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Refer Reply To:

CC:CORP:B03-PLR-144281-01

Date:

December 17, 2001

Re:

Distributing =

Controlled =

A =

B =

C =

State X =

Business Y =

Date Z =

d =

e =

f =

g =

h =

i =

j =

k =

PLR-144281-01

This is in response to a letter dated August 1, 2001, submitted on your behalf by your authorized representative, requesting rulings on the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated September 24, November 21, and December 11, 2001. The information submitted for consideration is summarized below.

Distributing is a State X calendar year, cash basis taxpayer that has been engaged in Business Y since its incorporation on Date Z (more than 5 years from the date of this letter). Distributing elected to be taxed as an S corporation since its incorporation on Date Z.

Distributing has outstanding f shares of \$10 par value voting common stock that are owned by family members A (g shares), B (h shares), and C (h shares). B and C are the sons of A. There are no securities or other interests of any kind that could be considered a stock interest.

Financial information has been received that indicates that Business Y has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

C wants to expand a part of Business Y, while A and B prefer to make the existing business more profitable without expansion and concentrate on better utilizing the corporate assets as they are. The difficulties created by this difference in philosophy have caused, and will continue to cause, a stagnation of corporate growth. Accordingly, the Distributing shareholders have decided to divide Business Y so that C can go his own separate way (as the sole owner of Controlled), leaving A and B as the sole shareholders of Distributing.

The following transaction has been proposed:

- (i) Distributing will form Controlled as a wholly owned State X corporation. Controlled will be a calendar year, cash method taxpayer.
- (ii) Distributing will transfer d percent of its assets to Controlled in exchange for e shares of stock of Controlled. No Distributing liabilities will be assumed by Controlled nor will Controlled receive any Distributing assets subject to liabilities.
- (iii) Distributing will distribute all of the Controlled stock to C in exchange for e shares of C's Distributing stock.
- (iv) Distributing will redeem the remaining i shares of Distributing stock held by C for a promissory note (the "Note") in the amount of \$j payable over k years at k percent interest as part of a buy-sell agreement.

PLR-144281-01

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

- (a) The fair market value of the Controlled stock and the Note received by C will be approximately equal to the fair market value of the Distributing stock surrendered by C in the exchange.
- (b) No part of the consideration to be distributed by Distributing will be received by C as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.
- (c) The 5 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.
- (d) Following the transaction, Distributing and Controlled will each continue, independently and with its separate employees, the active conduct of its share of all of the integrated activities of Business Y conducted by Distributing prior to the consummation of the transaction.
- (e) The distribution of the stock of Controlled is carried out for the following corporate business purpose: to resolve a shareholder dispute. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (f) 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) 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.
- (g) Other than the redemption of C's Distributing stock (described in step (iv), above), there is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift, have redeemed, or otherwise dispose of any of their stock in either Distributing or Controlled after the transaction.
- (h) Other than the redemption of C's Distributing stock (described in step (iv), above), 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 transaction, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696.
- (i) 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

PLR-144281-01

dispose of the assets of either corporation after the transaction, except in the ordinary course of business.

- (j) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (k) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock.
- (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) 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 combined voting power of all classes of stock entitled to vote or stock possessing 50 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 transfer by Distributing to Controlled of d percent of its assets in exchange for e shares of Controlled stock, as described above, followed by Distributing's distribution of all of the stock of Controlled to C, in exchange for e shares of Distributing stock held by C, will be 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) Distributing will recognize no gain or loss upon the transfer of d percent of its assets to Controlled in exchange for Controlled stock, as described above (§361(a)).
- (3) Controlled will recognize no gain or loss upon the receipt of d percent of Distributing's assets in exchange for Controlled stock, as described above (§1032(a)).
- (4) Controlled's basis of the assets received in the proposed transaction will equal the basis of such assets in the hands of Distributing immediately prior to the proposed transaction (§362(b)).

PLR-144281-01

- (5) Controlled's holding period of the assets received in the proposed transaction will include the period during which such assets were held by Distributing (§ 1223(2)).
- (6) For federal income tax purposes, the distribution to C of the Controlled stock and the Note in exchange of e shares and i shares, respectively, of C's Distributing stock will be considered part of a single transaction. This exchange would be described in § 355(a) of the Code except for the fact that the Note was received by C in addition to the Controlled stock. The exchange therefore will be governed by § 356 (§ 355(a)(4)).
- (7) Distributing will recognize no gain or loss upon its distribution of all of the Controlled stock and the Note to C in exchange for all of C's Distributing stock (§ 361(c)(1)).
- (8) C will recognize gain, if any, on his receipt of the Controlled stock and the Note in exchange for all of his Distributing stock, but not in excess of the fair market value of the Note received (§ 356(a)(1)). C will recognize no loss from the exchange (§ 356(c)).
- (9) C's basis in the stock of Controlled after the distribution will equal the basis of the Distributing stock surrendered by C in the exchange, decreased by the fair

market value of the Note received, and increased by the amount of gain, if any, that C recognized on the exchange (§ 358(a)(1)).

- (10) C's holding period of the Controlled stock received will include the holding period of the Distributing stock surrendered by C in the exchange, provided that the Distributing stock was held as a capital asset on the date of the exchange (§1223(1)).
- (11) Proper allocation of earnings and profits between Distributing and Controlled will be made under §1.312-10(a) of the Income Tax Regulations (§ 312(h)).

We express no opinion about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about 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.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) 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.

PLR-144281-01

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

Sincerely yours,
Richard E. Coss,
Assistant to the Branch Chief, Branch 3
Office of Associate Chief Counsel (Corporate)