

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

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Refer Reply To:

CC:CORP:1- PLR-109223-00

Date:

August 23, 2000

LEGEND:

A =

B =

Distributing =

Controlled =

State W =

Date =

Business X =

Business Y =

We respond to your authorized representative's April 19, 2000 letter requesting rulings regarding the tax treatment of a proposed transaction. The pertinent facts, as described in your letter and in an additional submission dated July 13, 2000, are set forth below.

Distributing is a State W corporation, all of whose stock is owned equally by A and B. Distributing is an S corporation engaged in Business X. Distributing wholly owns Controlled, which is also a State W corporation. Controlled is a qualified subchapter S subsidiary (QSUB) that is engaged in Business Y.

Financial information has been submitted indicating that Distributing and Controlled each have had gross income and operating expenses representing the conduct of an active business during each of the past five years.

Controlled's volume of work has increased significantly in recent years, which

has necessitated Controlled's hiring a key employee. In order to attract the appropriate key employee, Controlled found it necessary to offer the key employee an opportunity to purchase Controlled stock. The key employee cannot acquire an interest in Controlled without Controlled's disqualification as a QSUB under section 1361(b)(3)(B). Controlled also would not qualify as an S corporation under section 1361 because Distributing is not a permissible shareholder within the meaning of section 1361(b)(1)(B).

The taxpayer has proposed that Distributing will distribute all of its stock of Controlled to the Distributing shareholders on a pro rata basis.

The taxpayer has made the following representations with respect to the Distribution:

- (a) There is no plan or intention by the Distributing shareholders to sell, exchange, or otherwise dispose of a number of shares of Controlled stock received pursuant to the transaction that would reduce the Distributing shareholders' ownership of Controlled stock to a number of shares having a value, as of the date of the transaction, of less than 50 percent of the value of all of the outstanding stock of Controlled as of the same date.
- (b) After the transaction, the Distributing shareholders will be in control of Controlled within the meaning of section 368(c) of the Code.
- (c) At the time of the transaction, Controlled will not have outstanding any warrants, options, convertible securities, or any other type of right pursuant to which any person could acquire stock in Controlled that, if exercised or converted, would affect the Distributing shareholders' retention of control of Controlled, as defined in section 368(c).
- (d) There is no intercorporate indebtedness existing between Controlled and Distributing that was issued, acquired, or will be settled at a discount.
- (e) No parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).
- (f) No part of the consideration, if any, 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.
- (g) The five years of financial information submitted on behalf of Distributing (including its most recent balance sheet) is representative of Distributing's present operation, and with regard to Distributing, there have been no substantial operational changes since the date of the last financial statements

submitted.

- (h) The five years of financial information submitted on behalf of Controlled is representative of Controlled's present operation, and with regard to Controlled, there have been no substantial operational changes since the date of the last financial statements submitted.
- (i) Following the transaction, Distributing and Controlled each will continue the active conduct of its business, independently and with its separate employees.
- (j) The distribution of the stock of Controlled is carried out for the corporate business purpose of providing a substantial equity interest in Controlled to its key employee. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (k) 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.
- (l) There is no plan or intention to liquidate either Distributing or Controlled, to merge either Distributing or Controlled, or to sell or otherwise dispose of the assets of either Distributing or Controlled after the transaction, except in the ordinary course of business.
- (m) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (n) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the stock 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 arm's length.
- (p) Distributing is an S corporation (within the meaning of section 1361(a)). Controlled is a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B).
- (q) Distributing and Controlled have no accumulated earnings and profits as of January 1, 2000.
- (r) Distributing and Controlled will have no current earnings and profits as of the date of the distribution made pursuant to the transaction.

- (s) No distribution of property by Distributing immediately before the transaction would require recognition of gain resulting in current earnings and profits for the taxable year of the distribution.
- (t) Distributing is not aware of, nor is Distributing planning or intending, any event that will result in Distributing or Controlled having any positive current or accumulated earnings and profits after the distribution.

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 by Distributing upon the distribution to the Distributing shareholders of all the common stock of Controlled (section 361(c)).
- (2) No gain or loss will be recognized by, and no amount will be included in the income of, the Distributing shareholders upon the receipt of shares of Controlled common stock (section 355(a)(1)).
- (3) The basis of the common stock of Distributing and Controlled in the hands of the Distributing shareholders will be the same as the basis of their stock in Distributing held immediately before the distribution, allocated in proportion to the fair market value of each in accordance with section 1.358-2(a)(2) of the Income Tax Regulations.
- (4) The holding period of the Controlled stock to be received by the Distributing shareholders will include the period during which the shareholders held the Distributing stock with respect to which the Controlled stock was received, provided the Distributing stock was held as a capital asset on the date of the exchange (section 1223(1)).

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.

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 letter ruling is consummated.

In accordance with the power of attorney on file in this office, a copy of this letter is being sent to your authorized representatives.

Sincerely yours,
Associate Chief Counsel (Corporate)
By: Gerald Fleming
Acting Senior Technician Reviewer, Branch 1