

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

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Date:

March 29, 2002

Distributing =

State X =

Shareholder A =

Former Shareholder B =

Shareholder B Trust =

Trustee B =

Shareholder C =

Shareholder D =

Controlled 1 =

Employee E =

Controlled 2 =

Employee G =

Employee H =

Business A =

Business B =

m =

n =

p =

LLC =

r =

u =

w =

Dear

This letter responds to a letter dated September 14, 2001, requesting rulings concerning the federal income tax consequences of a proposed transaction. The information submitted in that letter and subsequent correspondence is summarized below.

Distributing, a State X corporation, is an S corporation that uses the accrual method of accounting and a calendar year. Distributing is primarily engaged in two businesses: Business A and Business B. Distributing has outstanding common stock, 50 percent held by Shareholder A and Shareholder B Trust (the "A-B Group"), and 50 percent held by Shareholders C and D (the "C-D Group"). Distributing has no securities outstanding. Employee E is a Distributing Employee who works in Business A. Employees G and H are Distributing key employees ("Key Employees") who work in Business B. Business A also utilizes (sometimes without compensation) the services of Shareholder A, Trustee B, Shareholder C, and Shareholder D.

Controlled 1 and Controlled 2, State X corporations, will each be an S corporation that uses the accrual method of accounting and a calendar year. Initially, all the outstanding stock in Controlled 1 and 2 will be held by Distributing.

LLC is a State X limited partnership that is, or will be, engaged in some or all aspects of Business A. Controlled 1 will be the general partner in LLC and members of the A-B Group will be limited partners.

Shareholders C and D are husband and wife. Former Shareholder B, who is now deceased, was the husband of Shareholder A. Shareholder C and Former Shareholder B had been active together for many years in Distributing's businesses. Since the death of Former Shareholder B, the A-B Group and the C-D Group have had

difficulty developing and maintaining a consistent business strategy, making business decisions about both existing and future commitments (especially as to an acceptable level and amount of risk), and deciding on which business opportunities Distributing should focus. To solve these problems, it is now desired to divide Distributing between the A-B and C-D shareholder groups. The proposed corporate separation will help enable Business A to realize its full potential and, importantly, it will enable the resultant corporations to deal with properties on which Distributing has already made commitments, so that these properties can be developed on a timely basis without default.

Former Shareholder B not only worked in Business A but was a key employee in Business B, and his death has increased the dependence of Distributing's Business B on its remaining employees, especially Key Employees G and H. Key Employees G and H each contribute significantly to the success of Business B. Each of these Key Employees has a specific talent and/or experience that is essential to Business B, and each has substantial experience in this industry. Retention of both of these Key Employees has become especially important now that Former Shareholder B is gone. Both Key Employees are dissatisfied with the present corporate structure in which they have no shareholder vote and no equity interest. In addition, neither wishes to be a shareholder in the present corporation as long as it is subject to the risks of Business A and has the prohibitively expensive stock associated with Business A. Finally, neither Key Employee wishes to be a shareholder in a subsidiary corporation where major decisions regarding the subsidiary would be made by a parent corporation in which they would not be involved. (And, in any event, it would be complex and/or impractical to transfer Business B to a subsidiary, as Business B holds contracts, licenses and/or agreements that are not assignable or divisible.) Instead, the Key Employees desire to be shareholders of a stand-alone corporation engaged in Business B. There is no alternative nontaxable transaction that Distributing could use to meet the objectives of the Key Employees. In order to retain the Key Employees and to give them increased motivation and incentive, Distributing and the Key Employees have come to an understanding that the Key Employees will each have the opportunity to acquire stock from Distributing. Under the terms of the offer, once Distributing is a stand-alone company engaged solely in Business B, each Key Employee will be able to purchase from Distributing an amount of stock that will constitute approximately percent of the resultant outstanding stock in Distributing.

The parties have already completed or intend to complete the following steps ("Steps") in the proposed transaction:

- (I) Distributing will form Controlled 1 and Controlled 2, each of which will have outstanding solely voting common stock.
- (II) Distributing will transfer to Controlled 1 approximately one half of the Business A assets (and related liabilities), cash, and a promissory note in the amount of approximately \$p ("Promissory Note") in exchange for Controlled 1 stock. Distributing will retain approximately one half of

Business A. In addition, Distributing will retain all of Business B. At this point, Distributing will hold all the outstanding stock in Controlled 1.

- (III) Distributing will distribute all the Controlled 1 stock to Shareholder A and Shareholder B Trust in exchange for all their stock in Distributing.
- (IV) Distributing will transfer to Controlled 2, all its remaining assets that are related to Business A. (Distributing will retain its Business B assets.)
- (V) Distributing will distribute all the Controlled 2 stock to Shareholders C and D.
- (VI) As soon as reasonably convenient after Step (V) and in all events within no more than 1 (one) year after completing Step (V), Key Employees G and H will each acquire from Distributing an amount of stock constituting r percent of all the outstanding Distributing stock (a total of u percent for the two employees). Each of the employees will pay for the stock with \$m cash and a promissory note for approximately \$n.

Shareholder C will continue in the management of Distributing with the assistance of the Key Employees. Key Employees G and H will each: (i) enter into multi-year senior position employment agreements with Distributing; and (ii) remain members of the board of directors of Distributing.

Subsequent to Step (III) in a separately motivated transaction, in order to combine the operation of Controlled 1's business with the operation of similar assets held by its shareholders (which they acquired previously in unrelated transactions), Controlled 1 and its shareholders will undertake the following transaction:

- (VII) Controlled 1 will transfer some, or all, of its Business A assets and associated liabilities to LLC. Shareholder A and Shareholder B Trust, will transfer some or all of their similar assets to LLC. In exchange for these transferred assets, Controlled 1, Shareholder A and Shareholder B Trust will receive partnership interests in LLC. Controlled 1 will act as LLC's general partner. Shareholder A and Shareholder B Trust will be limited partners.

Distributing has submitted financial and employee information that indicates that each of Business A and Business B had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past 5 years.

The following representations have been made in connection with the proposed Steps (I) through (V), involving the distributions of stock in Controlled 1 and 2:

- (a) Distributing, Controlled 1, Controlled 2, and each of the shareholders will each pay their own expenses in the transaction.

- (b) There is no plan or intention for any Distributing shareholder to transfer any assets to Distributing, Controlled 1 or 2, or any related entity.
- (c) Each of Controlled 1 and 2 will elect status as an S corporation (within the meaning of §1361(a) of the Internal Revenue Code) on the first available date after its distribution.
- (d) None of any outstanding debt in either Controlled 1 or 2 will constitute a security or an equity interest in Controlled 1 or 2.
- (e) For each shareholder, the fair market value of the Controlled 1 stock to be received by Shareholder A and Shareholder B Trust will approximately equal the fair market value of the Distributing stock surrendered by such shareholder in exchange therefor.
- (f) No part of the Controlled 1 stock received by the shareholders in the distribution is being received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.
- (g) The 5 years of financial information submitted on behalf of each of Business A and Business B is representative of the corporation's present operations, and with regard to each of these two businesses, there have been no substantial operational changes since the date of the last financial statements submitted.
- (h) Following the Step (III) and Step (V) distributions, Distributing will continue to be directly engaged in the active conduct of Business B independently and with its own employees. Business B's only shared employee will be Shareholder C. Business B will have been actively conducted (within the meaning of § 1.355-3(b)) by Distributing independently and with its own employees at all times in the 5-year period prior to the distributions of Controlled 1 and Controlled 2 stock.
- (i) Following the Step (III) distribution, Controlled 1 will continue to be directly engaged in the active conduct of Business A, independently and with its own employees. This continued active conduct of the business by Controlled 1 will be maintained, regardless of whether Controlled 1 operates this business directly itself, or operates it in partnership form as the general partner of LLC. Business A will have been actively conducted within the meaning of § 1.355-3(b) of the Income Tax Regulations) by Distributing independently and with its own employees at all times in the 5-year period prior to Step (III). Following Step (III), Controlled 1's Business A will include approximately w currently active properties as well as undeveloped property.

- (j) Following the Step (V) distribution, Controlled 2 will be directly engaged in the active conduct of Business A, independently and with its own employees (except for sharing Shareholder C). Business A will have been actively conducted (within the meaning of § 1.355-3(b)) by Distributing independently and with its own employees throughout the 5-year period immediately preceding the distribution. Following Step (V), Controlled 2 will hold approximately w active properties (similar to Controlled 1). Controlled 2, solely through its own employees and Shareholders C and D, will conduct Business A in substantially the same manner as it is conducted by Controlled 1, except that it is anticipated that Controlled 2 will focus on somewhat different business opportunities, including the riskier part of Business A.
- (k) The Step (III) distribution of Controlled 1 stock is being undertaken for the corporate business purpose of ending the present deadlock, and so that the resultant corporations will be better managed and more able to meet their existing business commitments as a result of each corporation being able to pursue a single consistent business strategy. The distribution of Controlled 1 stock is motivated in substantial part by this corporate business purpose of seeking a consistent strategy and improved management.
- (l) The Step (V) distribution of Controlled 2 stock is being carried out for the corporate business purpose of increasing the motivation, and retaining the services, of Key Employees G and H. The distribution of Controlled 2 stock is motivated, in substantial part, by this key employee corporate business purpose.
- (m) Except for (i) the Step (VI) sales of stock by Distributing to the Key Employees, (ii) transfers to members of the same family as defined in § 267(c) (4), and (iii) exchanges or issuances of Distributing, Controlled 1, or Controlled 2 stock in exchange for or as a result of owning stock in Distributing, Controlled 1, or Controlled 2 pursuant to a § 355(e)(3)(A) transaction, neither Shareholder A, Shareholder B Trust, Shareholder C, Shareholder D, Employee G, nor Employee H (nor any related person within the meaning of § 267(c)(4)): has any plan or intention to sell, give, redeem, transfer, receive, or in any way change his or her holding of stock in Distributing, Controlled 1, or Controlled 2; or has any plan or intention to take any action that would result in any other shareholder changing their holding of stock in Distributing, Controlled 1, or Controlled 2.
- (n) There is no plan or intention by either Distributing, Controlled 1, or Controlled 2, directly or through any subsidiary corporation, to purchase any of its outstanding stock in conjunction with or after the transaction.
- (o) Distributing has been an S corporation (within the meaning of §1361(a))

since 1990. It is anticipated that both Controlled 1 and Controlled 2 will remain S corporations. Neither the Step (III) nor the Step (V) distribution will result in an avoidance of the receipt of earnings and profits by Distributing shareholders.

- (p) None of the transactions in Steps (I) through (V) is intended or expected to result in any reduction in the total amount of federal income tax payable by Distributing and/or its successors. That is, the total amount of federal income tax payable after the transactions by Distributing, and Controlled 1 and 2 is anticipated to be at least as great as the amount that would have been payable by Distributing if the transactions had not occurred.
- (q) There is no plan or intention to liquidate either Distributing, Controlled 1, or Controlled 2, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation, except for: (i) dispositions in the ordinary course of business; and (ii) transfers described in Step (II) and Step (IV).
- (r) With regard to each of Controlled 1 and Controlled 2, the total adjusted basis and the fair market value of the assets transferred to the controlled corporation by Distributing will each equal or exceed the sum of the liabilities (as determined under § 357(d)) assumed by such controlled corporation.
- (s) With regard to each of Controlled 1 and Controlled 2, the liabilities of Distributing assumed by the controlled corporation (as determined under § 357(d)) and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets transferred.
- (t) Although investment tax credits were claimed with respect to certain of the properties being transferred to Controlled 1 and/or Controlled 2, the recapture periods for such credits have expired. None of any property transfers by Distributing to Controlled 1 or Controlled 2 will be an “early disposition” within the meaning of § 50(a).
- (u) No intercorporate debt will exist between Distributing, Controlled 1, and Controlled 2 at the time of the proposed transactions, or subsequent thereto, except for: (i) the Promissory Note; and (ii) any temporary accounts payable that may arise in the course of routine business transactions between the companies.
- (v) The Promissory Note is being issued by Distributing to Controlled 1 in order to equalize the value of the assets held by Distributing and Controlled 1. The Promissory Note will be due in 7 years and will provide

for the payment of interest at a rate similar to the rate that would be charged by a knowledgeable commercial lender.) Under the terms of the note, Controlled 1 will have only the same rights as those of a creditor. In the event of default, neither Controlled 1 nor its shareholders will be entitled to receive an equity interest in Distributing.

- (w) No substantial business transactions are anticipated between Distributing, Controlled 1, and Controlled 2. However, Distributing will provide certain services under existing contracts to Controlled 1 and Controlled 2. For any inter-company transactions, all payments between Distributing, Controlled 1, and Controlled 2 will be for fair market value based on terms and conditions arrived at by the parties bargaining at arms length.
- (x) No two parties to either the Step (II) or the Step (IV) transfer are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (y) Neither the Step (III) nor the Step (V) distribution will constitute a disqualified distribution within the meaning of § 355(d).
- (z) Neither the Step (III) nor the Step (V) distribution is 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 in either Distributing, Controlled 1, or Controlled 2, or stock possessing 50 percent or more of the total value of all classes of stock in either Distributing, Controlled 1, or Controlled 2.

Representations with regard to the Step (VII) transfer of assets from Controlled 1 to LLC:

- (aa) LLC is being formed under State X's Limited Liability Company Act.
- (bb) LLC will not elect to be treated as anything other than a partnership and will constitute a domestic eligible entity that is classified as a partnership under § 301.7701-3.
- (cc) For each partner, the fair market value of the partnership interest in LLC received by the partner will approximately equal the net fair market value of the assets received and liabilities assumed by LLC in exchange therefor.

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

Rulings with regard to the Steps (I) through (V) transfers from Distributing to Controlled 1 and 2 and distributions of stock in

Controlleds 1 and 2.

- (1) The transfer of some or all of Controlled 1's Business A assets from Controlled 1 to LLC, in which Controlled 1 is the general partner, as described above, will not prevent Controlled 1 from being considered as engaged in Business A for purposes of § 355 (Rev. Rul. 92-17, 1992-1 C.B. 142).
- (2) The transfer in Step (II) by Distributing to Controlled 1 of Business A assets and the \$p Promissory Note, in exchange for all the stock in Controlled 1 and the assumption by Controlled 1 of liabilities associated with the assets and business transferred followed by the distribution in Step (III) of all the Controlled 1 stock to Shareholder A and Shareholder B Trust constitutes a reorganization within the meaning of §§ 368(a)(1)(D) and 355. Distributing and Controlled 1 are each a "party to a reorganization" within the meaning of § 368(b).
- (3) No gain or loss is recognized by Distributing on the transfer of assets, subject to liabilities, to Controlled 1 in exchange for all the stock in Controlled 1 and the assumption of liabilities (§§ 361(a) and 357(a)).
- (4) No gain or loss is recognized by Controlled 1 on its receipt of assets in exchange for Controlled 1 stock (§ 1032(a)).
- (5) Controlled 1's basis in the assets received from Distributing equals the basis of such assets in the hands of Distributing immediately prior to the transfer (§ 362(b)).
- (6) Controlled 1's holding period for the assets received from Distributing includes the period during which Distributing held such assets (§ 1223(2)).
- (7) No gain or loss will be recognized to Distributing upon the distribution to Shareholder A and Shareholder B Trust of all the stock in Controlled 1 (§ 361(c)(1)).
- (8) No gain or loss will be recognized to (and no amount will be included in the income of) Shareholder A or Shareholder B Trust upon the receipt of Controlled 1 stock in exchange for all their Distributing stock (§ 355(a)(1)).
- (9) For each shareholder, the basis of the Controlled 1 stock received will be equal to the basis of the Distributing stock surrendered in exchange therefor (§ 358(a)(1)).
- (10) The holding period of the Controlled 1 stock received by the shareholders will include the period during which a shareholder held the Distributing

stock exchanged therefor, provided that the Distributing stock is a capital asset in the hands of the shareholders on the date of the exchange (§ 1223(1)).

- (11) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled 1 will be made under § 1.312-10(a) of the regulations.
- (12) As provided by § 1.1368-2(d)(3), the “accumulated adjustments account” (as defined in § 1368(e)(1)) of Distributing immediately prior to the Step (III) distribution of Controlled 1 stock will be allocated between Distributing and Controlled 1 in a manner similar to the manner in which the earnings and profits of Distributing are allocated (see ruling (11) above).
- (13) The transfer in Step (IV) by Distributing to Controlled 2 of Business A assets, in exchange for all the stock in Controlled 2 and the assumption by Controlled 2 of liabilities associated with the assets and business transferred followed by the distribution in Step (V) of all the Controlled 2 stock to Shareholders C and D constitutes a reorganization within the meaning of §§ 368(a)(1)(D) and 355. Distributing and Controlled 2 are each a “party to a reorganization” within the meaning of § 368(b).
- (14) No gain or loss is recognized by Distributing on the transfer of assets, subject to liabilities, to Controlled 2 in exchange for all the stock in Controlled 2 and the assumption of liabilities (§§ 361(a) and 357(a)).
- (15) No gain or loss is recognized by Controlled 2 on its receipt of assets in exchange for Controlled 2 stock (§ 1032(a)).
- (16) Controlled 2's basis in the assets received from Distributing equals the basis of such assets in the hands of Distributing immediately prior to the transfer (§ 362(b)).
- (17) Controlled 2's holding period for the assets received from Distributing includes the period during which Distributing held such assets (§ 1223(2)).
- (18) No gain or loss is recognized to Distributing upon the distribution to Shareholders C and D of all the stock in Controlled 2 (§ 361(c)(1)).
- (19) No gain or loss is recognized to (and no amount will be included in the income of) Shareholders C and D upon the receipt of Controlled 2 stock (§ 355(a)(1)).
- (20) For each of Shareholders C and D, the shareholder's total basis in the Controlled 2 stock and the Distributing stock held after the distribution will be the same as the basis of the Distributing stock held by such

shareholder immediately before the distribution. Each shareholder's total basis will be allocated between the Distributing stock and Controlled 2 stock in proportion to the relative fair market values of the Distributing stock and Controlled 2 stock in accordance with § 1.358-2(a)(2).

- (21) The holding period of the Controlled 2 stock received by Shareholders C and D will include the period during which such shareholders held the Distributing stock with regard to which the Controlled 2 stock is received, provided that the Distributing stock is a capital asset in the hands of Shareholders C and D on the date Step (V) is consummated (§ 1223(1)).
- (22) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled 2 will be made under § 1.312-10(a).
- (23) As provided by § 1.1368-2(d)(3), the "accumulated adjustments account" (as defined in § 1368(e)(1)) of Distributing immediately prior to the step (V) distribution of the Controlled 2 stock will be allocated between Distributing and Controlled 2 in a manner similar to the manner in which the earnings and profits of Distributing are allocated (see ruling (22) above).

Rulings with regard to the Step (VII) transfer of assets and associated liabilities from Controlled 1 to LLC.

- (24) Provided that LLC is not an investment company under section 721(b), no gain or loss will be recognized to Controlled 1, Shareholder A, Shareholder B Trust or LLC upon the contribution of assets by Controlled 1, Shareholder A, and Shareholder B Trust to LLC in exchange for membership interests (§ 721).
- (25) LLC will take a carryover basis in the assets received in the contribution (§ 723).
- (26) The basis of Shareholder A, Shareholder B Trust, and Controlled 1 in the LLC membership interests received in the exchange will equal their adjusted basis in the assets contributed in the exchange (§ 722).

No opinion is expressed about the tax treatment of the proposed transactions 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 transactions that are not specifically covered by the above rulings. In particular, no opinion is expressed as to the federal tax effect of the sale of Distributing stock to the Key Employees or as to whether the use of "adjusted book value" is an appropriate method of valuing Distributing Stock for purposes of such sale, or for any other purpose, or as to whether this valuation method should be treated as resulting in additional compensation to the Key Employees or as having other tax effects.

In addition, no opinion is expressed as to whether the transfer of any trade name, trademark, know-how, or similar items from Distributing to Controlled 1 or 2 constitutes the transfer of property (see Rev. Rul. 69-156, 1969-1 C.B. 101).

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) of the Code 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 transactions covered by this letter are consummated.

Sincerely yours,

By _____

Lisa A. Fuller
Assistant Branch Chief, Branch 1
Office of Assistant Chief Counsel
(Corporate)