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Person to Contact:

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Legend:

- Distributing =
- Controlled =
- Family Group A =
- Family Group B =
- Senior Generation Present Shareholders =
- Senior Generation Former Shareholders =
- X =
- Y =
- Z =
- Business T =

This letter responds to your April 10, 1999 request for rulings on certain federal income tax consequences of a proposed transaction on behalf of the above-captioned taxpayer. Additional information was received on September 24, October 8, October 17 and December 14, 1999. The material information submitted for consideration is summarized below.

Distributing, an S corporation incorporated in State Y, is engaged in Business T. Family Group A and Family Group B each own one-half of Distributing's common stock. The division of Distributing into two separate businesses is necessary because of the inability of the two Family Groups to agree upon fundamental management and operational issues. The two groups have widely divergent views regarding the present

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and future management of Distributing's business and the practices and procedures that need to be adopted to assure the continued growth and success of the business.

These divergent views have very seriously affected the management and operation of Distributing's business. Consequently, the parties have proposed that Distributing transfer approximately one-half of its net assets to a yet to be created corporation (Controlled) in exchange for 100% of Controlled's outstanding stock. Controlled intends to elect for Controlled to be an S corporation for its first taxable year. After the split-off and pursuant to a restructuring of indebtedness owing to Z, approximately 55% of the Z indebtedness will be an obligation solely of Controlled, and the remaining 45% will be a continuing obligation solely of Distributing, such percentages to be adjusted to take into account various additional equalizing items as determined by an Arbitration Board. Controlled will also assume a portion of Distributing's indebtedness. Distributing will then transfer all of Controlled's stock that it owns to Family Group A in exchange for all of their Distributing stock. There will also be a circular exchange of land as part of the transaction.

Senior Generation Present Shareholders (members of Family Group A) and Senior Generation Former Shareholders (members of Family Group B) are joint owners of various parcels of land, leased to Distributing under an oral lease (the two senior generation shareholder groups are sometimes hereinafter referred to collectively as Joint Owners). Distributing also owns some land outright, both as sole owner of some parcels and, as to other properties, jointly with the Joint Owners. The land, including the undivided fractional interests, will be exchanged by, between, and among the Joint Owners and Distributing. After the proposed exchange and split-off, there will be two corporations, both economically viable business operations of approximately equal value.

The exchange of property will be structured as a circular exchange. Senior Generation Former Shareholders will convey their relinquished property to Distributing; Distributing will convey its relinquished property to Senior Generation Present Shareholders; and Senior Generation Present Shareholders will convey their relinquished property to Senior Generation Former Shareholders. In all, twenty-five separate parcels of land are held by Distributing and the Joint Owners in whole and undivided fractional interests. The value of all interests to be relinquished by each party to the exchange is approximately equal. The value of the replacement property to be received in the exchange by each party is also about equal. At the conclusion of the transaction, each party which formerly held fractional interests in various parcels of land will generally be 100% owners of their respective parcels.

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

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In connection with the proposed transaction, the following additional representations are made:

- (a) The fair market value of the Controlled stock and other consideration to be received by each shareholder of Distributing will be approximately equal to the fair market value of the Distributing stock surrendered by the shareholder in exchange.
- (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 the corporation.
- (c) 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 since the date of the last financial statements submitted.
- (d) Following the transaction, the Distributing and Controlled corporations will each continue, independently and with its separate employees, the active conduct of its share of all the integrated activities of the business conducted by Distributing prior to the consummation of the transaction.
- (e) The Distribution is being carried out for the purposes set forth above. The Distribution is motivated, in whole or substantial part, by one or more of these corporate business purposes.
- (f) Except for a gifting program among Family Group A shareholders, 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.
- (g) Distributing is an S corporation (within the meaning of § 1361(a)). 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.
- (h) 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.
- (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 dispose of the assets of either corporation after the Distribution, except in the

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ordinary course of business.

(j) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject; and 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.

(k) 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 Public Law 101-508, Title 11, 104 Stat. 1388, 536 (1990), if applicable) to reflect an early disposition of property.

(l) Distributing neither accumulated its receivables nor made extraordinary payments of its payables in anticipation of the transaction.

(m) No income items, including accounts receivable or any item resulting from a sale, exchange or disposition of property, that would have resulted in income to Distributing, and no items of expense will be transferred to Controlled if Distributing has earned the right to receive the income or could claim a deduction for the expense under the accrual or similar method of accounting.

(n) Incident to the transfer of some of its assets to Controlled, Distributing and/or Controlled will cooperate in collecting and/or physically dividing the accounts receivable of Distributing as of the split-off date and will remit appropriate payments to the other so as to result in a nearly equal division of assets of Distributing between Distributing and Controlled. To the extent that one or more cooperatives will not agree to a transfer of a portion of the cooperative retains of Distributing to Controlled, cooperative retains will be handled in the same manner as accounts receivable. In the event that there is a collection of accounts receivable or of cooperative retains by Distributing or Controlled, Distributing or Controlled will be an open-account creditor of the other. Other than what is otherwise described in this paragraph, no intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Distribution.

(o) 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.

(p) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv) of the Internal Revenue Code.

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(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 percent or more of the total combined voting power of all classes of stock of either Distributing or Controlled entitled to vote, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.

(r) Less than 50 percent of the total combined voting power of all classes of Distributing stock entitled to vote and less than 50 percent of the total value of shares of all classes of Distributing stock will have been acquired by purchase under § 355(d)(5) or (8) during the five-year period ending on the date of the Distribution (determined after applying § 355(d)(6)).

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

(1) The transfer by Distributing to Controlled of certain of its assets in exchange for all of the common stock of Controlled followed by the distribution of all the Controlled stock, as described above, will constitute a reorganization under § 368(a)(1)(D) of the Code. Distributing and Controlled will each be "a party to a reorganization" under § 368(b) of the Code.

(2) Distributing will recognize no gain or loss upon the transfer of certain assets to Controlled in exchange for all of Controlled's stock and the assumption of liabilities, as described above (Code §§ 361(a) and 357(a)).

(3) No gain or loss will be recognized by Controlled on receipt of the assets in exchange for all the shares of Controlled, as described above (§ 1032(a)).

(4) Controlled's basis in the Distributing assets received by Controlled in the transaction will be the same as the basis of such assets in the hands of Distributing immediately before the transfer (§ 362(b)).

(5) Controlled's holding period of the Distributing assets received by Controlled in the transaction will include the period during which Distributing held the assets (§1223(2)).

(6) No gain or loss will be recognized to (and no amount will be included in the income of) the Family Group A shareholders upon receipt of Controlled stock in exchange for all of their Distributing stock, as described above (§ 355(a)).

(7) The basis of the Controlled stock received by each member of Group A will be the same as the basis of the Distributing stock that member surrendered in exchange therefor (§ 358(a)(1)).

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(8) The holding period of the Controlled stock to be received by the shareholders of Distributing, as described above, will include the period of the Distributing stock surrendered in the exchange, provided that such stock is held as a capital asset by those respective shareholders on the day of the exchange (§ 1223(1)).

(9) Distributing will recognize no gain or loss upon the distribution of all of its Controlled stock to Distributing shareholders, as described above, pursuant to § 361(c).

(10) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a).

(11) Distributing Corporation will not have any net recognized built-in gain under § 1374 resulting from the transfer of certain of its net assets to Controlled in exchange for all of the outstanding stock of Controlled and there will be no tax imposed under § 1374 on the income of Distributing for the taxable year in which such transfer occurs.

(12) The S election to be made by Controlled immediately following the distribution of Controlled's stock by Distributing, will not subject Controlled's assets to be taxed under 1374, nor will Controlled thereafter have any net recognized built-in gain under § 1374 on the income of Controlled with respect to the assets received from Distributing.

Section 1362(a) of the Code provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1368(e)(1) of the Code provides that the term "accumulated adjustment account" (AAA) means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under § 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under title 26 and the phrase "(but not below)" shall be disregarded in § 1367(b)(2)(A)) and no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation.

Section 1.1368-2(d)(3) of the Income Tax Regulations provides that if an S corporation with accumulated earnings and profits transfers a part of its assets constituting an active trade or business to another corporation in a transaction to which § 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which § 355 (or so much of § 356 as relates to § 355) applies, the AAA of the distributing corporation immediately before the transaction is allocated between the distributing corporation and

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the controlled corporation in a manner similar to the manner in which the earnings and profits of the distributing corporation are allocated under § 312(h).

For rulings (13) and (14), Distributing's momentary ownership of stock of Controlled as part of the reorganization will not cause Controlled to be an ineligible corporation under § 1361(b)(2)(A), therefore:

(13) Assuming that Controlled will otherwise meet the requirements of a small business corporation under § 1361 of the Code, Controlled will be eligible to make an S corporation election under § 1362(a) for its first taxable year.

(14) Distributing's AAA immediately before the transaction will be allocated between Distributing and Controlled in a manner similar to the manner in which Distributing's earnings and profits will be allocated under § 312(h).

(15) 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 Distributing's assets to Controlled.

(16) Under § 1250(d)(3), Distributing will recognize no gain and will include no amounts in income under § 1250(a) on the transfer of the portion of Distributing's assets to Controlled.

(17) No gain or loss will be recognized by Distributing as a result of the proposed transfer by Distributing of certain parcels of land and undivided fractional interests in certain other parcels of land in exchange for undivided fractional interests in other parcels of land to be transferred to Distributing by Senior Generation Former Shareholders. § 1031(a)(1).

(18) No gain or loss will be recognized by Senior Generation Former Shareholders as a result of the proposed transfer by them of undivided fractional interests in certain parcels of land in exchange for undivided fractional interests in other parcels of land to be transferred to them by Senior Generation Present Shareholders. § 1031(a)(1).

(19) No gain or loss will be recognized by Senior Generation Present Shareholders as a result of the proposed transfer by them of undivided fractional interests in certain parcels of land in exchange for certain other parcels of land and undivided fractional interests in certain other parcels of land to be transferred to them by Distributing. § 1031(a)(1).

(20) The bases of the parcels of land and the bases of the undivided fractional interests in the parcels of land to be acquired by each taxpayer, as described in rulings (17), (18) and (19) above, will be the same as that of the property

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exchanged by each such taxpayer, allocated among the parcels acquired according to their respective fair market values on the date of the exchange. § 1031(d).

The determination in ruling (20) above is valid only to the extent that the values of the properties relinquished and received by each taxpayer are approximately equal. No opinion is expressed as to whether the properties relinquished and received as described in rulings (17), (18) and (19) above are approximately equal.

Because the parties to this transaction are related as defined by § 267(b), we note the possible application of § 1031(f) if property received in the like-kind exchange is sold within two years after the date of the last transfer that was part of the exchange.

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 the taxpayer.

Sincerely,
Assistant Chief Counsel (Corporate)
By: Lewis K Brickates
Assistant to Chief, Branch 2