Index numbers: 355.01-01
368.00-00
1361.01-05

199907023

CC:DOM:CORP:3--PLR-114649-98

November 17, 1998

Distributing =

State X =

Date 1 =

Date 2 =

Business y =

z =

A =

This letter replies to a request dated June 10, 1998, for rulings about the federal income tax consequences of a proposed transaction. We have received additional information in letters dated September 11, October 30, November 3, and November 12, 1998. The information submitted for consideration is summarized below.

Distributing, a State X corporation, was incorporated on Date 1. It elected to be treated as an S corporation, effective Date 2. Distributing's taxable year ends on September 30th. Distributing operates Business y. Distributing has a single class of voting common stock, z percent of which is owned by A.

Financial information has been submitted indicating that Business y has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

To effectuate a split-off, Distributing proposes to form a

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new company (referred to here as "Controlled"), which will also have a single class of voting common stock. Distributing will then transfer certain assets of Business y to Controlled in exchange for all of the stock of Controlled; Controlled will not assume any liabilities of Distributing or receive any property subject to liabilities in the transaction. Thereafter, Distributing will transfer the stock of Controlled to A in exchange for all of his Distributing stock. Thus, following the transaction, Controlled will be wholly owned by A, and A will no longer own any Distributing stock. A will cause Controlled to elect to be treated as an S corporation.

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

(a) The fair market value of the Controlled stock to be received by A will be approximately equal to the fair market value of the Distributing stock surrendered by him in the exchange.

(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 the corporation.

(c) 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.

(d) Following the transaction, Distributing and Controlled will each continue, independently and with its separate employees, the active conduct of its share of all the integrated activities of the business conducted by Distributing prior to consummation of the transaction.

(e) The distribution of the stock of Controlled is carried out for the following corporate business purposes: avoiding disagreements over the operation and future direction of Distributing's business. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.

(f) Distributing is an S corporation. Controlled will elect to be an S corporation pursuant to § 1362(a) of the Internal Revenue Code on the first available date after the distribution. There is no plan or intent to revoke or otherwise terminate the S election of either corporation.

(g) Other than two shareholders' expressed plans to give

small amounts of Distributing stock to their children, 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 stock in, or securities of, either Distributing or Controlled after the transaction.

(h) 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, other than through stock purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30.

(i) 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.

(j) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of this transaction.

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

(l) 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.

(m) No two parties to the transaction are investment companies as defined in §§ 368(a)(2)(f)(iii) and (iv).

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

(1) The transfer of certain assets of Business y by Distributing to Controlled in exchange for all of the stock of Controlled followed by the distribution of all of the Controlled stock to A in exchange for all of the Distributing stock owned by A 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 by Distributing upon the transfer of assets to Controlled in exchange for the Controlled stock (§ 361(a)).

(3) No gain or loss will be recognized by Controlled upon the receipt of the assets from Distributing in exchange for the

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Controlled stock (§ 1032(a)).

(4) The basis of each of the assets to be received by Controlled in the transaction will equal the basis of such assets in the hands of Distributing immediately prior to the transaction (§ 362(b)).

(5) The holding period of each of the assets to be received by Controlled will include the period during which Distributing held such assets (§ 1223(2)).

(6) No gain or loss will be recognized by Distributing upon the distribution of the Controlled stock held by Distributing to A in exchange for all of A's stock in Distributing (§ 361(c)(1)).

(7) No gain or loss will be recognized by (and no amount will be included in the income of) A upon the receipt of Controlled stock in exchange for the Distributing stock held by A (§ 355(a)(1)).

(8) The basis of the Controlled stock to be received by A will be the same as the basis of the Distributing stock surrendered in exchange therefor (§ 358(a)(1)).

(9) The holding period of the Controlled stock to be received by A will include the holding period of the Distributing stock surrendered by A in exchange therefor provided that the Distributing stock is held as a capital asset on the date of the exchange (§ 1223(1)).

(10) Provided that Distributing immediately distributes the stock of Controlled to a qualified subchapter S shareholder, Distributing's momentary ownership of that stock in connection with a reorganization under § 368(a)(1)(D) will be disregarded for purposes of §§ 1361 and 1362, and, therefore, will not terminate Distributing's election to be taxed as an S corporation under § 1362(d)(2).

(11) Provided that Distributing immediately distributes the stock of Controlled, Distributing's momentary ownership of the stock will not cause Controlled to have an ineligible shareholder under § 1361(b)(1)(B). Therefore, Controlled is eligible to make a timely election, without the consent of Distributing, to be an S corporation for its first taxable year, provided that Controlled meets the other requirements of § 1361(b).

(12) Controlled will be subject to § 1374 with respect to any asset transferred to Controlled from Distributing to the same extent Distributing was subject to § 1374. Controlled's recognition period will be reduced by the portion of Distributing's recognition period that expired prior to

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Distributing's transfer of these assets to Controlled (Ann. 86-128, 1986-51 I.R.B. 22, and § 1374(d)(8)).

We express no opinion about the tax treatment of the transaction under other provisions of the Internal Revenue 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. Specifically, we express no opinion, and none was requested, regarding the validity of Distributing's past election or Controlled's intended election under § 1362(a) to be treated as an S corporation or whether Controlled otherwise will qualify as an S corporation. This ruling has no effect on any earlier transactions and is directed only to the taxpayer who requested it. Section 6110(k) (3) of the Code provides that it may not be used or cited as precedent.

Each affected taxpayer should attach a copy of this letter to the taxpayer's federal income tax returns for the taxable year in which the transaction covered by this ruling letter is consummated.

Sincerely yours,

Assistant Chief Counsel (Corporate)

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Branch 3