

## Internal Revenue Service

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## Departments of the Treasury

Washington, D.C. 20224

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**CC:CORP:1- PLR-110073-03**

Date:

**August 8, 2003**

Distributing =

Controlled 1 =

Controlled 2 =

Controlled 3 =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

Shareholder 4 =

Shareholder 5 =

Shareholder 6 =

Business A =

Year 1 =

Date 1 =

a =

b =

c =

d =

e =

f =

g =

h =

State X =

Dear

This letter is in reply to your letter dated January 12, 2003, requesting rulings as to the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated April 24, May 30, July 10, July 12, and July 30, 2003. The information submitted for consideration is summarized below.

Distributing is a State X cash basis corporation. Distributing elected to be taxed as an S corporation in Year 1. Distributing currently has h shares of voting common stock outstanding, which is owned by six "Shareholders:" Shareholder 1 (a%); Shareholder 2 (b%); Shareholder 3 (c%); Shareholder 4 (d%); Shareholder 5 (e%); and Shareholder 6 (f%). Distributing has directly engaged in Business A for more than five years through its shareholders and employees. Distributing employs no independent contractor in conducting the core operations of Business A. Pursuant to a "Stock Purchase Agreement" dated Date 1, each existing Shareholder of Distributing has an option to purchase a proportionate share of Distributing stock in the event of an

involuntary transfer of Distributing stock or upon the death of a Shareholder.

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 the business for each of the past five years.

Distributing's Shareholders cannot agree on the operation and management of Business A. To resolve these continuing shareholder disputes, Distributing has decided to separate Business A as follows ("Proposed Transaction"):

(i) Distributing will form Controlled 1, Controlled 2, and Controlled 3 under the laws of State X as cash basis corporations. Distributing will initially receive all of the outstanding shares of common stock of Controlled 1, Controlled 2, and Controlled 3 in exchange for a portion of the Business A assets ("Contribution"). In order to equalize values between Distributing and Controlled 1, Distributing will obtain a mortgage in the amount of \$g with respect to a parcel of property that will be transferred to Controlled 2. Then, after completing the above borrowing transaction, Distributing will contribute a parcel of property, subject to outstanding mortgage indebtedness, and cash to Controlled 1. Thereafter, as described in paragraph (ii), Shareholder 1 will exchange his Distributing stock for Controlled 1 stock. Shareholder 1 will not assume any of Distributing debt on the contributed property. At the same time, Distributing will contribute another parcel of property, subject to outstanding mortgage indebtedness, to Controlled 2. Thereafter, as described in paragraph (ii), Shareholder 2 will exchange his Distributing stock for Controlled 2 stock. Shareholder 2 will not assume any of Distributing debt on the contributed property. At the same time, Distributing will contribute yet another parcel of property, subject to outstanding mortgage indebtedness, and cash to Controlled 3. Thereafter, as described in paragraph (ii), Shareholder 3 will exchange her Distributing stock for Controlled 3 stock. Shareholder 3 will not assume any of Distributing debt on the contributed property.

(ii) Distributing will distribute all of the stock of Controlled 1 to Shareholder 1 in exchange for all of Shareholder 1's stock in Distributing. Distributing will distribute all of the stock of Controlled 2 to Shareholder 2 in exchange for all of Shareholder 2's stock in Distributing. Distributing will distribute all of the stock of Controlled 3 to Shareholder 3 in exchange for all of Shareholders 3's stock in Distributing. Cash will be paid in lieu of any fractional share interests in Controlled 1, Controlled 2, and Controlled 3. After the distribution of the stock of Controlled 1, Controlled 2, and Controlled 3, Distributing will retain a portion of the Business A assets. Shareholder 4, Shareholder 5, and Shareholder 6 will continue to own Distributing stock.

