits will be made among Distributing and each Controlled Corporation in accordance with §1.312-10(a) of the Income Tax Regulations.
- (11) As provided in §1.1368-2(d)(3) of the Income Tax Regulations, the Accumulated Adjustments Account (AAA) (as defined in §1368(e)(1)) of Distributing immediately prior to the distribution of the stock of each Controlled Corporation should be allocated among Distributing and the Controlled Corporations in a manner similar to the manner in which the earnings and profits of Distributing are allocated under §1.312-10(a).
- (12) Distributing's momentary ownership of the stock of each of the Controlled Corporations as part of the reorganization under §368(a)(1)(D) will not cause either Controlled Corporation to have an ineligible shareholder for any portion of its first tax year under §1361(b)(1)(B). If each of the Controlled Corporations otherwise meet the requirements of a "small business corporation" under §1361, they will be eligible to elect under §1362(a) to be S Corporations for their first tax year.
- (13) Controlled 1 and Controlled 2 will be subject to §1374 with respect to any asset transferred by Distributing to Controlled 1 or Controlled 2 to the same extent Distributing was subject to §1374 with respect to any such asset. For purposes of §1374, each Controlled Corporation's recognition period will be reduced by the portion of Distributing's recognition period that elapses prior to Distributing's transfer of any such asset to the Controlled Corporations. §1374(d)(8); Ann. 86-128, 1986-51 I.R.B 22.

CAVEAT

No opinion is expressed 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 transaction that are not specifically covered by the above rulings.

PROCEDURAL STATEMENTS

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.

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

A copy of this letter must be attached to the federal income tax return of each taxpayer involved in the taxable year in which the transaction is consummated.

Pursuant to a power of attorney on file in this office, we have sent a copy of this letter to your authorized representative.

Sincerely Yours,
Reginald Mombrun
Assistant to the Branch Chief, Branch 6
Office of Associate Chief Counsel
(Corporate)

cc: