

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

May 22, 2002

Legend

Distributing =

Controlled #1 =

Controlled #2 =

Controlled #3 =

Estate =

A =

B =

C =

D =

Business X =

Business Y =

Business Z =

Date 1 =

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Date 2 =

a =b =c =d =e =

State A =

Dear

This is in response to a letter dated November 21, 2001, submitted on behalf of Distributing, requesting rulings under §§ 355 and 368 of the Internal Revenue Code (the “Code”) with respect to a proposed transaction. Additional information was received in letters dated January 15, 2002, January 25, 2002, March 8, 2002, and April 3, 2002.

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. The material information submitted is summarized below.

Distributing is an S corporation that files federal income tax returns on a calendar-year basis and uses the cash method. Distributing is engaged in Business X, Business Y, and Business Z. Distributing first became engaged in Business Z on Date 1. Since Date 1, Distributing has expanded Business Z by acquiring other Business Z assets.

The stock of Distributing is owned by Estate, individuals A, B, C, revocable trusts for the benefit of D and a member of D’s immediate family, and members of the immediate families of each of A, B, and D. A, B, C, and D have managed the business, with varying degrees of involvement. Of A, B, C, and D, only A and A’s family wish to continue in Business X. A and A’s family have no interest in pursuing Business Z. Although B, C, and D all wish to continue in Business Z, the level of animosity, distrust, and lack of communication among A, B, C, and D has reached the point that they can no longer successfully operate a business together. The following series of transactions (collectively, the “Distribution”) is therefore proposed:

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Distributing will form three corporations, Controlled #1, Controlled #2, and Controlled #3 (collectively, the "Controlled Corporations"). Distributing will contribute to Controlled #1 the Business X operation. Controlled #1 will also assume or refinance, in the amount of \$a, a debt now secured by certain Business Z assets that will be contributed to Controlled #2. Distributing will contribute to Controlled #2 certain Business Z assets, cash or notes in the amount \$b, and certain equipment. Controlled #2 will receive cash or notes in the amount \$c from Controlled #1. Distributing will contribute to Controlled #3 the Business Y assets, certain Business Z assets, cash or notes in the amount \$d, a note in the amount \$e owed to Distributing by C, and certain equipment. Distributing will retain certain Business Z assets.

Distributing will then distribute all of the stock of Controlled #1 to A, the members of the A family holding Distributing stock, and to Estate in exchange for the shares of Distributing held by such shareholders. Shares of Controlled #1 owned by Estate will be settled solely to A. Distributing will distribute all of the stock of Controlled #2 to B, the members of the B family holding Distributing stock, and Estate, in exchange for the shares of Distributing held by such shareholders. Shares of Controlled #2 held by Estate will be settled solely to B. Distributing will distribute all of the stock of Controlled #3 to C and to Estate, in exchange for the shares of Distributing held by such shareholders. Shares of Controlled #3 held by Estate will be settled solely to C. Following the Distribution, Distributing will retain certain Business Z assets. The stock of Distributing will be owned by revocable trusts for the benefit of D and a member of D's immediate family, and members of D's immediate family. The Distribution will not be carried out prior to Date 2 (i.e., the day following the fifth anniversary of Date 1). Each of the Controlled Corporations will elect to be an S corporation on the first available date after the Distribution.

Financial information has been received indicating that Business X has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years, and that Business Z has had gross receipts and operating expenses representing the active conduct of a trade or business for the period beginning Date 1.

Distributing has made the following representations with respect to the Distribution:

- (a) The fair market value of the stock of each of the Controlled Corporations to be received by each shareholder of Distributing will be approximately equal to the fair market value of the stock of Distributing surrendered in the exchange.
- (b) No part of the consideration to be distributed by Distributing will be received by a shareholder of Distributing as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.

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- (c) The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operation with respect to its Business X activities, and there have been no substantial operational changes since the date of the last financial statements submitted for such operations. The financial information submitted on behalf of Distributing is representative of Distributing's present operation with respect to its Business Z activities since Date 1, and there have been no substantial operational changes since the date of the last financial statements submitted for such operations
- (d) Following the Distribution, Distributing and each of the Controlled Corporations will continue independently the active conduct of its share of all of the integrated activities of its business independently and with its separate employees, except that the services of one employee will be shared by Controlled #2 and Distributing.
- (e) The Distribution is being carried out for the following corporate business purpose: to eliminate disputes among A, B, C, and D regarding important business decisions, including decisions with respect to the types of business for the corporation to acquire, management styles, disclosure and sharing of information regarding management of assets, and the focus of the business.
- (f) Distributing is an S corporation within the meaning of § 1361(a) of the Code. Each of the Controlled Corporations 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 Distributing or of any of the Controlled Corporations, once made.
- (g) 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 stock in, or securities of, either Distributing or any of the Controlled Corporations after the transaction, except for gifts by shareholders of Distributing or the Controlled Corporations to the immediate family of such shareholders.
- (h) There is no plan or intention by any of the Distributing or any of the Controlled Corporations, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction, other than through purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30.

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- (i) There is no plan or intention to liquidate any of the Controlled Corporations, to merge any of the Controlled Corporations with any other corporation, or to sell or otherwise dispose of the assets of any of the Controlled Corporations after the Distribution, except in the ordinary course of business.
- (j) The Distribution is not part of a plan or series of related transactions (within the meaning of Code § 355(e)) pursuant to which one or more persons will acquire directly or indirectly stock possessing 50% or more of the total combined voting power of all classes of stock of either Distributing or any of the Controlled Corporations entitled to vote or stock possessing 50% or more of the total value of all classes of stock of either Distributing or any of the Controlled Corporations.
- (k) The total adjusted basis and the fair market value of the assets transferred to each of the Controlled Corporations by Distributing each equals or exceeds the sum of the liabilities assumed by each of the Controlled Corporations 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, except that, as noted above, in order to equalize values, a debt now secured by an asset to be transferred to Controlled #2 will be assumed by Controlled #1 or refinanced, and the security interest will be assets of Controlled #1.
- (l) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the Distribution.
- (m) No intercorporate debt will exist between Distributing and any of the Controlled Corporations at the time of, or subsequent to, the Distribution, except for the following, made to equalize the values in the Distribution: a note in favor of Controlled #2 obligating Distributing in an amount not to exceed \$b and a note in favor of Controlled #3 obligating Distributing in the amount not to exceed \$d.
- (n) Payments made in connection with all continuing transactions, if any, between Distributing and any of the Controlled Corporation will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (o) No two parties to the Distribution are investment companies as defined in Code § 368(a)(2)(F)(iii) and (iv).

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Based solely on the information submitted and the representations made, we have concluded that:

- (1) The transfer by Distributing to each of the Controlled Corporations of property in exchange for all of the stock of each of the Controlled Corporations, as described above, followed by the distribution by Distributing of all of the shares of the common stock of each of the Controlled Corporations to certain of the Shareholders as described above, will in each case constitute a reorganization within the meaning of Code § 368(a)(1)(D). Distributing and each of the Controlled Corporations will each be a party to a reorganization within the meaning of Code § 368(b).
- (2) Distributing will not recognize any gain or loss upon the transfer of its assets to the Controlled Corporations in exchange for shares of 100% of the common stock of the Controlled Corporations and the assumption of certain liabilities by the Controlled Corporations. Code §§ 361(a) and 357(a).
- (3) No gain or loss will be recognized to the Controlled Corporations upon the receipt of Distributing's assets in exchange for 100% of the stock of the Controlled Corporations and the assumption of the liabilities of Distributing by the Controlled Corporations. Code § 1032(a).
- (4) The basis of the assets received by the Controlled Corporations from Distributing will be the same as the basis of such assets in the hands of Distributing immediately prior to the transfer. Code § 362(b).
- (5) The holding period of each asset received by the Controlled Corporations from Distributing will include the period during which Distributing held such asset. Code § 1223(2).
- (6) No gain or loss will be recognized to Distributing upon the distribution to the Shareholders of 100% of the shares of the common stock of the Controlled Corporations pursuant to the Distribution. Code § 361(c)(1).
- (7) No gain or loss will be recognized to, and no amount will be included in the income of, the Shareholders upon the exchange of their shares of Distributing common stock for shares of the common stock of the Controlled Corporations pursuant to the Distribution. Code § 355(a)(1).
- (8) The basis of the shares of the common stock of each of the Controlled Corporations will be the same as the basis of the Distributing common stock surrendered in exchange therefor. Code § 358(a)(1).

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- (9) The holding period of the shares of the stock of the each of the Controlled Corporations to be received by the Shareholders will include the period during which the Shareholders held the Distributing stock surrendered in exchange therefore, provided that such shareholder held the Distributing stock as a capital asset on the date of the Distribution. Code § 1223(1).
- (10) As provided in Code § 312(h), the earnings and profits of Distributing will be allocated among the Controlled Corporations under Treas. Reg. § 1.312-10(a).

No opinion is expressed as to the tax treatment of the transactions under 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 transactions that are not specifically covered by the above ruling. Specifically, no opinion was requested and none is expressed as to the validity or effect of Distributing's S corporation election or the proposed S corporation election of any of the Controlled Corporations.

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.

Sincerely yours,
Gerald B. Fleming
Senior Technician Reviewer, Branch 2
Office of Associate Chief Counsel (Corporate)

cc: