

**Internal Revenue Service**

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Person To Contact:

, ID No.

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In Re:

Refer Reply To:

CC:CORP:B03 – PLR-147820-03

Date:

November 21, 2003

Distributing =

Controlled =

Shareholder A =

Shareholder B =

Shareholder C =

aa =

bb =

cc =

dd =

business e =

business f =

state G =

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Country H =

Date I =

Date J =

Year 1 =

X =

Y =

kk =

Dear

This letter responds to your August 8, 2003 request for rulings on certain federal income tax consequences of a proposed transaction. Additional information was received in letters dated October 24, 2003 and November 14, 2003. The information submitted is substantially as set forth below.

Distributing was incorporated on Date I and made an election to be taxed as an S corporation on Date J. Distributing is a state G Subchapter S corporation engaged in business e and business f. Distributing has kk shares of voting common stock outstanding. Distributing has three shareholders: shareholders A, B, and C. Shareholders A, B, and C each own aa percent of the outstanding Distributing stock. Distributing uses an accrual method of accounting and a calendar tax year.

We have received financial information indicating that business e and business f each has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Shareholder A and shareholder B have significant differences with shareholder C regarding the operation and future direction of Distributing. Shareholder C believes Distributing should continue to grow business f, expand international operations and commit significant resources to product development. Shareholder A and shareholder B do not agree with this strategy and have indicated they will not approve future growth in the international arena, nor will they agree to be at risk for growing debt, especially when the business f operations have not currently resulted in a fair or appropriate share

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of profits to the bottom line considering the risk involved. These disagreements are irreconcilable. In order to eliminate the problems generated by these shareholder disputes, the following transaction has been proposed:

- (i) Pursuant to a plan of agreement and reorganization, Distributing will cause Controlled to be incorporated as a state G corporation to receive the assets and liabilities of business e. Controlled will use the accrual method of accounting.
- (ii) The value of business e is less than the value of Distributing that Shareholder A and Shareholder B will relinquish in the proposed transaction if an equalization payment is not made. Therefore, to equalize the value of Distributing retained by Shareholder C and the value of Controlled retained by each of Shareholder A and Shareholder B (see (iii), below), Distributing will contribute to Controlled two notes in the principal amount of \$X each, payable in unequal monthly installments over a five-year period with interest at Y percent (the "Notes").
- (iii) Distributing will transfer all of the assets relating to business e and the two Notes to Controlled in exchange solely for all of the outstanding stock (cc shares) of Controlled and the assumption by Controlled of all liabilities relating to business e (together, the "Contribution").
- (iv) Following the Contribution, Distributing will distribute to each of shareholder A and shareholder B dd shares of Controlled voting common stock in exchange for all of their shares of Distributing stock (the "Distribution").

Following the Distribution, Controlled will be wholly owned by shareholder A and shareholder B, each owning bb percent of the outstanding stock of Controlled, and Controlled will be engaged in business e. Distributing will be wholly owned by shareholder C and will be engaged in business f.

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

- (a) The fair market value of the Controlled stock to be received by each shareholder of Distributing will be approximately equal to the fair market value of the Distributing stock surrendered by the shareholder in the exchange.

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- (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 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, other than the acquisition of the Country H facility by the business f Division in Year 1.
- (d) Following the Distribution, Distributing and Controlled will each continue, independently and with its separate employees, the active conduct of its business.
- (e) The Distribution is being carried out for the following corporate business purpose: alleviating the significant shareholder disputes between shareholders A and B, on the one hand, and shareholder C, on the other, regarding the management and direction of business e and business f. The distribution of the stock, or stock and securities, of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (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 Distribution.
- (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 after the Distribution, 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 after the Distribution, except in the ordinary course of business.
- (i) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing in the Contribution (excluding the Notes) will, in each instance, equal or exceed the liabilities assumed (as determined under § 357(d) of the Internal Revenue Code) by Controlled.

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- (j) The liabilities to be assumed (as determined under § 357(d)) in the Contribution were incurred in the ordinary course of business and are associated with the assets transferred.
- (k) The indebtedness evidenced by the Notes will not constitute stock or securities. Immediately prior to (or simultaneously with) the Distribution, no intercorporate debt will exist between Distributing and Controlled. Following the Distribution, the only such intercorporate debt that will exist will be the indebtedness evidenced by the Notes.
- (l) 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) Distributing is an S corporation (within the meaning of §1361(a)). Controlled will elect to be an S corporation 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.
- (o) The distribution of stock in Controlled 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 fifty percent or more of the total combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing fifty percent or more of the total value of all classes of stock of Distributing or Controlled.

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

- (1) The Contribution, followed by the Distribution, will be a reorganization within the meaning of §368(a)(1)(D). Distributing and Controlled will each be "a party to the reorganization" within the meaning of §368(b).
- (2) Distributing will recognize no gain or loss upon the Contribution, as described above (§§ 361(a) and 357(a)).

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- (3) Controlled will recognize no gain or loss on the Contribution, as described above (§ 1032(a)).
- (4) The basis of each business e asset received by Controlled in the Contribution will equal the basis of that same asset in the hands of Distributing immediately prior to the transfer (§ 362(b)).
- (5) The holding period of each business e asset received by Controlled in the Contribution will include the period during which Distributing held that asset (§ 1223(2)).
- (6) No gain or loss will be recognized to Distributing upon the Distribution, as described above (§ 361(c)(1)).
- (7) No gain or loss will be recognized by shareholder A or shareholder B (and no amount will be included in their income) upon their receipt of Controlled stock in exchange for all of their Distributing stock (§ 355(a)(1)).
- (8) The basis of the Controlled stock in the hands of shareholder A and shareholder B will, in each instance, equal the basis of the Distributing stock surrendered in the exchange (§ 358(a)(1)).
- (9) The holding period of the Controlled stock received by shareholder A and shareholder B will include the holding period of the Distributing stock surrendered in exchange therefor, provided that such Distributing stock was held as a capital asset on the date of the exchange (§ 1223(1)).
- (10) As provided in §312(h) of the Code, proper allocation of earnings and profits between Distributing and Controlled will be made under §1.312-10(a) of the regulations.
- (11) The accumulated adjustments account of Distributing will be allocated between Distributing and Controlled in a manner similar to the manner in which the earnings and profits of Distributing will be allocated under § 312(h) (see § 1.312-10(a)) (§ 1.1368-2(d)(3)).
- (12) The momentary affiliation of Distributing and Controlled in connection with the corporate separation to which § 368(a)(1)(D) applies will not, in and of itself, prohibit Controlled from making a valid S corporation election under § 1362(a), provided it satisfies the other requirements for making such election.

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- (13) Controlled will be subject to section 1374 with respect to any asset transferred to Controlled to the same extent Distributing was subject to § 1374 with respect to such asset. For purposes of § 1374, the recognition period for Controlled will be reduced by the portion of Distributing's recognition period that elapses prior to the transfer of these assets to Controlled. Section 1374(d)(8) and Ann. 86-128, 1986-51 1986-51 I.R.B. 22.

Except as specifically set forth above, we express no opinion concerning the tax consequences of the proposed transaction under any other provision of the Code or regulations, or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction. Specifically, no opinion is expressed concerning the tax consequences associated with the basis of the two Notes.

The rulings contained in this letter are based upon the facts and representations submitted by the taxpayers and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of the request of a ruling. Verification of the information, representations, and other data may be required as part of the audit process. See §§ 12.04 and 12.05 of Rev. Proc. 2003-1, 2003-1 I.R.B. 1, 44, which discuss in greater detail the revocation or modification of ruling letters. However, when the criteria in § 12.06 of Rev. Proc. 2003-1, 2003-1 I.R.B. 1, 45, are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

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 is consummated.

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

Sincerely,  
Richard E. Coss  
Richard E. Coss  
Senior Counsel, Branch 3  
Office of Associate Chief Counsel (Corporate)