

Internal Revenue Service

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Person to Contact:

Telephone Number:

Refer Reply To:

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LEGEND:

Distributing =

NewCo =

Sub A =

State Z =

Business M =

Business N =

Year 1 =

Year 2 =

Date T =

Date U =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Shareholder E =

tt =

uu =

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vv =

ww =

xx =

yy =

zz =

Dear

This letter responds to your October 29, 2001 request for rulings regarding certain federal income tax consequences of a proposed transaction. The information submitted in that request and in later correspondence is summarized below.

SUMMARY OF FACTS

Distributing incorporated under subchapter C in State Z in Year 1. On Date T, Distributing made a subchapter S election. Distributing formed Sub A, a wholly owned subsidiary, in Year 2. On Date T, Distributing made a qualified subchapter S subsidiary election for Sub A. Distributing conducts Business M directly and Business N (through Sub A).

Currently, Distributing has four shareholders. Shareholder A owns a ww percent interest. Shareholder B owns a xx percent interest. Shareholder C owns a yy percent interest. Shareholder D owns a zz percent interest. On Date U, Distributing redeemed all of Shareholder E's shares. Shareholder E owned vv of the stock of Distributing before the redemption.

Shareholder A is involved primarily in Business M, and Shareholder B is involved in both Business M and Business N. Shareholder C and Shareholder D are related to Shareholder B and received their stock in Distributing as gifts from Shareholder B. Neither Shareholder C nor Shareholder D actively participate in either business.

Financial information has been received indicating that Distributing has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Shareholder A and Shareholder B have differences with respect to management styles and business philosophies. To eliminate these differences, the following series of transactions are proposed:

- (1) Distributing will form NewCo (i.e., Controlled).

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- (2) Distributing will transfer to NewCo the assets and liabilities associated with Business M.
- (3) The value of Business N exceeds the value of Business M, so that the value of Distributing would exceed the value of NewCo if an equalization payment was not made. Therefore, to equalize the values of Distributing and NewCo, Distributing will pay Value Equalization Payments to NewCo. Distributing will transfer to NewCo a Value Equalization Note for part (and possibly all) of the amount needed to fund the Value Equalization Payments. The Value Equalization Note will bear interest at a rate of tt percent and will be payable in monthly interest only payments for a period of uu years with a balloon payment due at the end of the uu -year period. Distributing may borrow cash from a third-party lender to fund a portion of the Value Equalization Payments. The total Value Equalization Payments (*i.e.*, the sum of any cash plus the face amount of the Value Equalization Note) will be 50 percent of the value differential between Business M and Business N.
- (4) Distributing will distribute all of the shares of stock of NewCo to Shareholder A in a split-off transaction (the "Distribution"). Shareholder A will surrender his ww percent interest in Distributing upon receipt of the NewCo stock.
- (5) Following the Distribution, Shareholder B, Shareholder C and Shareholder D will own all of the stock of Distributing, which will continue to engage in Business N. Shareholder A will own all of the stock of NewCo, which will engage in Business M.

REPRESENTATIONS

- (a) The indebtedness evidenced by the Value Equalization Note will not constitute stock or securities.
- (b) The fair market value of the NewCo common stock to be received by Shareholder A will be approximately equal to the fair market value of the Distributing common stock surrendered by Shareholder A in the exchange.
- (c) 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.
- (d) 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

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since the date of the last financial statements submitted.

- (e) Following the transaction, Distributing and NewCo will each continue the active conduct of its business, independently and with its separate employees.
- (f) Immediately after the Distribution, the gross assets of the active business conducted by Distributing (as defined in section 355(b)(2)) will have a fair market value that is at least 5 percent of the total fair market value of the gross assets of Distributing.
- (g) Immediately after the Distribution, the gross assets of the active business conducted by NewCo (as defined in section 355(b)(2)) will have a fair market value that is at least 5 percent of the total fair market value of the assets of NewCo.
- (h) The Distribution is carried out for the corporate business purpose of resolving the fundamental differences among the principal shareholders with regard to their management styles and business philosophies and for allowing the principal shareholders to go their own way. Shareholder A will focus exclusively on Business M because his investment will be restricted to that business. Shareholder B will focus exclusively on Business N because his investment (and the minority investments of Shareholder C and Shareholder D) will be restricted to that business. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.
- (i) There is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift or otherwise dispose of any of their stock in, or securities of, either Distributing or NewCo after the transaction.
- (j) There is no plan or intention by either Distributing or NewCo, 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 section 4.05(1)(b) of Rev. Proc. 96-30.
- (k) There is no plan or intention by the shareholders to liquidate either Distributing or NewCo, 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.
- (l) No shareholder of Distributing will hold immediately after the Distribution disqualified stock within the meaning of section 355(d)(3), which constitutes a 50 percent or greater interest in Distributing or NewCo.

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- (m) The Distribution is not 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 NewCo, or stock possessing 50 percent or more of the total value of shares of all classes of stock of either Distributing or NewCo.
- (n) The total adjusted bases, and the fair market value of the assets transferred to NewCo by Distributing, excluding the Value Equalization Note, each equals or exceeds the sum of the liabilities assumed by NewCo plus any liabilities to which the transferred assets are subject.
- (o) 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.
- (p) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (q) Immediately prior to (or simultaneously with) the Distribution, no intercorporate debt existed between Distributing and NewCo. Following the Distribution, the only such intercorporate debt that will exist will be indebtedness evidenced by the Value Equalization Note.
- (r) Except for making required payments under the Value Equalization Note, there are no continuing, planned or intended transactions between Distributing and NewCo following the Distribution, either directly or indirectly. Payments made in connection with all other continuing transactions, if any, between Distributing and NewCo, will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (s) No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).
- (t) Distributing is an S corporation (within the meaning of section 1361(a)). NewCo will elect to be an S corporation pursuant to section 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 NewCo.

RULINGS

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

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- (1) The transfer by Distributing to NewCo of the assets of Business M and the Value Equalization Payments (as defined herein) in exchange for all of the stock of NewCo and the assumption by NewCo of liabilities, if any, associated with the assets of Business M followed by the Distribution will qualify as a reorganization within the meaning of section 368(a)(1)(D). Distributing and NewCo each will be a “party to a reorganization” within the meaning of section 368(b).
- (2) No gain or loss shall be recognized by Distributing on its transfer to NewCo of the assets and liabilities of Business M, cash and the Value Equalization Note solely in exchange for stock of NewCo (sections 361(a) and 357(a)).
- (3) Distributing will recognize no gain or loss upon the transfer of all of the stock of NewCo to Shareholder A (section 361(c)).
- (4) No gain or loss will be recognized by NewCo upon the receipt of the assets and liabilities of Business M, the Value Equalization Note and any cash transferred to fund the Value Equalization Payments in exchange for all of the shares of NewCo stock (section 1032(a)).
- (5) The basis of the assets of Business M received by NewCo will be the same as the basis of the assets of that business in the hands of Distributing immediately prior to the transaction (section 362(b)).
- (6) The holding period of the assets of Business M received by NewCo will include the period during which Distributing held the assets of such business (section 1223(2)).
- (7) Shareholder A will recognize no gain or loss (and no amount will be included in his income) upon the receipt of all of the NewCo common stock in exchange for all of his Distributing common stock (section 355(a)(1)).
- (8) Shareholder A’s basis in his NewCo common stock will equal his basis in the shares of Distributing common stock surrendered in the exchange (section 358(a)(1)).
- (9) The holding period of the NewCo common stock received by Shareholder A will include the holding period of the Distributing common stock surrendered in the exchange, provided that the Distributing common stock is held as a capital asset on the date of the exchange (section 1223(1)).
- (10) As provided in section 312(h), proper allocation of earnings and profits between Distributing and NewCo will be made in accordance with section

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1.312-10(a).

- (11) Distributing's momentary ownership of the stock of NewCo, as part of the reorganization under section 368(a)(1)(D), will not cause NewCo to have an ineligible shareholder for any portion of its first taxable year under section 1361(b)(1)(B). If NewCo otherwise meets the requirements of a small business corporation under section 1361, NewCo will be eligible to make a subchapter S election under section 1362(a) for its first taxable year.
- (12) NewCo will be subject to section 1374 with respect to any asset transferred by Distributing to NewCo to the same extent that Distributing was subject to section 1374 with respect to any such asset. For purposes of section 1374, NewCo's recognition period will be reduced by the portion of Distributing's recognition period that elapses prior to Distributing's transfer of any such asset to NewCo (section 1374(d)(8)). Distributing will continue to be subject to section 1374 with respect to its assets retained (i.e., assets not transferred to NewCo).
- (13) Distributing's accumulated adjustments account (including that of Sub A) immediately before the transaction will be allocated between Distributing and NewCo in a manner similar to the manner in which Distributing's earnings and profits will be allocated under section 312(h) (section 1.1368-2(d)(3)).

CAVEATS

No opinion is expressed about the tax treatment of the transaction under any other provision of the Code or Regulations, or the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above rulings. In particular, no opinion is expressed concerning the tax consequences associated with:

- (a) whether Distributing's S election is valid;
- (b) whether Distributing's election to treat Sub A as a qualified subchapter S subsidiary is valid;
- (c) whether NewCo is otherwise eligible to elect to be taxed as an S corporation and whether NewCo's election will be valid under section 1362(a); or

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(d) the basis of the Value Equalization Note.

PROCEDURAL STATEMENTS

The rulings contained in this letter are predicated upon the 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 a ruling. Verification of the information, representations, and other data may be required as part of the audit process.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to the federal income tax return of each taxpayer involved for the taxable year in which the transaction is consummated.

Under a power of attorney on file in this office, a copy of this letter has been sent to your authorized representatives.

Sincerely yours,

Alfred C. Bishop, Jr.
Branch Chief, Branch 6
Associate Chief Counsel (Corporate)

cc: