

INTERNAL REVENUE SERVICE

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November 13, 1998

Re:

Distributing =

Controlled =

B =

C =

D =

E =

F =

G =

H =

J =

K =

L =

M =

N =

P =

Business Q =

State Z =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

m =

n =

p =

q =

r =

s =

t =

u =

v =

w =

x =

y =  
z =  
aa =  
bb =  
cc =  
dd =  
ee =  
ff =  
gg =  
hh =  
ii =  
kk =  
mm =  
nn =  
pp =  
qq =  
rr =  
ss =  
tt =  
uu =  
ww =

Dear :

This letter responds to your request dated May 27, 1998 for a ruling as to the federal tax consequences of a proposed transaction. Additional information was submitted on November 3, 1998, November 6, 1998, November 18, 1998, November 20, 1998, and November 24, 1998.

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

Distributing is a closely held State Z corporation. It is an accrual basis taxpayer and the last day of its taxable year is the last day of the month of February. Distributing has b shares of Class A voting no par common stock authorized of which c shares are issued and outstanding. In addition, Distributing has d shares of Class B nonvoting no par common stock authorized of which c shares are issued and outstanding. The stock is owned as follows:

<u>Shareholder</u>	<u>Class A</u>		<u>Class B</u>		<u>Total</u>	
	<u>%</u>	<u>#</u>	<u>%</u>	<u>#</u>	<u>%</u>	<u>#</u>
B (brother of F and K)	<u>e</u>	<u>bb</u>	---	---	<u>s</u>	<u>bb</u>
C (wife of B)	<u>f</u>	<u>cc</u>	---	---	<u>t</u>	<u>cc</u>
D (son of B and C)	---	---	<u>j</u>	<u>gg</u>	<u>u</u>	<u>gg</u>
E (daughter of B and C)	---	---	<u>k</u>	<u>ff</u>	<u>v</u>	<u>ff</u>
F (sister of B and K)	<u>g</u>	<u>dd</u>	<u>m</u>	<u>hh</u>	<u>w</u>	<u>pp</u>
G (son of F)	---	---	<u>n</u>	<u>jj</u>	<u>x</u>	<u>jj</u>
H (son of F)	---	---	<u>n</u>	<u>jj</u>	<u>x</u>	<u>jj</u>
J (son of F)	---	---	<u>n</u>	<u>jj</u>	<u>x</u>	<u>jj</u>
K (brother of B and F)	<u>h</u>	<u>ee</u>	<u>p</u>	<u>kk</u>	<u>y</u>	<u>qq</u>
L (wife of K)	<u>i</u>	<u>ff</u>	<u>q</u>	<u>mm</u>	<u>z</u>	<u>rr</u>
M (son of K and L)	---	---	<u>r</u>	<u>nn</u>	<u>aa</u>	<u>nn</u>
N (daughter of K and L)	---	---	<u>r</u>	<u>nn</u>	<u>aa</u>	<u>nn</u>
P (son of K and L)	---	---	<u>r</u>	<u>nn</u>	<u>aa</u>	<u>nn</u>

Distributing is engaged in two businesses: Business Q and the rental real estate business. Financial information has been received indicating that each of Distributing's two businesses had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years. The real estate business holds a number of residential and commercial rental real estate properties. In

addition, it holds a number of undeveloped parcels of land. K, L, M, N and P (the K Family Group) want to expand the real estate business by making improvements to certain of the rental properties and by building additional rental properties on the undeveloped land. Distributing's other shareholders are not interested in expanding the real estate business and want to devote their attention and the company's resources to Business Q. Accordingly, the shareholders have adopted a plan of reorganization to go their own separate ways which consists of the following steps:

- (1) Distributing will form Controlled, a State Z corporation, which will be an accrual basis taxpayer and the last day of Controlled's taxable year will be the last day of the month of February.
- (2) Controlled will issue ss shares of Class A no par common voting stock and tt shares of nonvoting no par common stock. Distributing will transfer certain of its residential and commercial rental real estate properties and certain of its parcels of undeveloped land to Controlled solely in exchange for all of the shares of Controlled stock.
- (3) Distributing will distribute all of its Controlled Class A and Class B stock to K, L, M, N, and P in exchange for all of their Distributing Class A and Class B stock.
- (4) Distributing and Controlled will each elect to be treated as an "S" corporation immediately after the distribution.

In the 12 month period immediately following the distribution of the Controlled stock, Controlled will employ a full-time business manager to advertise tenant vacancies and negotiate new leases, collect rents and pay bills, handle tenant questions and problems, do bookkeeping, and perform everyday carpentry, plumbing, and electrical work. Controlled will also employ a part time employee to do general carpentry, electrical, mechanical, and plumbing work. During this period, Controlled will make improvements to certain of its rental properties costing approximately \$ uu and begin site work on certain of its undeveloped properties costing approximately \$ ww. In connection with these projects, the business manager will determine specifications for building improvements, act as general contractor evaluating subcontractor bids and hiring subcontractors, and ensure compliance with the requirements of various governmental oversight agencies. To fund these projects, K will make a capital contribution to Controlled of \$ ww.

Distributing has made the following representations concerning the proposed transaction:

- (a) Controlled will not be indebted to Distributing after the distribution of the Controlled stock.

- (b) The fair market value of the Controlled stock 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 the exchange.
- (c) 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.
- (d) No part of the consideration to be distributed by Distributing will be received by a security holder.
- (e) 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.
- (f) Following the transaction, Distributing and Controlled will each continue, independently and with its separate employees, the active conduct of its business or businesses.
- (g) The distribution of the stock of Controlled is carried out for the following corporate business purpose: To allow the rental real estate business to prosper by allowing one group of shareholders to operate and manage that division without interference from the other shareholders. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (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 either Distributing or Controlled after the transaction.
- (i) There is no plan or intention by either Distributing or Controlled, directly or indirectly, to purchase any of its outstanding stock after the transaction.
- (j) There is no plan or intention to liquidate either Distributing or Controlled, to merge either corporation with any other corporation, or to sell or to otherwise dispose of the assets of either corporation after the transaction, except in the ordinary course of business.
- (k) The total 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. 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.

- (l) The income tax liability for the taxable year in which investment credit property (including any building to which section 47(d) applies) is transferred will be adjusted pursuant to section 50(a)(1) or (a)(2) (or section 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 the property.
- (m) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (n) No intercorporate indebtedness will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled.
- (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 arms length.
- (p) No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).

Based solely on the information submitted and the representations made, we conclude as follows concerning the proposed transaction:

- (1) The transfer by Distributing to Controlled of a portion of the assets of the rental real estate business, solely in exchange for all of the shares of Controlled stock, followed by the distribution of the Controlled stock in redemption of all of the Distributing stock owned by K, L, M, N and P, will be a reorganization within the meaning of section 368(a)(1)(D) of the Code. Distributing and Controlled will each be "a party to the reorganization" within the meaning of section 368(b).
- (2) No gain or loss will be recognized by Distributing upon the transfer of assets, subject to liabilities, if any, to Controlled in exchange for shares of Controlled stock (sections 361(a) and 357(a)). No gain or loss will be recognized by Controlled on the receipt of assets from Distributing in exchange for the shares of Controlled stock (section 1032(a)).
- (3) The basis of the assets received by Controlled from Distributing will be the same as the basis of such assets in the hands of Distributing immediately prior to the transaction (section 362(b)).
- (4) The holding period of the Distributing assets received by Controlled will include

the period during which such assets were held by Distributing (section 1223(2)).

- (5) No gain or loss will be recognized by Distributing upon the distribution of all of the shares of Controlled to K, L, M, N and P in exchange for their shares of Distributing (section 361(c)).
- (6) No gain or loss will be recognized by (and no amount will be included in the income of) K, L, M, N or P on the receipt of Controlled stock in exchange for their Distributing stock (section 355(a)).
- (7) The basis of the Controlled stock received by K, L, M, N and P will be the same as the basis of the Distributing stock surrendered in exchange therefor (section 358(a)).
- (8) The holding period of the Controlled stock received by K, L, M, N and P will include the holding period of the Distributing stock surrendered in exchange therefor, provided that such stock is being held as a capital asset on the date of the exchange (section 1223(1)).
- (9) As provided in section 312(h) of the Code, proper allocation of earnings and profits between Distributing and Controlled will be made under section 1.312-10(a) of the regulations.

No opinion is expressed about 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 specifically covered by the above rulings.

The ruling is directed only to the taxpayers who requested it. Section 6110(j)(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 return of each taxpayer involved for the taxable year in which the transaction covered by this ruling letter is consummated.

Sincerely yours,  
Assistant Chief Counsel (Corporate)

By \_\_\_\_\_

Mark S. Jennings  
Senior Technician Reviewer, Branch 1