

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
August 31, 1999

Distributing =

Controlled =

State X =

Shareholder A =

Shareholder B =

Shareholder C =

Business R =

Business S =

Key Employee =

Year =

p =

PLR-109946-99

We respond to your letter dated May 26, 1999, requesting rulings as to the income tax consequences of a proposed transaction. You submitted additional information in letters dated July 8, August 11, and August 13, 1999. The relevant information is summarized below.

Distributing is a State X corporation that is an accrual basis taxpayer. Shareholders A, B, and C each own equal interests in the stock of Distributing and have owned Distributing for more than five years. Distributing is directly engaged in the conduct of Business R.

Controlled, a State X corporation, also is an accrual basis taxpayer and is a wholly owned subsidiary of Distributing. Distributing has owned Controlled for more than five years. Controlled is directly engaged in Business S.

Financial information has been received which indicates that Business R conducted by Distributing and Business S conducted by Controlled both have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Key Employee has been the Chief Operating Officer of Distributing since Year. Under Key Employee's management, Distributing substantially has increased its business activities. Key Employee desires to acquire an equity interest in Distributing and has indicated that he intends to seek other employment if he does not receive a significant equity interest in the Distributing corporation.

In order to satisfy the Key Employee's desires, Distributing proposes the following transaction:

- (i) Distributing will distribute its shares in Controlled to the stockholders of Distributing on a pro rata basis.
- (ii) As soon as practicable, and within one year of the distribution of the Controlled stock, Key Employee will receive p percent of stock in Distributing as part of his compensation. Additionally, the ownership of Distributing stock will entitle Key Employee to a position on the Board of Directors of Distributing.

The taxpayer has made the following representations with respect to 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.

PLR-109946-99

- (b) The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statement submitted.
- (c) The five years of financial information submitted on behalf of Controlled is representative of Controlled's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statement submitted.
- (d) Following the transaction, Distributing and Controlled each will continue the active conduct of its business, independently and with its separate employees.
- (e) The distribution of the stock of Controlled is being carried out for the corporate business purpose of providing a substantial equity interest in Distributing to Key Employee. The distribution of the stock of Controlled is, in whole or substantial part, motivated by this corporate business purpose.
- (f) 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 or securities in either Distributing or Controlled after this transaction.
- (g) There is no plan or intention by Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction.
- (h) 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 transaction, except in the ordinary course of business.
- (i) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock. No indebtedness has been or will be canceled in connection with the transaction.
- (j) There are no planned or intended transactions between Distributing and Controlled following the distribution, either directly or indirectly. In the event there should be any such transactions, payments made in connection with all continuing transactions between Distributing and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arms length.

PLR-109946-99

- (k) Immediately before the distribution, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable intercompany transaction regulations (See §1.1502-13 and §1.1503-14 as in effect before the publication of T.D. 8597, 1995-32 I.R.B. 6, and as currently in effect, §1.1502-13 as published by T.D. 8597). Further, Distributing's excess loss account with respect to the Controlled stock will be included in income immediately before the distribution (See §1.502-19).
- (l) No two parties to the transaction are investment companies as defined in §368(a)(2)(F)(iii) and (iv).
- (m) Neither Distributing nor Controlled is currently an S corporation (within the meaning of § 1361(a)), and there is no plan or intention by Distributing or Controlled to make an S corporation election pursuant to §1362(a).
- (n) The distribution is not 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 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.

Based solely on the information submitted and on the representations set forth above, we hold as follows with respect to the proposed transaction:

- (1) No gain or loss will be recognized to Distributing upon the distribution of all of the Controlled stock (§355(c)).
- (2) No gain or loss will be recognized to (and no amount will be included in the income of) Distributing's shareholders upon the receipt of Controlled stock (§ 355(a)(1)).
- (3) The basis of the stock of Distributing and Controlled in the hands of the Distributing shareholders after the distribution will be the same as the aggregate basis of the Distributing stock held immediately before the distribution, allocated in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) of the Income Tax Regulations (§ 358(a)(1)).
- (4) The holding period of the Controlled stock received by each Distributing shareholder will include the holding period of the Distributing stock with respect to which the distribution was made, provided that such Distributing stock is held as a capital asset on the date of the distribution (§ 1223(1)).

PLR-109946-99

- (5) As provided in § 312(h) of the Code, proper allocation of earnings and profits between Distributing and Controlled will be made in accordance with § 1.312-10(b) of the regulations.

We express no opinion concerning the federal income tax treatment of the described 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 transaction that are not specifically covered by the above rulings.

This ruling letter is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. Each affected taxpayer must attach a copy of this letter to the federal income tax return for the taxable year in which the transaction covered by this letter ruling is consummated.

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

Sincerely yours,

Assistant Chief Counsel (Corporate)

By: *Filiz A. Serbes*

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Assistant to the Chief, Branch 5