

INTERNAL REVENUE SERVICE

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November 19, 1998

Re:

Distributing =

Controlled =

State A =

Products =

Supplier =

Date A =

Division I =

Division II =

A =

B =

C =

D =

E =

Amended Supplier Agreements =

x =

Dear :

This is in response to your letter, dated July 17, 1998, submitted on behalf of Distributing, requesting rulings concerning the federal income tax consequences of proposed transactions. Additional information was submitted in letters dated August 26, September 15 and 28, October 13 and 15, and November 2, 1998. The information submitted for consideration is summarized below.

Distributing, a wholesale distributor of Products of Supplier, is an S corporation incorporated in State A and is an accrual basis taxpayer with a Date A fiscal year. Distributing is engaged in the distribution of Products ("Wholesale Business") through two divisions, Division I and Division II, in separate geographical locations. Distributing has outstanding a single class of voting common stock held by two families: A owns 50 percent of the stock. B, the principal shareholder of her group (owning x percent of the stock held by her group), and her three children, C, D and E, ("B Group") own the remaining 50 percent of the Distributing stock. No one shareholder of Distributing has majority voting control.

In order to retain the exclusive rights to engage in the Wholesale Business with regard to Supplier Products within the designated territories assigned to Division I and Division II, Distributing must comply with new requirements imposed by Supplier. Under these requirements set forth in Amended Supplier Agreements, Supplier is requiring Distributing (and other wholesalers): (i) to provide an equity interest in the Wholesale Business to the manager of the business ("Manager"), a person approved by Supplier (the "Manager Equity Interest Requirement"); and (ii) to have one person hold voting control of the entity conducting the Wholesale Business ("Voting Control Requirement"). Distributing desires to comply with the new Supplier requirements. However, neither A nor the B Group is willing to cede voting control to the other as long as Division I and Division II are both parts of Distributing.

In order to comply with these new Supplier requirements and to meet the objections of both A and the B Group to holding less than 50 percent of the vote, Distributing proposes to separate Division I and Division II into separate corporations (each of which will have its own controlling shareholder), and thereafter transfer each of the corporations' Wholesale Business operating assets into a limited liability company in which its Manager will hold an equity interest. Accordingly, Distributing proposes to undertake the following steps:

- (I) Distributing will form a new corporation ("Controlled") and transfer the Wholesale Business assets of Division II and certain other assets, together with

their associated liabilities, to Controlled solely in exchange for all the outstanding voting common stock in Controlled. Among the assets to be transferred to Controlled are certain non-operating assets designed to equalize values between Distributing and Controlled.

- (II) Distributing will transfer all the stock of Controlled to the B Group in exchange for the surrender of all their stock in Distributing. (This will result in one person, A, having voting control of Distributing and one person, B, having voting control of Controlled, thus meeting Supplier's Voting Control Requirement.)
- (III) As operating entities, Distributing and Controlled will each form a lower tier limited liability company ("LLC") (treated as a partnership under § 301.7701-3(b)(1)(i) of the regulations). Distributing and Controlled will each transfer to its LLC the essential Wholesale Business operating assets associated with its business. Distributing and Controlled each will retain the warehouse, vehicles and equipment used by its division and lease these properties to its lower tier LLC. Distributing also will retain a second warehouse, which is leased to Supplier. The lower tier LLC of Distributing will conduct the former Wholesale Business of Division I, and the lower tier LLC of Controlled will conduct the former Wholesale Business of Division II. Each corporation, through its own officers and employees, including the Manager, will be responsible for providing management, control, and direction of the LLC.
- (IV) The respective Managers of each lower tier LLC will acquire an equity interest in such LLC sufficient to satisfy the Manager Equity Interest Requirement. It is anticipated that each Manager will initially hold a 10 percent interest and eventually a 25 percent interest in the applicable LLC.

The following representations have been made in connection with the proposed transactions:

- (a) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing will each equal or exceed the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject.
- (b) The liabilities to be assumed by Controlled in step (I), 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.
- (c) Distributing neither accumulated its receivables nor made extraordinary payments of its payables in anticipation of this transactions.