The following representations have been made in connection with the Proposed Transaction:

- (a) There will be no debt outstanding between Distributing and any Controlled after the Proposed Transaction.
- (b) The fair market value of the stock of Controlled 1, Controlled 2, and Controlled 3 to be received by Shareholder 1, Shareholder 2, and Shareholder 3, will be approximately equal to the fair market value of the Distributing corporation stock surrendered by such Shareholder in the exchange.
- (c) No part of the consideration distributed by Distributing is being received by any Shareholder as a creditor, employee or in any capacity other than that as a shareholder of Distributing.
- (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 since the date of the last financial statements submitted.
- (e) Following the transaction, Distributing and each Controlled corporation will each continue, independently and with its separate employees, the active conduct of all of the integrated activities of the business conducted by Distributing prior to the consummation of the transaction.
- (f) The distribution of stock of Controlled 1, Controlled 2, and Controlled 3 is being carried out for the following corporate business purposes: (i) resolution of shareholder disputes, (ii) diversification of risk, and (iii) reduction of costs. The distribution of the stock of Controlled 1, Controlled 2, and Controlled 3 is motivated in whole or in substantial part by one or more of these corporate business purposes.
- (g) Distributing corporation is an S corporation (within the meaning of section 1361(a) of the Internal Revenue Code). Each of Controlled 1, Controlled 2, and Controlled 3 will elect to be an S corporation pursuant to section 1362(a) of the Internal Revenue Code ("Code") 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 any of Distributing, Controlled 1, Controlled 2, or Controlled 3.
- (h) 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 any of Distributing, Controlled 1, Controlled 2, or Controlled 3 after the transaction, except for possible gifts of Distributing stock by Shareholder 4 to her children and transfers of Distributing shares owned by Shareholder 4 subject to the Stock Purchase Agreement. Any such gifts will constitute, in the aggregate, no more than 50% of the total respective value of Distributing stock outstanding immediately after consummation of the Proposed Transaction.

(i) There is no plan or intention by any of Distributing, Controlled 1, Controlled 2, or Controlled 3, 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.

(j) There is no plan or intention to liquidate any of Distributing, Controlled 1, Controlled 2, or Controlled 3, to merge any of the corporations with any corporation, or to sell or otherwise dispose of the assets of any of the corporations after the transaction except in the ordinary course of business.

(k) In each case, the total adjusted basis and fair market value of the assets transferred to Controlled 1 and Controlled 3, respectively, by Distributing equals or exceeds the sum of the liabilities assumed by Controlled 1 and Controlled 3, plus any liabilities to which the transferred assets are subject. The fair market value of the assets contributed to Controlled 2 by Distributing will equal or exceed the sum of the liabilities assumed by Controlled 2, plus any liabilities to which the transferred assets are subject. However, the liabilities assumed by Controlled 2, plus the liabilities to which the transferred assets are subject, will exceed the adjusted basis of the property contributed by an amount equal to the liabilities to which the contributed assets are subject.

(l) No investment credit determined under section 46 of the Code has been or will be claimed with respect to any property transferred to Controlled 1, Controlled 2, or Controlled 3.

(m) Distributing neither accumulated its receivables nor made any extraordinary payment of its payables in anticipation of the transaction.

(n) No intercorporate debt will exist between Distributing and any of Controlled 1, Controlled 2, or Controlled 3 at the time of, or subsequent to, the distribution of the Controlled 1, Controlled 2, and Controlled 3 stock.

(o) Payments made in connection with all continuing transactions, if any, between any of Distributing, Controlled 1, Controlled 2 or Controlled 3, or between Controlled 1, Controlled 2, or Controlled 3, 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 section 368(a)(2)(F)(ii) and (iv).

(q) The distribution of the stock of Controlled 1, Controlled 2, and Controlled 3 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 any of Distributing, Controlled 1, Controlled 2, or Controlled 3 or stock possessing 50% or more of the total value of all classes of stock of any of Distributing, Controlled 1, Controlled 2, or Controlled 3.

(r) None of the distributions of the stock of Controlled 1, Controlled 2 and Controlled 3 will be a disqualified distribution within the meaning of section 355(d)(2).

(s) The payment of cash in lieu of fractional shares of Controlled 1, Controlled 2, and Controlled 3 stock is solely for the purpose of avoiding the expense and inconvenience to Controlled 1, Controlled 2, and Controlled 3 of issuing fractional shares and does not represent separately bargained for consideration. The total cash consideration that will be paid instead of issuing fractional shares of Controlled 1, Controlled 2, and Controlled 3 stock will not exceed 1% of the total consideration that will be issued pursuant to the distribution of such stock. The fractional share interests will be aggregated, and no holder of Distributing stock will receive cash in an amount greater than the value of one full share of Controlled 1, Controlled 2, and Controlled 3 stock.

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

- (1) The transfer by Distributing to each of Controlled 1, Controlled 2 and Controlled 3 of a portion of the assets of Business A plus, in the case of Controlled 1 and Controlled 3, Distributing's contribution of cash to equalize values, in exchange for all of the stock of each Controlled and the assumption of liabilities by each Controlled, followed by the distribution of stock of each of Controlled 1, Controlled 2, and Controlled 3 to Shareholder 1, Shareholder 2, and Shareholder 3, respectively, will in each case be a reorganization within the meaning of section 368(a)(1)(D). Distributing and each Controlled will be a "party to the reorganization" within the meaning of section 368(b).
- (2) Gain will be recognized to Distributing upon the transfer of assets, subject to liabilities, to Controlled 2 solely exchange for the shares of Controlled 2 stock, as described above (section 357(c)). No gain or loss will be recognized to Distributing upon the transfer of assets, subject to liabilities, to Controlled 1 and Controlled 3 solely in exchange for Controlled 1 and Controlled 3 stock, respectively, as described above (section 361(a) and 357(a)).
- (3) No gain or loss will be recognized by Controlled 1, Controlled 2, and Controlled 3 upon the receipt of the assets from Distributing in exchange for shares of stock of such Controlled corporation (section 1032(a)).

(4) The basis of the assets received by each of Controlled 1, Controlled 2, and Controlled 3 will be the same as the basis of such assets in the hands of Distributing immediately prior to their transfer to Controlled 1, Controlled 2, and Controlled 3 (section 362(b)).

(5) The holding period of the Distributing assets received by Controlled 1, Controlled 2, and Controlled 3 will include the period during which such 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 1, Shareholder 2, and Shareholder 3 upon their receipt of the shares of Controlled 1, Controlled 2, and Controlled 3 stock, respectively, in exchange for all of their Distributing shares, as described above (section 355(a)(1)).

(7) No gain or loss will be recognized by Distributing upon the distribution of stock of Controlled 1, Controlled 2, and Controlled 3 to Shareholder 1, Shareholder 2, and Shareholder 3, respectively, as described above (section 361(c)).

(8) The basis of the stock of Controlled 1, Controlled 2, and Controlled 3 in the hands of Shareholder 1, Shareholder 2, and Shareholder 3, respectively, will be the same as the basis of the Distributing stock surrendered by such shareholder in exchange therefor (section 358(a)(1)).

(9) The holding period of the stock of Controlled 1, Controlled 2, and Controlled 3 received by Shareholder 1, Shareholder 2, and Shareholder 3, respectively, will include the holding period of the Distributing stock surrendered in exchange therefor, provided that the Distributing stock is held as a capital asset on the date of the distribution (section 1223(1)).

(10) As provided in section 312(h), proper allocation of earnings and profits between Distributing and each of Controlled 1, Controlled 2, and Controlled 3, respectively, will be made under section 1.312-10(a) of the Income Tax Regulations.

(11) Any payment of cash in lieu of a fractional share interest in any Controlled will be treated for federal income tax purposes as if the fractional share interest had been issued in the distribution of stock of such Controlled and then redeemed by such Controlled. The cash payment will be treated as having been received in exchange for the constructively redeemed fractional share under section 302(a).

No opinion is expressed 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 directly covered by the above rulings. Specifically, no opinion is expressed

regarding the allocation of the accumulated adjustment accounts between Distributing, and each of Controlled 1, Controlled 2, and Controlled 3.

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.

The rulings contained in this letter are predicated upon the facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for a ruling. Verification of the factual information, representations, and other data may be required as part of the audit process.

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

Sincerely yours,  
Associate Chief Counsel (Corporate)

By \_\_\_\_\_  
Lisa A. Fuller  
Assistant to Chief, Branch 1

cc: