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Telephone Number:

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Date:

May 05, 2004

Distributing =

Controlled =

Trust =

H and W =

State X =

Business A =

Business B =

c =

d =

Date 1 =

Date 2 =

Dear

We respond to your request dated December 31, 2003, for rulings on the federal income tax consequences of a partially consummated transaction. Additional information was received in a letter dated April 23, 2004. The material information submitted for consideration is summarized below.

The rulings contained in this letter are based on facts and representations submitted by the taxpayer 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 for rulings. Verification of the information, representations, and other data may be required as part of the audit process. In particular, this Office has made no determination regarding whether the transaction: (i) satisfies the business purpose requirement of §1.355-2(b) of the Income Tax Regulations, (ii) is used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (see §355(a)(1)(B) of the Internal Revenue Code and §1.355-2(d)), and (iii) is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation (see §355(e)(2)(A)(ii) and §1.355-7T).

Distributing is a State X subchapter S corporation engaged directly in Business A and Business B. The taxpayer has supplied financial information that indicates that each of Business A and Business B had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years. Distributing has outstanding c shares of voting common stock that are entirely owned by Trust, a State X revocable grantor trust. The grantors and beneficiaries of Trust are H and W, a husband and wife.

Controlled is a recently formed State X corporation and wholly owned subsidiary of Distributing that was incorporated in order to effectuate the proposed transaction.

For what are represented to be valid business purposes, the following transaction is proposed and partially consummated:

- (i) Controlled was formed on Date 1. On Date 2, Distributing transferred Business A to Controlled, together with cash, assets, and liabilities associated with that business in exchange for d shares of Controlled common stock, constituting all of the outstanding shares of stock of Controlled.
- (ii) Distributing will distribute all of Controlled's outstanding stock to its sole shareholder, Trust.

- (iii) After the distribution, Controlled will elect to be an S corporation pursuant to §1362(a) of the Internal Revenue Code for its first taxable year.

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

- (a) No part of the consideration to be distributed by Distributing will be received by Trust 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 operations, 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 carried out for the following corporate business purposes: (1) segregation of the assets and risks of Business A from the assets and risks of Business B; (2) elimination of insurance redundancies and reduction in overall insurance costs; and (3) allowing the economic performance of the two businesses to be readily ascertained and evaluated from each corporation's stand alone set of books and records. The distribution of the stock of Controlled is motivated, in whole or substantial part, by one or more of these corporate business purposes.
- (e) Distributing is an S corporation (within the meaning of §1361(a)). Controlled will elect to be an S corporation pursuant to §1362(a) effective immediately after the distribution. 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 Trust, as the sole shareholder of Distributing, to sell, exchange, transfer by gift, or otherwise dispose of any of its stock in either Distributing or Controlled after the transaction.
- (g) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its respective outstanding stock after the transaction, 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 transaction, except in the ordinary course of business.
- (i) The transaction is not used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.
- (j) The total adjusted bases and the fair market value of the assets to be transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities to be assumed (as determined under §357(d)) by Controlled.
- (k) The liabilities to be 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.
- (l) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock.
- (m) 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.
- (n) No two parties to the transaction are investment companies as defined in §368(a)(2)(F)(iii) and (iv).
- (o) There is no acquisition of stock of Distributing or Controlled (including any predecessor or successor of any such corporation) that is part of a plan or series of related transactions (within the meaning of §1.355-7T) that includes the distribution of the Controlled stock.
- (p) Immediately after the distribution, no person will hold "disqualified" stock in Distributing or Controlled that constitutes a 50 percent or greater interest in such corporations within the meaning of §355(d).
- (q) The income tax liability for the taxable year in which investment credit property (including any building to which §47(d) applies) is transferred will be adjusted pursuant to §50(a)(1) or (a)(2) (or §47, as in effect before amendment by Pub. L. No. 101-508, title 11, 104 Stat. 1388, 536 (1990), if applicable) to reflect an early disposition of the property.

Based solely on the information submitted and representations made, we hold as follows:

- (1) The transfer by Distributing of the Business A assets to Controlled in exchange for all of the issued and outstanding stock of Controlled and the assumption by Controlled of the liabilities associated with Business A followed by the distribution of the stock of Controlled, as described above, will qualify as a reorganization under §368(a)(1)(D). Distributing and Controlled each will be a “party to a reorganization” under §368(b).
- (2) Distributing will recognize no gain or loss upon the transfer of the Business A assets to Controlled in exchange for Controlled stock and the assumption of liabilities, as described above (§§361(a) and 357(a)).
- (3) Controlled will recognize no gain or loss on the receipt of the Business A assets in exchange for Controlled stock, as described above (§1032(a)).
- (4) Controlled’s basis in each asset received from Distributing will equal the basis of such asset in the hands of Distributing immediately prior to the transfer (§362(b)).
- (5) Controlled’s holding period for each asset received from Distributing will include the period during which Distributing held such asset (§1223(2)).
- (6) Under §1245(b)(3), Distributing will recognize no gain and will include no amounts in income under §1245(a) on the transfer of a portion of its assets to Controlled.
- (7) Distributing will recognize no gain or loss on the distribution of the Controlled stock (§361(c)(1)).
- (8) Distributing’s shareholder, Trust, will recognize no gain or loss (and no amount will be included in its income) upon its receipt of the Controlled stock, as described above (§355(a)(1)).
- (9) The aggregate basis of the Distributing and Controlled stock in the hands of Trust immediately after the distribution will equal Trust’s aggregate basis in its Distributing stock immediately before the distribution, allocated in proportion to the fair market value of each in accordance with §1.358-2(a)(2) (§§358(a)(1), (b) and (c)).
- (10) Trust’s holding period of the Controlled stock received in the distribution will include the holding period of the Distributing stock on which the distribution is made, provided that such Distributing stock is held by Trust as a capital asset on the date of the distribution (§1223(1)).
- (11) Earnings and profits will be allocated between Distributing and Controlled in accordance with §1.312-10(a).

- (12) 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)).
- (13) The momentary ownership by Distributing of the stock of Controlled in connection with the reorganization will not, in and of itself, make Controlled ineligible to elect to be an S corporation for its first taxable year, provided that Controlled meets the other requirements under §1361(b). Distributing's consent to Controlled's election to be an S corporation is not required.
- (13) Controlled will be subject to §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 elapsed prior to the transfer of these assets to Controlled (§1374(d)(8) and Ann. 86-128, 1986-51 I.R.B. 22).

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code or regulations or 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. In particular, no opinion is expressed regarding: (i) whether the distribution satisfies the business purpose requirement of §1.355-2(b); (ii) whether the transaction is used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both; and (iii) whether the distribution and an acquisition or acquisitions are part of a plan (or series of related transactions) under §355(e)(2)(A)(ii). Further, no opinion is expressed concerning whether Distributing's S election is valid; whether Controlled is otherwise eligible to be taxed as an S corporation; and whether Controlled's election to be an S corporation will be valid under §1362(a).

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.

It is important that a copy of this letter be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this letter is consummated.

Pursuant to the power of attorney on file in this office, a copy of this letter has been sent to the taxpayers' authorized representative.

Sincerely,

Filiz A. Serbes
Chief, Branch 3
Office of Associate Chief Counsel

(Corporate)

cc: