

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:
March 17, 2000

LEGEND:

- Distributing =
- Controlled =
- Shareholder =
- Business A =
- Business B =
- State X =
- Year 1 =
- Date 1 =
- V =
- W =
- Y =
- Z =

This letter responds to your Authorized Representatives' letter dated January 3, 2000, in which you requested rulings under section 355 of the Internal Revenue Code. Additional information regarding your request has been submitted in letters dated January 11, 2000 and March 10, 2000. The material information submitted for consideration is summarized below.

Distributing, a State X Subchapter S corporation, is engaged directly in Business A and Business B. Business A has been conducted for more than five years. Business B was begun in Year 1 as part of Business A in order to provide an additional sales outlet to an expanded market of customers. Distributing files its federal income tax returns on a calendar year basis and uses the accrual method of accounting. Distributing is wholly-owned by Shareholder.

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Controlled, a State X corporation, was formed on Date 1 for the purpose of independently operating Business B. Controlled intends to elect Subchapter S status on the first available date after the proposed transaction. Controlled will file its federal income tax returns on a calendar year basis and will use the accrual method of accounting.

The taxpayer has supplied financial information which indicates that Distributing has been conducting a business that has had gross receipts and operating expenses representative of the active conduct of such business for each of the past five years.

In order for Business B to remain competitive and grow, additional working capital of approximately \$V to \$W is needed. Distributing intends to issue stock in a private placement to generate this capital. Distributing has been advised by investment firms that participation in the private placement would be maximized if Business A and Business B were separated.

Accordingly, Distributing has proposed the following transaction. First, Distributing will transfer all of the Business B assets to Controlled in exchange for all of the issued and outstanding stock of Controlled. Distributing will then distribute all of the issued and outstanding stock of Controlled to Shareholder. Within one year from the distribution of Business B, Controlled will issue approximately Y% to Z% of its outstanding stock to private investors in the private placement. The private placement will result in no more than Z% of the outstanding stock of Controlled being issued to private investors.

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

- (a) No part of the consideration to be distributed by Distributing will be received by Shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.
- (b) The five years of financial information submitted on behalf of Distributing is representative of its present operations, and with regard to Business A and Business B, there have been no substantial operational changes since the date of the last financial statements submitted.
- (c) Following the proposed transaction, Distributing and Controlled will each continue the active conduct of its respective business, independently and with its separate employees. To the extent that Distributing and Controlled share employees for a transitional period, each company receiving the benefit will either pay arm's length compensation or reimburse the provider for costs.

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- (d) The distribution of the stock of Controlled is being undertaken for the corporate business purpose of raising capital needed for the growth of Business B. The distribution of Controlled stock is motivated, in whole or substantial part, by such corporate business purpose.
- (e) Distributing is an S corporation (within the meaning of section 1362(a)). Controlled 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 Controlled.
- (f) There is no plan or intention on the part of Shareholder to sell, exchange, transfer by gift, or otherwise dispose of any of his stock in either Distributing or Controlled after the proposed transaction.
- (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 transaction, other than through stock purchases meeting the requirements of Section 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 any of the assets of either corporation subsequent to the proposed transaction, except in the ordinary course of business.
- (i) The total adjusted gross bases and the fair market value of the assets to be transferred to Controlled by Distributing each equal or exceed the sum of the liabilities assumed by Controlled.
- (j) The liabilities assumed in the proposed transaction were incurred in the ordinary course of business and are associated with the assets being transferred.
- (k) None of the transferred assets will include property that will be subject to investment tax credit recapture.
- (l) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the proposed transaction.
- (m) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock, except as may arise if there is a temporary need for shared services or facilities. Any temporary debt arrangement would not constitute a security of Controlled.

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- (n) 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.
- (o) No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).
- (p) No Distributing shareholder will hold immediately after the distribution disqualified stock within the meaning of § 355(d)(3) which constitutes a 50% or greater interest in Distributing or Controlled.
- (q) 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% or more of the combined voting power of all classes of stock entitled to vote of either Distributing or Controlled, or stock possessing 50% or more of the total value of all classes of stock of either Distributing or Controlled.

Based solely upon the information submitted and the representations made, we rule as follows:

- (1) The transfer by Distributing of the assets of Business B to Controlled, solely in exchange for all of the issued and outstanding stock of Controlled and the assumption by Controlled of the liabilities associated with the transferred assets, followed by the distribution of all of the Controlled stock to the Distributing Shareholder, will be a reorganization within the meaning of section 368(a)(1)(D) of the Code. Distributing and Controlled will each be "a party to a reorganization" within the meaning of section 368(b).
- (2) Distributing will recognize no gain or loss on the transfer of assets to Controlled in exchange for Controlled stock and the assumption by Controlled of liabilities associated with the transferred assets (sections 357(a) and 361(a)).
- (3) Controlled will recognize no gain or loss on the receipt of the Business B assets in exchange for the Controlled stock (section 1032(a)).
- (4) The basis of each asset received by Controlled will be the same as the basis of that asset in the hands of Distributing immediately prior to the transaction (section 362(b)).
- (5) The holding period of each Distributing asset received by Controlled will

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include the period during which these assets were held by Distributing (section 1223(2)).

- (6) No gain or loss will be recognized by (and no amount will be included in the income of) Shareholder upon the receipt of the Controlled stock (section 355(a)(1)).
- (7) No gain or loss will be recognized by Distributing on the distribution of the Controlled stock to Shareholder (section 361(c)).
- (8) The aggregate basis of the Distributing stock and the Controlled stock in the hands of Shareholder immediately after the distribution will be the same as the basis of the Distributing stock in the hands of Shareholder immediately prior to the distribution (section 358(a)(1) and section 1.358-1(a)). Such aggregate basis will be allocated between the Distributing stock and the Controlled stock in proportion to the relative fair market value of each corporation's stock in accordance with section 1.358-2(a)(2) of the Income Tax Regulations (section 358(b)).
- (9) The holding period of the Controlled stock received by Shareholder will include the holding period of the Distributing stock with respect to which the distribution will be made, provided that the Distributing stock is held as a capital asset on the date of the distributions (section 1223(1)).

No opinion is expressed or implied 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 letter is directed only to the taxpayer who requested 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 letter is consummated.

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

Sincerely yours,
Assistant Chief Counsel (Corporate)
By Assistant to the Chief, Branch 2
(Corporate)