

**Internal Revenue Service**

Department of the Treasury

Number: **200234025**  
Release Date: 8/23/2002  
Index Number: 355.04-00

Washington, DC 20224

Person to Contact:

Telephone Number:  
(202) 622-7790  
Refer Reply To:  
CC:CORP:B3-PLR-163762-01  
Date:  
May 15, 2002

RE:

Distributing =

Controlled =

Agreement A =

Agreement B =

Shareholder C =

Shareholder D =

LLC 1 =

LLC 2 =

State X =

Date 1 =

Business M =

Business N =

e =

f =

g =

h percent =

PLR-163762-01

i percent =\$j =

Asset Group =

Debt =

\$k =m =n =v =w percent =x percent =y =

Dear

We respond to your letter dated November 19, 2001, requesting rulings on the federal income tax consequences of a proposed transaction. The information submitted in that request and in the subsequent correspondence of February 22 and May 14, 2002, is substantially as set forth below.

Distributing is a State X corporation that made a subchapter S election on Date 1 and that uses the accrual method of accounting. Distributing has two classes of common stock issued and outstanding, Class A voting common stock (Class A common) and Class B nonvoting common stock (Class B common). Shareholder D, an individual, owns e shares of Class A common, which constitutes all of the Class A common, and f shares of Class B common. Shareholder C, an individual, owns the remaining g shares of the Class B common. There are two classes of preferred stock authorized, none of which is issued or outstanding.

PLR-163762-01

Distributing is a holding company that owns interests in wholly-owned subchapter C corporations, qualified subchapter S subsidiaries, and limited liability companies. Distributing is engaged in two distinct businesses: Business M and Business N. Business M is conducted through a wholly owned limited liability company, LLC 1, and Business N is conducted through a wholly owned limited liability company, LLC 2. We have received financial information indicating that Business M and Business N 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.

Controlled will be formed under the laws of State X to effectuate the proposed transaction described below. After the transaction, Controlled will elect to be treated as a subchapter S corporation and will use the accrual method of accounting.

Distributing intends to incorporate Controlled and will transfer LLC 2, cash of amount \$j, Asset Group, and Debt of amount \$k in exchange for all of the outstanding stock of Controlled. Controlled will have one class of common stock.

Distributing desires to separate the different businesses to permit management of each business to focus on the significantly different business plans of Business M and Business N. Distributing also desires to provide a mechanism for key employees of Business M and Business N to obtain meaningful equity interests in the respective businesses in order to retain and motivate existing employees. Distributing also desires to provide Controlled with acquisition currency that does not involve LLC 1's Business M.

Thus, Distributing proposes the following transaction:

- (i) Distributing will amend and restate its certificate of incorporation to change its authorized stock to one class of common stock (New Common Stock). All other classes of stock will be cancelled. Each shareholder will receive y shares of New Common Stock for each share of his Class A or Class B common stock. Distributing will cancel all existing shares of Distributing stock held as treasury stock. Thus, after the recapitalization, Shareholder C will own m shares of New Common Stock and Shareholder D will own n shares of New Common Stock;
- (ii) Distributing will transfer the following assets to newly formed Controlled in exchange for all of the outstanding Controlled stock and the assumption by Controlled of the liabilities associates with the transferred assets: 100 percent ownership interest in LLC 2; Asset Group; \$j in cash; and Debt in the principal amount of \$k;
- (iii) Distributing will distribute the shares of Controlled common stock pro rata to the shareholders of Distributing, Shareholder C and Shareholder D; and
- (iv) Key employees of Distributing and Controlled will be granted restricted stock awards within one month of the distribution. These rewards will require each

PLR-163762-01

recipient to remain with the granting corporation, with x percent of the restricted stock grant vesting each year until completion of the y-year vesting period. At the end of the vesting period, key employees of Distributing collectively will own h percent of the outstanding vote and value of the stock of Distributing, and key employees of Controlled collectively will own i percent of the outstanding vote and value of the stock of Controlled. In addition, additional amounts of stock will be made available to key employees through incentive stock option awards.

The taxpayer has made the following representations:

- (a) 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.
- (b) 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.
- (c) Following the transaction, Distributing and Controlled each will continue the active conduct of its business, independently and with its separate employees.
- (d) The distribution of the stock of Controlled is being carried out for the corporate business purpose of providing a substantial equity interest in Distributing and Controlled to their respective key employees. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (e) Distributing is an S corporation (within the meaning of §1361(a) of the Internal Revenue Code). Controlled will elect to be an S corporation pursuant to §1362(a) of the Code 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 either Distributing or Controlled.
- (f) 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, either Distributing or Controlled after the transaction, except that Shareholder C and Shareholder D may make gifts of some of their shares to their children, not to exceed w percent of the stock of either Distributing or Controlled.
- (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

PLR-163762-01

after the transaction, except pursuant to Agreement B, which provides for repurchases of stock from shareholders in certain circumstances, in line with currently existing policies and to maintain ownership of Distributing and Controlled in a closely-held group.

- (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 after the transaction, except in the ordinary course of business.
- (i) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed (as determined under §357(d)) by Controlled. The liabilities assumed (as determined under §357(d)) in the transaction 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, other than amounts owing from Distributing to Controlled under Agreement A, which provides for transitional management services.
- (k) 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.
- (l) No two parties to the transaction are investment companies as defined in §§368(a)(2)(F)(iii) and (iv) of the Code.
- (m) 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 total value of all classes of stock of either Distributing or Controlled.

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

- (1) The transfer by Distributing to Controlled of the assets described above in exchange for all of the stock of Controlled and the assumption by Controlled of the liabilities associated with those assets, followed by the distribution of all the Controlled stock pro rata to the shareholders of Distributing will qualify as 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) No gain or loss will be recognized by Distributing upon the transfer of assets

PLR-163762-01

to Controlled solely in exchange for Controlled stock and the assumption by Controlled of certain liabilities of Distributing (§§361(a) and 357(a)).

- (3) No gain or loss will be recognized by Controlled on the receipt of the assets in exchange for Controlled stock (§1032(a)).
- (4) The basis of the assets received by Controlled will be equal to the basis of such assets in the hands of Distributing immediately before the transfer (§362(b)).
- (5) The holding period of the assets received by Controlled will include the period during which such assets were held by Distributing (§1223(2)).
- (6) No gain or loss will be recognized by Distributing upon the distribution of all of the Controlled stock (§361(c)).
- (7) No gain or loss will be recognized to and no amount will be included in the income of the shareholders of Distributing upon receipt of all of the stock of Controlled from Distributing (§355(a)(1)).
- (8) The basis of the stock of Distributing and Controlled in the hands of Distributing shareholders after the distribution will be the same as the basis of the Distributing stock held immediately before the distribution, allocated in proportion to the fair market value of each in accordance with §1.358-2(a)(2) of the Income Tax Regulations (§358(a)(1)).
- (9) The holding period of the Controlled stock received by the shareholders will include the holding period of the Distributing stock with respect to which the distribution will be made, provided that such stock is held as a capital asset on the date of the distribution (§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).

Except as expressly provided herein, we express no opinion concerning the Federal income tax consequences of any aspect of the proposed transaction, or under any other provisions of the Code or 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, and specifically, no opinion is expressed regarding the allocation of the accumulated adjustments account between Distributing and Controlled.

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 returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter

PLR-163762-01

is consummated.

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

Sincerely,  
Filiz A. Serbes  
Chief, Branch 3  
Office of the Associate Chief Counsel  
(Corporate)

cc: