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Date:
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LEGEND:

Distributing =

Controlled 1 =

Controlled 2 =

Family 1 =

Family 2 =

Family 3 =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Shareholder E =

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Shareholder F =

Shareholder G =

Shareholder H =

Shareholder I =

State X =

Business A =

Business B =

Business C =

a =b % =c % =d % =e % =f % =g % =

This letter responds to your authorized representative's letter dated November 27, 2000, in which you requested rulings under section 355 of the Internal Revenue Code. Additional information was submitted in letters dated June 22, September 7, and October 4, 2001. By letter of September 7, 2001, the proposed transaction was modified in part and certain requested rulings were withdrawn. The material information submitted for consideration is summarized below.

Distributing, a State X Subchapter S corporation, files its federal income tax return on a calendar year basis and uses the accrual method of accounting. Distributing has outstanding a shares of voting common stock, which is owned by three related families; Family 1 (b %), Family 2 (c %), and Family 3 (d %). Family 1 consists

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of Shareholder A (d %), Shareholder B (e %), Shareholder C (f %), Shareholder D (g %), and shareholder E (f %). Family 2 consists of Shareholder F (d %), Shareholder G (e %), and Shareholder H (f %). Family 3 consists of Shareholder I (d %).

Distributing is engaged directly in Business A, Business B, and Business C. Each of these businesses has been conducted for more than five years. Business A has been operated primarily by the members of Family 1 and Businesses B and C have been operated primarily by the members of Family 2. Family 3 does not participate in the daily business operations.

Controlled 1 will be a State X corporation and will be formed for the purpose of independently operating Business A. Controlled 2 will be a State X corporation and will be formed for the purpose of independently operating Business B and Business C. Controlled 1 and Controlled 2 both intend to elect Subchapter S status on the first available date after consummation of the proposed transaction. Controlled 1 and Controlled 2 will file federal income tax returns on the accrual method of accounting for each calendar year.

The taxpayer has supplied financial information which indicates that Distributing's Businesses A, B, and C each had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Over time, Family 1 has become predominantly interested in Business A, and Family 2 has become predominantly interested in Businesses B and C. Family 3 will continue its interest as a shareholder of each of the businesses. In order to accommodate divergent shareholder interests and to eliminate shareholder disputes regarding the management and operation of Distributing's businesses, Distributing proposes a corporate separation as set forth below (the "Proposed Transaction").

- (i) Distributing will form Controlled 1 and will transfer all of the Business A assets to Controlled 1 in exchange for all of the issued and outstanding stock of Controlled 1 and the assumption by Controlled 1 of liabilities associated with Business A.
- (ii) Distributing will form Controlled 2 and will transfer all of the Business B and Business C assets to Controlled 2 in exchange for all of the issued and outstanding stock of Controlled 2 and the assumption by Controlled 2 of liabilities associated with Business B and Business C.
- (iii) Distributing will distribute all of the issued and outstanding stock of Controlled 1 to the Family 1 shareholders in exchange for all of their Distributing stock and to the Family 3 shareholder in exchange for a portion of her Distributing stock (Distribution 1).

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- (iv) Distributing will then distribute all of the issued and outstanding stock of Controlled 2 to the Family 2 shareholders in exchange for all of their Distributing stock and to the Family 3 shareholder in exchange for the remainder of her Distributing stock (Distribution 2).
- (v) Distributing will then dissolve pursuant to State X law.

The following additional representations have been made in connection with the Proposed Transaction:

- (a) The Distributing and Controlled corporations and their respective shareholders will each pay their own expenses, if any, incurred in connection with this transaction.
- (b) 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.
- (c) The fair market value of Controlled stock and other consideration to be received by each shareholder of Distributing will be approximately equal to the fair market value of Distributing stock surrendered in the exchange.
- (d) The five years of financial information submitted on behalf of Distributing is representative of its present operations, and there have been no substantial operational changes since the date of the last financial statements submitted.
- (e) Following the Proposed Transaction, Controlled 1 and Controlled 2 will each continue the active conduct of its respective business or businesses, independently and with its separate employees.
- (f) The distribution of the stock of Controlled 1 and Controlled 2 is carried out for the following corporate business purposes: (i) resolution of shareholder disputes. The distribution of the Controlled 1 and Controlled 2 stock is motivated, in whole or substantial part, by this corporate business purpose.
- (g) 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 Controlled 1 or Controlled 2 after the Proposed Transaction.
- (h) There is no plan or intention by either Controlled 1 or Controlled 2, 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*.

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- (i) Distributing is an S corporation (within the meaning of section 1361(a)). Controlled 1 and Controlled 2 will each elect to be an S corporation pursuant to section 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 Controlled 1 or Controlled 2.
- (j) Distributing, Controlled 1 and Controlled 2 have no accumulated earnings and profits at the beginning of their respective taxable years.
- (k) Distributing, Controlled 1 and Controlled 2 will have no current earnings and profits as of the date of the distribution.
- (l) No distribution of property by Distributing immediately before the Proposed Transaction would require recognition of gain resulting in current earnings and profits for the taxable year of the distribution.
- (m) Distributing is not aware of, nor is it planning or intending, any event that will result in Distributing, Controlled 1 or Controlled 2 having positive current or accumulated earnings and profits after the distribution.
- (n) There is no plan or intention to liquidate either Controlled 1 or Controlled 2, to merge either corporation with any other corporation, or to sell or otherwise dispose of any of the assets of either corporation subsequent to the Proposed Transaction, except in the ordinary course of business.
- (o) The total adjusted bases and the fair market value of the assets transferred to Controlled 1 and Controlled 2 by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled 1 and Controlled 2 plus any liabilities to which the transferred assets are subject.
- (p) 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.
- (q) The income tax liability for the taxable year in which investment credit property is transferred is not required to be adjusted because the recapture period has closed with respect to such property.
- (r) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the Proposed Transaction.
- (s) No intercorporate debt will exist between Distributing and the Controlled corporations at the time of, or subsequent to, the distribution of the Controlled 1 and Controlled 2 stock.

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- (t) Payments made in connection with all continuing transactions, if any, between Controlled 1 and Controlled 2 following the distribution, either directly or indirectly, will be for fair market value based on terms and conditions determined by the parties bargaining at arm's length.
- (u) No two parties to the Proposed Transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv) of the Code.
- (v) No Distributing shareholder will hold immediately after the distribution disqualified stock within the meaning of § 355(d)(3) which constitutes a 50% or greater interest in Distributing, Controlled 1 or Controlled 2.
- (w) 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% or more of the combined voting power of all classes of stock entitled to vote of either Distributing, Controlled 1 or Controlled 2, or stock possessing 50% or more of the total value of all classes of stock of either Distributing, Controlled 1 or Controlled 2.

Based solely upon the information submitted and the representations made, we rule as follows with respect to Distribution 1:

- (1) The transfer of the assets of Business A by Distributing to Controlled 1, solely in exchange for all of the issued and outstanding stock of Controlled 1 and the assumption by Controlled 1 of the liabilities associated with the transferred assets, followed by the distribution of all of the stock of Controlled 1 to the Family 1 shareholders in exchange for all of their Distributing stock and to the Family 3 shareholder in exchange for a portion of her Distributing stock, will be a reorganization within the meaning of section 368(a)(1)(D) of the Code. Distributing and Controlled 1 will each be "a party to a reorganization" within the meaning of section 368(b).
- (2) Distributing will recognize no gain or loss upon the transfer of the Business A assets to Controlled 1 in exchange for the stock of Controlled 1 and the assumption by Controlled 1 of the liabilities associated with the transferred assets. Sections 361(a) and 357(a).
- (3) Controlled 1 will recognize no gain or loss upon the receipt of the Business A assets from Distributing in exchange for the stock of Controlled 1. Section 1032(a).
- (4) The basis of the assets received by Controlled 1 in the transaction will be the same as the basis of such assets in the hands of Distributing immediately prior to their transfer to Controlled 1. Section 362(b).

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- (5) The holding period of the assets received by Controlled 1 from Distributing in the transaction will include the period during which such assets were held by Distributing. Section 1223(2).
- (6) The Family 1 shareholders will recognize no gain or loss (and no amount will be included in the income of such shareholders) upon the receipt of Controlled 1 stock in exchange for all of the Distributing stock held by such shareholders. Section 355(a)(1). The Family 3 shareholder will recognize no gain or loss (and no amount will be included in the income of such shareholder) upon the receipt of Controlled 1 stock in exchange for a portion of her Distributing stock. Section 355(a)(1).
- (7) Distributing will recognize no gain or loss upon the distribution of the Controlled 1 stock to the Distributing shareholders in exchange for all or a portion of their stock in Distributing. Section 361(c).
- (8) The basis of the stock of Controlled 1 in the hands of each Distributing shareholder will, in each instance, be the same as the basis of the Distributing stock surrendered by the shareholders in exchange therefor. Section 358(a)(1).
- (9) The holding period of the Controlled 1 stock received by each Distributing shareholder will, in each instance, include the holding period of the Distributing stock surrendered in exchange therefor, provided that the Distributing stock is held as a capital asset on the date of the exchange. Section 1223(1).

Based solely upon the information submitted and the representations made, we rule as follows with respect to Distribution 2:

- (10) The transfer of the assets of Business B and Business C by Distributing to Controlled 2, solely in exchange for all of the issued and outstanding stock of Controlled 2 and the assumption by Controlled 2 of the liabilities associated with the transferred assets, followed by the distribution of all of the stock of Controlled 2 to the Family 2 shareholders in exchange for all of their Distributing stock and to the Family 3 shareholder in exchange for the remainder of her Distributing stock, will be a reorganization within the meaning of section 368(a)(1)(D) of the Code. Distributing and Controlled 2 will each be "a party to a reorganization" within the meaning of section 368(b).
- (11) Distributing will recognize no gain or loss upon the transfer of the Business B and Business C assets to Controlled 2 in exchange for the stock of Controlled 2 and the assumption by Controlled 2 of the liabilities associated with the transferred assets. Sections 361(a) and 357(a).

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- (12) Controlled 2 will recognize no gain or loss upon the receipt of the Business B and Business C assets from Distributing in exchange for the stock of Controlled 2. Section 1032(a).
- (13) The basis of the assets received by Controlled 2 in the transaction will be the same as the basis of such assets in the hands of Distributing immediately prior to their transfer to Controlled 2. Section 362(b).
- (14) The holding period of the assets received by Controlled 2 from Distributing in the transaction will include the period during which such assets were held by Distributing. Section 1223(2).
- (15) The Family 2 shareholders will recognize no gain or loss (and no amount will be included in the income of such shareholders) upon the receipt of Controlled 2 stock in exchange for all of the Distributing stock held by such shareholders. Section 355(a)(1). The Family 3 shareholder will recognize no gain or loss (and no amount will be included in the income of such shareholder) upon the receipt of Controlled 2 stock in exchange for the remainder of her Distributing stock. Section 355(a)(1).
- (16) Distributing will recognize no gain or loss upon the distribution of the Controlled 2 stock to the Distributing shareholders in exchange for all of their stock in Distributing. Section 361(c).
- (17) The basis of the stock of Controlled 2 in the hands of each Distributing shareholder will, in each instance, be the same as the basis of the Distributing stock surrendered by the shareholders in exchange therefor. Section 358(a)(1).
- (18) The holding period of the Controlled 2 stock received by each Distributing shareholder will, in each instance, include the holding period of the Distributing stock surrendered in exchange therefor, provided that the Distributing stock is held as a capital asset on the date of the exchange. Section 1223(1).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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 must be attached to any income tax return to which it is relevant.

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In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

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.

Charles M. Levy
Reviewer, Branch 2
Office of Associate Chief Counsel
(Corporate)