- (d) None of the property transferred from Distributing to Controlled is property with regard to which any investment credit under § 46 has been, or will be, claimed or with regard to which any investment credit is required to be recaptured.
- (e) Any indebtedness owed by Controlled to Distributing after the distribution of Controlled stock will not constitute stock or securities.
- (f) None of the outstanding Distributing stock was acquired by either A or the B Group shareholders by purchase within the meaning of § 355(d)(5), and none of the stock in Distributing or Controlled will be “disqualified stock” within the meaning of § 355(d)(3).
- (g) The B Group shareholders will receive solely stock in Controlled in exchange for their stock in Distributing.
- (h) Distributing, Controlled, and their shareholders will each pay their own expenses incurred in connection with the transactions.
- (i) The fair market value of the stock of Controlled received by the B Group shareholders will, for each shareholder, approximately equal the fair market value of the Distributing stock surrendered by such shareholder in the exchange.
- (j) No part of the stock in Controlled received by the B Group shareholders is being received by a shareholder as a creditor, employee, or in any capacity other than as a shareholder of Distributing.
- (k) The 5 years of financial information submitted on behalf of Division I and Division II of Distributing is representative of the present operations of each Division, and with regard to each such operation, there have been no substantial operational changes since the date of the last financial statement submitted.
- (l) Distributing will continue, independently and with its separate employees, the active conduct of the Division I business. Controlled will continue, independently and with its separate employees, the active conduct of the Division II business.
- (m) The distribution of the stock of Controlled is carried out for the following corporate business purpose: to comply with the Owner Voting Control Requirement imposed by Supplier in the Amended Supplier Agreements by causing a single shareholder to have voting control of the Wholesale Business of Division I and Division II, and to align the economic interest of that controlling shareholder with the business over which such shareholder has voting control. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.

- (n) 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.
- (o) There is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift, have redeemed, or otherwise dispose of any of their stock in either Distributing or Controlled after the transactions.
- (p) 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.
- (q) There is no plan or intention to liquidate Distributing or Controlled, to merge either Distributing or Controlled with any other corporation, or to sell or otherwise dispose of the assets of either Distributing or Controlled after the transaction, except in the ordinary course of business.
- (r) 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.
- (s) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (t) There is no plan or intent for A to lose control of Distributing (that is, to cease to hold over 50 percent of both (i) the total combined voting power and (ii) the total value of shares of all classes of stock in Distributing).
- (u) There is no plan or intent for B to lose control of Controlled (that is, to cease to hold over 50 percent of both (i) the total combined voting power and (ii) the total value of shares of all classes of stock in Controlled).

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

- (1) The transfer in step (I) by Distributing to Controlled of assets in exchange for all of the stock of Controlled and the assumption of certain liabilities, followed by the distribution in step (II) of all the stock of Controlled to the B Group shareholders, as described above, will be a reorganization within the meaning of §§ 368(a)(1)(D) and 355. Distributing and Controlled will each be “a party to a reorganization” within the meaning of § 368(b).

- (2) Distributing will recognize no gain or loss upon the transfer of assets, subject to liabilities, to Controlled in exchange for Controlled stock and the assumption by Controlled of certain liabilities. Sections 361(a) and 357(a).
- (3) No gain or loss will be recognized to Controlled on the receipt of assets in exchange for Controlled stock. Section 1032(a).
- (4) The basis of each of the assets received by Controlled will be the same as the basis of such asset in the hands of Distributing immediately prior to step (I). Section 362(b).
- (5) The holding period of Distributing assets received by Controlled will include the period during which such assets were held by Distributing. Section 1223(2).
- (6) No gain or loss will be recognized to Distributing upon the distribution of all of the stock of Controlled pro rata to the members of the B Group in exchange for all of their stock in Distributing. Section 361(c)(1).
- (7) No gain or loss will be recognized to (and no amount will be included in the income of) any of the B Group shareholders upon their receipt of Controlled stock in exchange for all their stock in Distributing. Section 355(a)(1).
- (8) The basis of the Controlled stock in the hands of the B Group shareholders immediately after the distribution of such stock will, in each instance, be the same as the basis of the Distributing stock surrendered in exchange therefor. Section 358(a)(1).
- (9) The holding period of the Controlled stock received by the B Group shareholders will, in each instance, include the holding period of the Distributing stock exchanged therefor, provided the Distributing stock is held as a capital asset by such shareholders on the date of the exchange. Section 1223(1).
- (10) As provided in § 312(h) of the Code, proper allocation of earnings and profits between Distributing and Controlled will be made pursuant to § 1.312-10(a) of the regulations.
- (11) Controlled is subject to the built-in-gain tax of § 1374 with respect to the built-in-gain assets it receives from Distributing. For purposes of the built-in-gain tax, Controlled's recognition period is reduced by the portion of Distributing's recognition period that expires before Distributing's transfer of these assets to Controlled.
- (12) As provided in § 1.1368-2(d)(3) of the regulations, the accumulated adjustments account of Distributing before the transaction will be allocated

between Distributing and Controlled in a manner similar to the manner in which earnings and profits must be allocated pursuant to ruling (10) above.

(13) The momentary ownership of Controlled by Distributing in connection with the corporate separation described herein, to which § 368(a)(1)(D) applies, will not, in and of itself, prohibit Controlled from making a valid S corporation election under § 1362(a) for its first taxable year.

No opinion is expressed about the tax treatment of the proposed transactions under any other provisions of the Code or regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transactions not specifically covered by the above rulings.

The ruling is directed only to the taxpayer which requested it . Section 6110(j)(3) of the Code provides that this private letter ruling 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.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to the taxpayer.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By: \_\_\_\_\_  
Howard W. Staiman  
Assistant to the Branch Chief, Branch 1