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Person To Contact:

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In Re:

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Date:

December 22, 2003

LEGEND

Distributing =

Controlled =

LLC =

X =

Business 1 =

Business 2 =

Bank =

Asset =

a =

Dear :

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This letter responds to your August 8, 2003 request for rulings on certain federal income tax consequences of a proposed transaction. The information submitted in that letter and in subsequent correspondence is summarized below.

### SUMMARY OF FACTS

Distributing is an S corporation, which conducts Business 1 and Business 2. Distributing has two classes of common stock outstanding, Class A voting and Class B nonvoting.

Financial information has been submitted indicating that Business 1 and Business 2 has each had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Distributing is in the process of expanding the operations of Business 2, and needs a substantial amount of additional capital to fund the expenses of such expansion. Distributing also needs to borrow to fund an additional portion of its unfunded pension obligations.

Distributing proposes to obtain the necessary funds through a loan from Bank, Distributing's historic lender, to be secured by Asset, which relates to Business 1. Consistent with industry practice, to isolate the property securing the loan from the claims of Business 2 creditors Bank requires that Asset be held in an entity separate and apart from Business 2. Bank has therefore made the proposed loan contingent upon the separation of Business 1 from Business 2.

In addition, Distributing is the guarantor on an earlier loan from Bank to LLC, a partnership controlled by Distributing's shareholders. The guarantee provided by Distributing contains covenants requiring that Distributing maintain a minimum tangible net worth, and that its total funded debt not exceed a specified amount (together, the "Covenants"). Documentation submitted by Bank indicates that the separation of Business 1 from Business 2 would enable Distributing to borrow the needed funds without violating its obligations under the Covenants.

### PROPOSED TRANSACTION

Distributing proposes a corporate separation as set forth below ("the Proposed Transaction").

- (i) Distributing will borrow approximately \$a from Bank.

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- (ii) Distributing will contribute all of the assets and liabilities associated with Business 2 to newly formed Controlled in exchange for all of the common stock of Controlled (“the Contribution”).
- (iii) Distributing will change its name to X.
- (iv) Distributing will distribute all of the Controlled stock pro rata to the shareholders of Distributing (“the Distribution”).
- (v) Controlled will elect to be taxed as an S corporation on the first available date after the Distribution.

### REPRESENTATIONS

The following representations have been made regarding the Proposed Transaction:

- (a) 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.
- (b) The five years of financial information submitted on behalf of each of Business 1 and Business 2 is representative of its present operations, and with regard to each business, 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 their respective trades or businesses, independently and with their separate employees. Certain employees will be employed by both Distributing and Controlled, and will be compensated by Distributing and Controlled based upon the services provided to each corporation.
- (d) The distribution of Controlled is primarily carried out for the following corporate business purposes: to facilitate borrowings to fund working capital needs and business expansion of Controlled’s operations. The Distribution is motivated, in whole or substantial part, by these corporate business purposes.
- (e) 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, or securities of, either Distributing or Controlled after the transaction.

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- (f) 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 Proposed Transaction, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696, 705.
- (g) 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 Proposed Transaction, except in the ordinary course of business.
- (h) 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 (as determined under section 357(d)) by Controlled and any liabilities to which the transferred assets are subject.
- (i) The liabilities assumed (as determined under section 357(d)) by Controlled in the transaction and the liabilities to which the assets transferred from Distributing to Controlled are subject, if any, were incurred in the ordinary course of business and are associated with the assets being transferred.
- (j) Distributing neither accumulated its receivables nor made extraordinary payments of its payables in anticipation of the Proposed Transaction.
- (k) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Proposed Transaction.
- (l) Payments made in connection with any transactions between Distributing and Controlled following the Distribution will be for fair market value and based upon terms and conditions consistent with parties bargaining at arm's-length.
- (m) No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).
- (n) For purposes of section 355(d), immediately after the Distribution, no person (determined after applying section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired

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by purchase (as defined in section 355(d)(5) and (8)) during the five-year period (determined after applying section 355(d)(6)) ending on the date of the Distribution.

- (o) For purposes of section 355(d), immediately after the Distribution, no person (determined after applying section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote or 50 percent or more of the total value of shares of all classes of Controlled stock, that was either (i) acquired by purchase (as defined in section 355(d)(5) and (8)) during the five-year period (determined after applying section 355(d)(6)) ending on the date of the Distribution, or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in section 355(d)(5) and (8)) during the five-year period (determined after applying section 355(d)(6)) ending on the date of the Distribution.
- (p) The Distribution 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 either Distributing or Controlled, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.
- (q) Distributing is an S corporation (within the meaning of section 1361(a)). Controlled will elect to be treated as an S corporation pursuant to section 1362(a) effective on the first available date after the Distribution. There is no plan or intention to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

### RULINGS

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

- (1) The Contribution, followed by the Distribution, will be a reorganization under section 368(a)(1)(D). Distributing and Controlled will each be “a party to a reorganization” under section 368(b).
- (2) No gain or loss will be recognized by Distributing on the Contribution (sections 357(a), 361(a) and 361(b)).

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- (3) No gain or loss will be recognized by Controlled on the Contribution (section 1032(a)).
- (4) The basis of each asset received by Controlled in the Contribution will equal the basis of that asset in the hands of Distributing immediately before its transfer (section 362(b)).
- (5) The holding period of each asset received by Controlled in the Contribution will include the period during which Distributing held that asset (section 1223(2)).
- (6) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) the Distributing shareholders on receipt of Controlled stock in the Distribution (section 355(a)(1)).
- (7) The aggregate basis of the Distributing stock and the Controlled stock in the hands of the Distributing shareholders after the Distribution will equal the aggregate basis of the Distributing stock held by the Distributing shareholders immediately before the Distribution, allocated between the Distributing stock and Controlled stock in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) (section 358(b)).
- (8) The holding period of the Controlled stock received by each Distributing shareholder will, in each instance, include the holding period during which the Distributing shareholders held the Distributing shares on which the Distribution is made, provided the Distributing stock is held as a capital asset on the date the Distribution (section 1223(1)).
- (9) No gain or loss will be recognized by Distributing on the Distribution (section 361(c)(1)).
- (10) As provided in section 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a).
- (11) Distributing's accumulated adjustments account 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 section 312(h).
- (12) Provided that Distributing immediately distributes the stock of Controlled and provided that Controlled meets the requirements of section 1361(b), Distributing's momentary ownership of Controlled's stock as part of the

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reorganization will not cause Controlled to have an ineligible shareholder under section 1361(b)(1)(B), and Controlled will be eligible to make an S corporation election under section 1362(a) for its first taxable year.

### CAVEATS

We express no opinion about the tax treatment of the transaction under other provisions of the Code and regulations or about the tax treatment of any conditions at the time of, or effects resulting from, the transaction that are not specifically covered by the above rulings.

### PROCEDURAL STATEMENTS

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.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

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,

*Sean P. Duffley*

Sean P. Duffley  
Assistant to the Chief, Branch 4  
Office of Associate Chief Counsel  
(Corporate)