

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

Number: **200414018**

Release Date: 4/2/04

Index Number: 355.00-00

Person To Contact:

, ID No.

Telephone Number:

In Re:

Refer Reply To:

CC:CORP:B05 – PLR-146647-03

Date:

December 15, 2003

Distributing =

Controlled One =

Controlled Two =

State X =

Date 1 =

Date 2 =

Date 3 =

A =

B =

Business C =

PLR-146647-03

Business D =

Key Employee =

n dollars =o dollars =p dollars =q dollars =w percent =y percent =z percent =

Dear :

This letter responds to your July, 30, 2003, request for rulings regarding certain federal income tax consequences of a proposed transaction. The facts submitted for consideration are substantially as set forth below.

Distributing, a holding company, was incorporated under the laws of State X in Date 1. Distributing elected to be an S corporation effective Date 2. Distributing has accumulated earnings and profits. Distributing has outstanding a single class of voting common stock, fifty percent of which is held by each of A and B.

Controlled One, a C corporation, was incorporated under the laws of State X in Date 1. Controlled Two was incorporated under the laws of State X in Date 3. Controlled Two elected to be a qualified subchapter S subsidiary (QSUB) effective Date 2.

Distributing owns y percent of the outstanding stock of Controlled One and wholly owns Controlled Two. Key Employee holds z percent of Controlled One's shares. Controlled One has outstanding solely voting common stock. Controlled One is engaged in Business C and Controlled Two is engaged in Business D.

PLR-146647-03

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

Key Employee is a key employee of Controlled One. Key Employee has expressed a desire to significantly increase his equity interest in Controlled One. At the same time Key Employee wants Controlled One to be separated from Distributing in order to reduce certain obstacles to a planned expansion of Business C.

Accordingly, the following transaction is proposed:

- (i) Controlled One will make a pro rata distribution of approximately n dollars, plus a receivable owing from Distributing to Controlled One in the amount of p dollars, to Distributing and Key Employee.
- (ii) Key Employee will purchase from Distributing w percent of the issued and outstanding stock of Controlled One.
- (iii) The remaining shares of stock of Controlled One will be distributed by Distributing to shareholder B and Distributing will distribute cash and short term notes in the approximate amount of q dollars to shareholder A.

It is intended that, after the consummation of the proposed transaction, Key Employee will be given an option to acquire up to an additional z percent interest in Controlled One, and a second key employee will be given an option to acquire up to a w percent interest in Controlled One.

In connection with the proposed transaction, it has been represented that:

- (a) Distributing has accumulated earnings and profits of approximately \$q.
- (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 Distributing.
- (c) The five years of financial information submitted on behalf of Distributing, Controlled One, and Controlled Two is, in each instance, 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.

PLR-146647-03

- (d) The distribution of the stock of Controlled One is carried out for the following corporate business purpose: to increase the motivation, and retain the services of, Key Employee.
- (e) 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 One after the transaction.
- (f) There is no plan or intention by either Distributing or Controlled One, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction.
- (g) There is no plan or intention to liquidate either Distributing or Controlled One, 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.
- (h) 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 representing a 50 percent or greater interest (as defined in § 355(d)(4)) in Distributing or Controlled One.
- (i) Immediately after the distribution, no person will hold, directly or indirectly, disqualified stock (within the meaning of § 355(d)(3)) in Distributing or Controlled One that constitutes a 50 percent or greater interest (within the meaning of § 355(d)(4)) in Distributing or Controlled One.
- (j) Payments made in connection with all continuing transactions, if any, between Distributing and Controlled One will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (k) Except for receivables arising in the ordinary course of business, no intercorporate debt will exist between Distributing and Controlled One at the time of, or subsequent to, the distribution of the Controlled corporation stock.
- (l) The gross assets of the trades or businesses that will be relied upon by Distributing and Controlled One to satisfy the active trade or business requirement of § 355(b) will, in the aggregate, have a fair market value that is not less than five percent of the total fair market value of the gross assets of the company directly operating such trades or businesses.

PLR-146647-03

- (m) Immediately after the distribution at least ninety percent of the fair market value of the gross assets of Distributing will consist of the stock of Controlled Two, a corporation that is engaged in the active conduct of a trade or business as defined in § 355(b)(2).
- (n) Distributing is an S corporation within the meaning of § 1361(a). Controlled Two is a qualified subchapter S subsidiary (QSUB) (within the meaning of § 1361(b)(3)(B)). Controlled One 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 One (after said election is made) or the QSUB election of Controlled Two.
- (o) Following the proposed transaction, each of Controlled One and Controlled Two will continue the active conduct of its business independently and with its separate employees.
- (p) Distributing and Controlled One agree that the accumulated adjustment account of Distributing immediately before the distribution of the remaining shares of Controlled One to Shareholder B will be allocated between Controlled One and Distributing in a manner similar to the manner in which the earnings and profits of Distributing will be allocated under § 312(h).

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

- (1) No gain or loss will be recognized by (and no amount will be included in the income of) Distributing upon the distribution of the stock of Controlled One to Distributing's shareholder B (§ 355(c)(1)).
- (2) The distributions by Controlled One to its shareholders, as described in step (i), above, and the distribution by Distributing to shareholder A, as described in step (iii), shall qualify as distributions of property subject to § 301(a).
- (3) No gain or loss will be recognized by (and no amount will be included in the income of) Distributing's shareholder B upon the receipt of the stock of Controlled One (§ 355(a)(1)).
- (4) The basis of the stock of Distributing in the hands of Distributing's shareholder B prior to the transaction will be allocated between the stock of Controlled One received in the transaction and the stock of Distributing,

PLR-146647-03

based upon their relative fair market values in accordance with § 1.358-2(a)(2) of the Income Tax Regulations (§ 358(b)).

- (5) As provided in § 312(h) of the Code, proper allocation of earnings and profits between Controlled and Distributing will be made under § 1.312-10(b).
- (6) The distribution of cash and notes to Shareholder A as part of the transaction shall be treated by Shareholder A as an S corporation distribution. Section 1368(a) shall apply to the distribution by Distributing to Shareholder A and shall be included in the gross income of Shareholder A to the extent required under § 1368.
- (7) The accumulated adjustment account of Distributing immediately before the distribution of the remaining shares of Controlled One to Shareholder B will be allocated between Controlled One and Distributing in a manner similar to the manner in which the earnings and profits of Distributing will be allocated under § 312(h).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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 must be attached to any income tax return to which it is relevant.

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

Sincerely,

*Debra Carlisle*

Debra Carlisle  
Chief, Branch 5  
Office of Associate Chief Counsel

(Corporate)