

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

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Refer Reply To:

**CC:CORP:1 PLR-104530-00**

Date:

August 22, 2000

Distributing =

Controlled =

State X =

Year 1 =

Year 2 =

Date 1 =

Date 2 =

Business 1 =

Business 2 =

Business 3 =

a =

b =

c =

d =

:

This is in response to your letter dated February 23, 2000, in which you requested rulings on the federal income tax treatment of the transactions described below. Specifically, you requested rulings under § 355 of the Internal Revenue Code. Additional information regarding your request has been submitted in subsequent letters. The information submitted for our review is summarized below.

Distributing, a State X corporation, was incorporated in Year 1, and engages in

several lines of business, including Businesses 1, 2, and 3. Until Date 1, Distributing was the common parent of an affiliated group of corporations that filed a consolidated return. On Date 2, Distributing made an election to be taxed as a Subchapter S corporation, which terminated the consolidated group. Distributing currently has d shareholders, and maintains its books and files its federal income tax returns using the accrual method of accounting.

Controlled, also a State X corporation, was incorporated in Year 2 and, until Date 1 was a member of Distributing's consolidated group. Following its S election, Distributing elected that Controlled become a Qualified Subchapter S Subsidiary and, thus, be disregarded for federal tax purposes.

Financial information has been received which indicates that Business 1 (the Distributing active business) and Business 3 (the Controlled active business) have had gross receipts and operating expenses representative of the active conduct of a trade or business.

Distributing has had trouble recruiting and retaining employees to work in Business 1 due to the competitive labor market. Distributing's management believes it must provide an equity-based compensation package that will attract recruiting candidates and retain and motivate its current employees. In order to motivate the key employees involved in Businesses 1 and 2 and other rank-and-file employees involved in those businesses, Distributing created an equity-based Employee Stock Option Plan (ESOP). Currently, the ESOP owns a% of Distributing stock. The key employees of Distributing currently own b% of the ESOP. However, Management of Distributing believes that as long as Controlled's earnings and asset base are included in the earnings and value of Distributing shares held in the ESOP, the Business 1 and 2 employees are insufficiently motivated to increase the success of Businesses 1 and 2. In order to give the key employees of Businesses 1 and 2 a more direct stake in their businesses, undiluted by the results of Business 3 and other unrelated businesses, Distributing intends to separate Businesses 1 and 2 from Business 3 and other unrelated businesses in the following transactions:

- (1) The outstanding shares of Distributing and Controlled will be increased through a stock split. Fractional shares will be issued to the Distributing shareholders in the stock split.
- (2) Business 3 and other assets will be transferred to Controlled.
- (3) The "participating shareholders" (all shareholders except the ESOP) will surrender some of their Distributing stock for stock of Controlled. Immediately thereafter, Controlled will elect to be taxed as an S corporation. Fractional shares will not be issued; Distributing and Controlled will issue cash in lieu of fractional shares.

Following the distribution of Controlled, the ESOP's interest in Distributing will increase to 6%.

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

- (a) The fair market value (FMV) of the Controlled common stock to be received by each participating shareholder will be approximately equal to the FMV of the Distributing common stock surrendered by each participating shareholder 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 Business 1 (the Distributing active business) is representative of the present operations of the business, and with regard to that business, there has been no substantial operational changes since the date of the last financial statements submitted.
- (d) The five years of financial information submitted on behalf of Business 3 (the Controlled active business) is representative of the present operations of the business, and with regard to that business, there has been no substantial operational changes since the date of the last financial statements submitted.
- (e) Following the distribution, Distributing will continue the active conduct of its businesses, independently and with its separate employees. Controlled will also continue to actively and independently conduct its businesses. Any continuing transactions between Distributing and Controlled will be at arms' length.
- (f) The distribution will be carried out for the corporate business purpose of motivating Distributing's executives and rank-and-file employees to focus on and increase the growth and profitability of the businesses retained and conducted by Distributing following the distribution. Following the distribution, Distributing's executives and rank-and-file employees will have a more direct equity stake in the Business 1 business. The distribution is motivated, in whole or substantial part, by this corporate business purpose.
- (g) Distributing is an S corporation (within the meaning of § 1361(a)). Controlled will elect to be taxed as an S corporation pursuant to § 1361(a). Controlled will elect to be an S corporation pursuant to § 1362(a) on the first available date after the distribution, and there is no plan or intention to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

- (h) There is no plan or intention by the shareholders of Distributing to sell, exchange, or otherwise dispose of any of their stock in either Distributing or Controlled after the transaction except that some Distributing and Controlled shareholders may make gifts of Distributing and/or Controlled stock to family members and charity. Some shareholders may also sell some of their stock to the ESOP. However, if after the distribution, any shareholder sells or redeems shares of Distributing or Controlled in a transaction in which capital gain is recognized, such transaction will be executed only if the shareholder sells or redeems an equal percentage of shares in both Distributing and Controlled.
- (i) 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.
- (j) 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.
- (k) The total adjusted bases and the fair market value of the assets to be transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities to be assumed by Controlled plus any liabilities to which the transferred assets are subject.
- (l) The liabilities to be assumed in the transaction and the liabilities to which the assets to be transferred are subject, were incurred in the ordinary course of business and are associated with the assets to be transferred.
- (m) Distributing will not accumulate its receivables nor make any extraordinary payment of its payables in anticipation of the proposed transaction.
- (n) 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.
- (o) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (p) The distribution will not be a disqualified distribution within the meaning of § 355(d)(2) because, during the five-year period ending on the date of the distribution and immediately after the distribution, no person has held, nor will hold, disqualified stock of either Distributing or Controlled which constitutes a 50% or greater interest in either corporation.

- (q) 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 total combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing 50% or more of the total value of all classes of stock of either Distributing or Controlled.
- (r) Immediately after the distribution, the gross assets of the active trade or business directly conducted by Distributing (as defined in § 355(b)(2)) will have a fair market value equal to at least five percent of the total fair market value of the gross assets of Distributing.
- (s) Immediately after the distribution, the gross assets of the active trade or business directly conducted by Controlled (as defined in § 355(b)(2)) will have a fair market value equal to at least five percent of the total fair market value of the gross assets of Controlled.
- (t) The payment of cash in lieu of fractional shares of Distributing and Controlled is solely for the purposes of avoiding the expense and inconvenience to Distributing and Controlled of issuing fractional shares and does not represent separately bargained for consideration. The share interests of each shareholder of Distributing and Controlled will be aggregated and no shareholder will receive cash in an amount equal to or greater than the value of one full share of either Distributing or Controlled stock. The total amount of cash paid in lieu of fractional shares will not exceed one percent of the fair market value of either Distributing or Controlled stock.

Based solely on the information submitted and the representations made, we rule as follows:

- (1) The transfer of the assets and liabilities of Business 3 and other assets by Distributing to Controlled followed by Distributing's distribution of all the stock of Controlled to the participating shareholders, will constitute a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each be a "a party to a reorganization" within the meaning of § 368(b).
- (2) No gain or loss will be recognized by Distributing as a result of the transfer of the Business 3 and other assets and liabilities to Controlled in exchange for the stock of Controlled. §§ 361(a) and 357(a).
- (3) No gain or loss will be recognized by Controlled upon the receipt of the assets from Distributing in exchange for the stock of Controlled. § 1032(a).
- (4) The basis of each of the assets received by Controlled in the transaction will

equal the basis of such assets in the hands of Distributing immediately prior to their transfer to Controlled. § 362(b).

- (5) The holding period of each of the assets to be received by Controlled in the transaction will include the period during which such assets were held by Distributing. § 1223(2).
- (6) No gain or loss will be recognized by Distributing upon the distribution of all of the stock of Controlled. § 361(c)(1).
- (7) No gain or loss will be recognized by (and no amount will be included in the income of) the participating shareholders of Distributing upon the receipt of the stock of Controlled. § 355(a)(1).
- (8) The aggregate basis of the stock of Distributing and Controlled in the hands of the participating shareholders immediately following the distribution will be the same as the basis in their 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). § 358(b)(2).
- (9) The holding period of the stock of Controlled received by the participating shareholders will include the holding period of the Distributing stock provided that the Distributing stock was held as a capital asset on the date of the proposed transaction. § 1223(1).
- (10) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a).
- (11) Controlled will be subject to § 1374 with respect to any asset transferred to it 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 the transfer of the assets to it. § 1374(d)(8).
- (12) Cash received by a Distributing shareholder otherwise entitled to a fractional share as a result of the Distribution will be treated as if the fractional share were distributed as part of the Distribution and then redeemed as provided in § 302(a). This receipt of cash will result in gain or loss measured by the difference between the basis of such fractional share interest and the cash received. Such gain or loss will be capital gain or loss to the Distributing shareholder, provided the Distributing stock or the Controlled stock (as the case may be), is a capital asset in the hands of such shareholder and, as such, will be subject to the provisions and limitations of Subchapter P of Chapter 1. Rev. Rul. 66-365, 1965-2 C.B. 116 and Rev. Proc. 77-41, 1977-2 C.B. 574.

No opinion is expressed about the tax treatment of the proposed 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 proposed transactions that are not specifically covered by the above rulings.

This ruling is directed only to the taxpayer who requested it. Section 6610(k)(3) 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 transactions covered by this ruling is consummated. Pursuant to the Power of Attorney on file with this office, a copy is being mailed to your authorized representatives.

Sincerely Yours,  
Associate Chief Counsel (Corporate)

By \_\_\_\_\_

Christopher W. Schoen  
Assistant to the Chief, CC:CORP:1