

Internal Revenue Service

Department of the Treasury

Number: **200327027**
Release Date: 7/3/2003
Index Numbers: 355.01-01
368.04-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:CORP:B06-PLR-166465-02
Date:

March 24, 2003

Distributing =

DSub =

Controlled =

CSub =

IP1 =

IP2 =

A =

B =

x =

\$y =

Dear :

This letter responds to your letter dated November 27, 2002, submitted on your behalf by your authorized representative, requesting rulings under I.R.C. sections 368 and 355. Additional information was received in a letter dated March 14, 2003. The information submitted in your letters is summarized below.

PLR-166465-02

Distributing is an "S" corporation that owns DSub, a qualified subchapter S subsidiary. A and B are equal owners of Distributing. Prior to the transactions described below, Distributing, directly and through DSub, owned all the intellectual property related to IP1 and IP2. It also engaged in licensing activities related to both IP1 and IP2 (Business 1 and Business 2, respectively).

The taxpayer has supplied financial information that indicates that each of Business 1 and Business 2 had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

A and B have divergent views as to the current operations and future direction of Business 1, which have adversely affected the business operations of Distributing. To address this problem and to allow each shareholder to concentrate on the business that that shareholder is interested in, the parties have devised the following plan:

- (1) Distributing has established a subsidiary, Controlled, a qualified subchapter S subsidiary.
- (2) Controlled has established a subsidiary, CSub, a qualified subchapter S subsidiary.
- (3) DSub has transferred Business 1 to Distributing.
- (4) Distributing has transferred Business 1 to Controlled, IP1 and a nominal amount of cash (the "Contribution").
- (5) Controlled has transferred Business 1 to Csub.
- (6) Distributing will distribute all of the Controlled stock to A in exchange for A's Distributing stock (the "Distribution").
- (7) Distributing and Controlled have agreed that Distributing will make additional contingent payments to Controlled over a period of x years. The aggregate amount of these payments will not exceed \$y and the amounts to be paid will be determined by reference to certain increases in the net equity of Distributing over a specified floor amount. Each of the parties has agreed that the assets initially contributed to Controlled and the conditional payments, in the aggregate, have a fair market value that equals 50% of the fair market value of Distributing.

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

- (a) 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 and any liabilities to which the transferred assets are subject (as determined under section 357(d)).

PLR-166465-02

- (b) The liabilities assumed by Controlled in the transaction and the liabilities to which the assets transferred from Distributing to Controlled are subject (as determined under section 357(d)) were incurred in the ordinary course of business and are associated with the assets being transferred.
- (c) No investment credit determined under section 46 has been (or will be) claimed with respect to any property transferred between Distributing and Controlled.
- (d) Distributing neither accumulated its receivables nor made extraordinary payments of its payables in anticipation of the Distribution.
- (e) Except for the contingent payments described elsewhere, no intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Distribution, except for indebtedness incurred in the ordinary course of business.
- (f) Payments made in connection with such transaction, 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.
- (g) No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).
- (h) 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.
- (i) The fair market value of Controlled stock to be received by A will be approximately equal to the fair market value of Distributing stock surrendered by A in the exchange.
- (j) The five years of financial information submitted on behalf of Distributing is representative of its present operations, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (k) The gross assets of the trades or businesses that will be relied upon by Distributing and Controlled to satisfy the active trade or business requirement of section 355(b) will, in the aggregate, have a fair market value that is not less than five percent of the total fair market value of the gross assets of the company directly operating such trades or businesses.
- (l) Following the Distribution, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees. Additionally, following the Distribution, Distributing and Controlled will not share the services of any employees.
- (m) The Distribution of Controlled is primarily carried out for the following corporate business purpose: Fit and Focus. The Distribution is motivated, in whole, by this corporate business purpose.

PLR-166465-02

- (n) There is no plan or intention by A and B to sell, exchange, transfer by gift or otherwise dispose of any of their stock in Distributing or Controlled after the Distribution.
- (o) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the Distribution.
- (p) 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 Distribution, except in the ordinary course of business.
- (q) For purposes of section 355(d), immediately after the Distribution, no person (determined after applying section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power 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 section 355(d)(5) and (8)) during the five year period (determined after applying section 355(d)(6)) ending on the date of the Distribution.
- (r) For purposes of section 355(d), immediately after the Distribution, no person (determined after applying section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power or 50 percent or more of the total value of shares of all classes of Controlled stock, that was either (i) acquired by purchase (as defined in section 355(d)(5) and (8)) during the five year period (determined after applying section 355(d)(6)) ending on the date of the Distribution or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in section 355(d)(5) and (8)) during the five year period (determined after applying section 355(d)(6)) ending on the date of the Distribution.
- (s) The Distribution is not a part of a plan or series of related transactions (within the meaning of section 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.
- (t) Distributing is an S corporation (within the meaning of section 1361(a)). Controlled will elect to be treated as an S corporation pursuant to section 1362(a) effective on the first available date after the Distribution, Controlled will elect to treat Csub as a Qsub of Controlled effective on the same date, and there is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

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

PLR-166465-02

- (1) The Distribution will cause the termination of the Qsub election of Controlled because Controlled will cease to be a 100 percent subsidiary of Distributing. As a result, Controlled will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the Distribution from Distributing in exchange for stock of Controlled. Section 1.1361-5(b)(1). Because CSub is a Qsub of Distributing before the Distribution, and Controlled will elect to treat CSub as a Qsub of Controlled effective on the first available date after the Distribution, CSub will not be treated as a separate corporation before or after the Distribution Section 1.1361-5(b)(3), Example (9).
- (2) The transfer by Distributing of Business 1 (including IP1) to Controlled in exchange for all of the Controlled voting common stock and the assumption by Controlled of the associated liabilities, followed by the non-pro rata distribution by Distributing of all of the Controlled stock to A, will constitute a reorganization within the meaning of section 368(a)(1)(D) of the Internal Revenue Code. Distributing and Controlled will each be a "party to the reorganization" within the meaning of section 368(b). Section 1.1361-5(b)(3), Example (4).
- (3) No gain or loss will be recognized by Distributing upon its receipt of Controlled stock in exchange for the transfer of assets to, and the assumption of liabilities by, Controlled. Section 361(a) and (b)(1) and section 357(a).
- (4) No gain or loss will be recognized by Controlled upon its receipt of assets in exchange for its issuance of shares of Controlled stock. Section 1032(a).
- (5) Controlled's basis in the assets received from Distributing will equal the basis of such assets in the hands of Distributing immediately prior to the transfer. Section 362(b).
- (6) The holding period of each asset received by Controlled from Distributing will include the period during which Distributing held such asset. Section 1223(2).
- (7) Distributing will not recognize gain or loss upon the Distribution of the stock in Controlled to A. Section 361(c)(1).
- (8) No gain or loss will be recognized to (and no amounts will be included in the income of) A upon its receipt of Controlled stock. Section 355(a)(1).
- (9) The basis of the Controlled stock in the hands of A will be the same as the basis of the Distributing stock surrendered in exchange therefor. Section 358(a)(1).
- (10) The holding period of the Controlled stock received by A will include the holding period of the Distributing stock surrendered in exchange therefor, provided that the Distributing stock is held as a capital asset on the day of the Distribution. Section 1223(1).
- (11) As provided in section 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made in accordance with Treas. Reg. section 1.312-10(a).

PLR-166465-02

- (12) Contingent payments made by Distributing to Controlled after the Distribution, as described above, will be treated as occurring immediately before the Distribution. See Arrowsmith v. Commissioner, 344 U.S. 6 (1952) (tax character of later transaction will derive from earlier, related transaction), and Rev. Rul. 83-73, 1983-1 C.B. 84. Thus, any such payments will be considered part of the Contribution and treated under section 368(a)(1)(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.

This ruling is directed only to the taxpayer 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 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.

Sincerely,

Reginald Mombrun

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

cc: