Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Index Number: 355.01-01, 368.04-00

Number: **200039033**
Release Date: 9/29/2000

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Telephone Number:

Refer Reply To:
CC:DOM:CORP:4 - PLR-104669-00

Date:
June 30, 2000

Distributing =

Controlled =

Estate of A =

B =

Business X =

Business Y =

C =

D =

This letter responds to your February 18, 2000 request for rulings concerning the federal income tax consequences of a proposed transaction.

Summary of Facts

Distributing is an S corporation (within the meaning of § 1361(a) of the Internal Revenue Code) that conducts Business X and Business Y. Its one class of stock is owned 55 percent by the Estate of A and 45 percent by A's widow, B. The Estate of A is expected to transfer its Distributing shares to B pursuant to A's will.

We have received financial information indicating that Business X and Business Y each has had gross income and operating expenses representing an active business during each of the past five years.

C and D are key employees of Business Y, and each wishes to purchase stock in an entity that conducts only Business Y. Further, the taxpayer has submitted evidence from an independent insurance provider that the cost of liability insurance for Business Y would be reduced significantly if Business Y were separated from Business X. Placing Business Y in a subsidiary or limited liability company owned partially by C

and D and partially by Distributing would not satisfactorily achieve either goal in that (i) the new entity would be unable to enjoy the flowthrough benefits of Subchapter S of the Code and (ii) the insurance cost saving can be attained only if the new entity is not owned in significant part by Distributing.

Proposed Transaction

To accommodate the wishes of C and D and to achieve the cost saving, the following transaction is proposed:

(i) Distributing will transfer all the assets of Business Y to newly formed, wholly owned Controlled in exchange for Controlled voting stock and the assumption by Controlled of related liabilities (the “Contribution”).

(ii) Distributing will distribute the Controlled stock pro rata to the Estate of A and B (the “Distribution”).

(iii) Within 90 days after issuance of this letter ruling, C and D each will purchase for fair market value sufficient Controlled stock from Controlled to give each 20 percent of the Controlled stock outstanding after the purchases.

Representations

The taxpayer has made the following representations concerning the proposed transaction:

(a) No intercorporate debt will exist between Distributing and Controlled at the time of, or after, the Distribution.

(b) No part of the consideration distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than as a shareholder of Distributing.

(c) The five years of financial information submitted on behalf of Business X and Business Y represent Distributing’s present operation of each business, and, with regard to each business, there has been no substantial operational change since the last financial statement submitted.

(d) Following the transaction, Distributing and Controlled each will continue the active conduct of its business, independently and with its separate employees.

(e) The Distribution is being carried out to provide C and D with significant equity interests in Business Y and to achieve significant cost savings. The Distribution is motivated, in whole or substantial part, by these corporate business purposes.

(f) 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, Distributing or Controlled after the transaction, except for the distribution of Distributing and Controlled stock by the Estate of A to A's surviving spouse, B.

(g) 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 section 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696, 705.

(h) 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.

(i) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing each exceeds the liabilities assumed (as determined under § 357(d)) by Controlled. .

(j) The liabilities assumed (as determined under § 357(d)) in the transaction were incurred in the ordinary course of business and are associated with the assets being transferred.

(k) Distributing has neither accumulated its receivables nor made any extraordinary payment of its payables in connection with the transaction.

(l) Payments made in any continuing transactions between Distributing and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arms length.

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

(n) Distributing is an S corporation within the meaning of § 1361(a). Controlled will elect to be an S corporation pursuant to § 1362(a) on the first available date after the transaction, and there is no plan or intention to revoke or otherwise terminate the S corporation election of Distributing or Controlled.

(o) 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 percent or more of the combined voting power of all classes of stock of Distributing or Controlled entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing or Controlled stock.

Rulings

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

(1) The Contribution, followed by the Distribution, will be a reorganization under § 368(a)(1)(D). Distributing and Controlled each will be a "party to a reorganization" under § 368(b).

(2) No gain or loss will be recognized by Distributing on the Contribution (§§ 361(a) and 357(a)).

(3) No gain or loss will be recognized by Controlled on the Contribution (§ 1032(a)).

(4) The basis of each asset received by Controlled in the Contribution will equal the basis of that asset in the hands of Distributing (§ 362(b)).

(5) The holding period of each asset received by Controlled will include the holding period of that asset in the hands of Distributing (§ 1223(2)).

(6) No gain or loss will be recognized by Distributing on the Distribution (§ 361(c)(1)).

(7) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) the Estate of A or B on its or her receipt of Controlled stock in the Distribution (§ 355(a)(1)).

(8) The aggregate basis of the Controlled and Distributing stock in the hands of each shareholder after the Distribution will equal the shareholder's basis in the Distributing stock held immediately before the Distribution (§ 358(a)(1)). The basis will be allocated between the Controlled and Distributing stock in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) of the Income Tax Regulations (§ 358(b)(2) and (c)).

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

(10) Earnings and profits will be allocated between Distributing and Controlled in accordance with §§ 312(h) and 1.312-10(a).

Caveats

We express no opinion on the federal income tax treatment of the proposed transaction under other provisions of the Code or regulations or the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above rulings.

Procedural Statements

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Each taxpayer involved in the transaction should attach a copy of this letter to the taxpayer's federal income tax return for the taxable year in which the transaction is completed.

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

Sincerely,
Assistant Chief Counsel (Corporate)
By: Wayne T. Murray
Senior Technician Reviewer
Branch 4