Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact: 199904040

Telephone Number:

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Distributing	=
Wholesaler	=
State A	=
Grantor	=
Grantor's Wife	=
Trustee	=
Child 1	=
Child 2	=
Child 3	=
T1	=
T2	=
T3	=
a	=
b	=

c =

d =

e =

f =

g =

h =

i =

X =

Y =

This is in reply to a letter dated April 30, 1998, submitted on behalf of Distributing, requesting rulings concerning the federal tax consequences of a proposed transaction. Additional information was submitted in subsequent submissions. The information submitted for consideration is summarized below.

The facts as presented indicate that Distributing is an S corporation within the meaning of § 1361(a) of the Internal Revenue Code. Distributing files its income tax return on a calendar year basis using the accrual method of accounting. Distributing's stock is owned as follows: Grantor - a%, Grantor's Wife - b%, Child 1 - c%, Child 2 - c%, Child 3 - c%, T1 - d%, T2 - d% and T3 - d%.

Distributing is engaged in the X and Y businesses. The X business consists of selling Wholesaler's products to retailers. Distributing is Wholesaler's exclusive distributor of Wholesaler's products in State A under an agreement (Agreement) between Wholesaler and Distributing. The Y business consists of the ownership, maintenance, management and leasing of Ys.

Wholesaler has instituted a new policy under the agreements with its distributorships that requires the distributorship's "Manager" own a h % equity interest in the distributorship. In satisfying this h % interest, the Agreement allows the Manager to initially own a g % equity interest upon being designated the Manager and allows

one or more owners of the distributorship to transfer the additional i % equity interest to the Manager on the death of such owner. Child 1 is the Manager of Distributing. Grantor and Grantor's Wife are willing to currently transfer to a trust benefitting Child 1 sufficient interest in the X business to satisfy the g % equity interest requirement but are not willing to transfer an interest in the Y business. Child 1 is unable to afford to purchase the amount of stock necessary to satisfy Wholesaler.

To accomplish his objective, Distributing will contribute the Y business to a newly-formed corporation ("Controlled") in exchange for Controlled stock. Distributing will then distribute the Controlled stock pro rata to Distributing's shareholders.

Grantor and Grantor's Wife will transfer to an irrevocable trust (Trust), which Child 1 will be the beneficiary, an amount of Distributing stock (e shares) so that Child 1 will be the beneficial owner of g % of Distributing's stock. Trustee will be the trustee of Trust. Grantor will retain an annuity amount approximately equal to $ f to be paid to Grantor annually until the earlier of Grantor's death or the fourth anniversary of the creation of Trust. If Grantor dies before the fourth anniversary of Trust, Grantor will have the power to appoint Trust's property by will. If Grantor survives the fourth anniversary of Trust, Trust's property will be distributed to Child 1.

The remaining equity interest to meet the Wholesaler's requirements will pass to Child 1 in trust on the death of Grantor and Grantor's Wife. The transfer of Distributing stock to Trust described above and the transfer in trust on the death of Grantor and Grantor's Wife will satisfy Wholesaler's requirements.

Article I, paragraph (a) of Trust provides that Trust is irrevocable.

Article III of Trust provides that Trust will terminate upon the earlier of four years from Trust's creation (Trust Termination Date) or the date of Grantor's death.

Article III, paragraph (d) of Trust provides that for each taxable year of Trust during Grantor's lifetime, the trustee shall also pay to Grantor an amount (the "Income Tax Reimbursement Amount") equal to the excess, if any, of (1) Grantor's personal federal, state and local income tax liability for the year with or within which such taxable year of Trust ends over (2) Grantor's personal federal, state and local income tax liability for such year computed on the assumption that the total taxable income (including capital gains) of Trust for such taxable year did not exceed the Annuity Amount payable to Grantor for such taxable year.

Article III, paragraph (e) part (1) of Trust provides that if Grantor is alive on the Trust Termination Date the trustee shall pay to Grantor, or expend for the Grantor's benefit, any accrued and undistributed portion of the Annuity Amount and Income Tax

Reimbursement Account. If Child 1 is living on the Trust Termination Date, the trustee shall pay over and distribute the balance of the trust property (including accrued and undistributed income) to Child 1. If Child 1 is not alive upon the Trust Termination Date but either of Grantor's other children is living on the Trust Termination Date, the trustee shall pay over and distribute such balance of the trust property in equal shares to Grantor's other children who are living on the Trust Termination Date.

Article III, paragraph (e) part (2) of Trust provides that if Grantor dies before the Trust Termination Date the trustee shall pay to the executor of Grantor estate, any accrued and undistributed portion of the Annuity Amount and Income Tax Reimbursement Account. The trustee shall distribute the remaining trust property, including any accrued and undistributed income, to such one or more persons or organizations, including Grantor's estate, as Grantor may appoint by will.

Article III, paragraph (f) of Trust provides that the Annuity Amount and the Income Tax Reimbursement Amount shall be paid from the net income of Trust and, to the extent that the net income of Trust is not sufficient, from the principal of Trust. Any net income of Trust for a taxable year in excess of the Annuity Amount and the Income Tax Reimbursement Amount payable for that year will be added to principal.

Article X of Trust provides that Distributing currently operates pursuant to the Agreement. The Agreement, among other things, requires Distributing to seek the approval of Wholesaler prior to certain transfers of Distributing ownership interests. The trustee and special trustee acknowledge that any transfers of Distributing ownership interests which are subject to the terms of the Agreement at the time of the proposed transfer from Trust hereunder, other than to Grantor, Grantor's spouse and any of Grantor's children, may require the prior approval of Wholesaler in order to comply with the terms of the Agreement.

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

(a) No part of the consideration distributed by Distributing is being received by a shareholder as a creditor, employee, or in any capacity other than that or a shareholder of the corporation.

(b) No part of the consideration distributed by Distributing is being received by a security holder as a creditor, employee, or in any capacity other than that or a security holder of the corporation.

(c) The 5 years of financial information submitted with respect to the X business is representative of Distributing's present X business operation

and, with regard to such operation, there have been no substantial operational changes since the date of the last financial statements submitted.

(d) The 5 years of financial information submitted with respect to the Y business is representative of Distributing's present Y business operation and, with regard to such operation, there have been no substantial operational changes since the date of the last financial statements submitted.

(e) Following the transaction, the Distributing and Controlled corporations will each continue the active conduct of its respective businesses, independently and with its separate employees.

(f) The distribution of the Controlled stock is being carried out for the corporate business purposes of providing an increased equity interest in the X business to Child 1. The distribution of the stock of Controlled is motivated entirely by this corporate business purpose.

(g) Except as described above, there is no plan or intention by the shareholders or security holders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their Distributing or Controlled stock (or any other securities of Distributing or Controlled) after the transaction.

(h) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding Distributing or Controlled stock after the transaction.

(i) There is no plan or intention to liquidate either the 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.

(j) The total adjusted bases and the fair market value of the assets being transferred to Controlled by Distributing corporation each equals or exceeds the sum of the liabilities to be assumed by Controlled, if any, plus the liabilities to which the transferred assets are subject, if any. The liabilities to be assumed by Controlled, if any, 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.

(k) Distributing neither accumulated its receivables nor made extraordinary

payment of its payables in anticipation of the transaction.

(l) No intercorporate debt will exist between Distributing and Controlled at the time or, or subsequent to, the distribution of the Controlled stock.

(m) 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.

(n) Neither Distributing nor Controlled are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).

(o) Distributing is an S corporation within the meaning of § 1361(a), having elected to be treated as such under § 1362(a). Controlled will make the election under § 1362(a) to be treated as an S corporation on the first available date after completion of the proposed transaction described herein.

Section 1361(b)(1) defines "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not have (A) more than 75 shareholders, (B) as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual, (C) a nonresident alien as a shareholder, and (D) more than one class of stock.

Section 1361(c)(2)(A)(i) provides that, for purposes of § 1361(b)(1)(B), a trust may be a shareholder of an S corporation if all of the trust is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the United States.

Sections 673 through 677 specify the circumstances under which the grantor is treated as the owner of a portion of the trust.

Section 674(a) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Section 674(b)(3) provides that § 674(a) will not apply to a power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the

approval or consent of any adverse party.

Section 1.674(b)-1(b)(3) of the Income Tax Regulations provides that if a trust instrument provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will, the grantor is treated as the owner of the trust. Moreover, if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law, capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion.

Section 677(a)(1) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse.

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

(1) The transfer by Distributing to Controlled of the assets described above solely in exchange for all of the stock of Controlled and the assumption of liabilities, followed by the distribution of Controlled stock, will be a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each be "a party to a reorganization" within the meaning of § 368(b).

(2) No gain or loss will be recognized to Distributing upon the transfer of assets to Controlled in exchange for Controlled stock and the assumption of liabilities, as described above. I.R.C. §§ 361(a) and 357(a).

(3) No gain or loss will be recognized to Controlled on the receipt of the assets in exchange for Controlled stock, as described above. I.R.C. § 1032(a).

(4) No gain or loss will be recognized by Distributing upon the distribution of all of its stock of Controlled as described above. I.R.C. § 355(c).

(5) No gain or loss will be recognized to (and no amount shall be includible in the income of) the shareholders of Distributing upon receipt of the Controlled stock in the distribution described above. I.R.C. § 355(a)(1).

(6) The basis of the stock of Controlled and Distributing in the hands of each of Distributing shareholders immediately after the distribution will, in the aggregate, be the same as the basis of the Distributing stock in such shareholder's hands immediately prior to the distribution. Such aggregate basis will be allocated in proportion to the fair market value of each in accordance with Treasury Regulation § 1.358-2(a)(2). I.R.C. § 358(b).

(7) The basis of the assets to be received by Controlled will be the same as the basis of such assets in the hands of Distributing immediately prior to the transfer. I.R.C. § 362(a).

(8) The holding period of the assets to be transferred to Controlled by Distributing will be the same as the holding period of such assets in the hands of Distributing immediately prior to the transfer. I.R.C. § 1223(2).

(9) The holding period of the Controlled stock received by each Distributing shareholder will include the holding period of the Distributing stock on which the distributions will be made, provided such stock is held as a capital asset on the date of the distribution. I.R.C. § 1223(1).

(10) During Trust's term, Grantor will be treated as the owner of Trust under §§ 674(a) and 677(a)(1). Accordingly, during Trust's term, Trust will be a permitted shareholder of an S corporation described in I.R.C. § 1361(c)(2)(a)(i).

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the facts described above under any other provisions of the Code. Specifically, we express no opinion concerning whether the election of Distributing to be treated as a subchapter S corporation is a valid election under § 1362.

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.

A copy of this letter must be attached to any income tax return to which it is relevant.

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

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By Lewis K Brickates
Lewis K Brickates
Assistant to the Chief, CC:DOM:CORP:2