

**Internal Revenue Service**

Department of the Treasury

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Date:  
July 5, 2001

Legend

Distributing =

Controlled =

Financial Advisor =

Key Employee =

Business A =

Business B =

State X =

State Y =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

This is in response to your letter dated February 28, 2001, requesting rulings on behalf of Distributing with respect to a proposed and partly consummated transaction.

Additional information was received under cover of letters dated May 31, 2001, June 29, 2001 and July 3, 2001. The material information submitted is summarized below.

Distributing, a State X corporation engaged in Business A, was incorporated on Date 1 and originally filed its tax returns as a Subchapter C corporation. On and as of Date 2, Distributing elected Subchapter S status. Distributing is an accrual method taxpayer that files its returns on a calendar-year basis.

Distributing has only one class of stock, Class A Voting Common Stock. Two hundred shares are outstanding. Distributing's stock is closely held by eight people. Since its formation, it has had essentially the same shareholders, all of whom are U.S. persons.

Controlled, a State Y corporation, was formed as a Subchapter C corporation on Date 3 in connection with the transaction discussed below. Controlled is an accrual method taxpayer that files its returns on a calendar-year basis. Controlled is engaged in Business B. Only one class of Controlled stock is outstanding. On Date 4, Distributing owned 100% of the stock of Controlled.

Prior to Date 4, Distributing had historically carried on both operational and managerial activity relating to Business A and Business B through its own employees. Financial information has been received indicating that Business A and Business B each have had gross receipts and operating expenses representing the active conduct of a trade or business during each of the past five years.

Distributing determined that in order to realize the immediate corporate business objectives of funding Business B's operations, as well acquiring sufficient funds to finance the acceleration of the sales and marketing of its product line, there was a need to raise significant amounts of third-party equity capital. Based on the advice of its Financial Advisor, Distributing concluded that positioning Business B as an independent stand-alone corporation would allow it most efficiently to raise the needed capital.

In order to achieve that separation, on Date 3, Distributing formed Controlled. On Date 5, Distributing's Board of Directors ratified the transfer of all the assets and liabilities of Business B to Controlled as of Date 4, in return for 100% of Controlled's then issued and outstanding stock (the "Transfer"). In order to accomplish the separation of Business B from Distributing, Distributing proposes to distribute (the "Distribution" or "spin-off") its Controlled shares to Distributing's shareholders on a pro rata basis. In order to raise the equity capital needed for growth, Controlled proposes to issue additional shares of up to a maximum of 10% of its issued and outstanding shares, in a private offering to third party investors, who are not currently Distributing shareholders. Distributing's Financial Advisor concluded that the stock offering will raise more funds per share if Distributing and Controlled are independent, stand-alone corporations.

The taxpayers have stated that Key Employee has relinquished the title of CEO of Controlled, and that he will not reassume that title. Further, within six months of the Distribution, Key Employee will relinquish the title of President/COO of Controlled, and will not reassume such title at any time while serving as an officer of Distributing.

The taxpayers have represented that Controlled's stock offering will be completed within one year of the date of the Distribution. The funds raised by the private offering will be used by Controlled to achieve the above-stated business purposes. Upon completion of the private offering and the spin-off, Distributing shareholders will own over 80% of the outstanding shares of Controlled. To date, approximately 24% of the available private placement shares have been issued.

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

1. No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity as other than that of a shareholder of Distributing.
2. The 5 years of financial information submitted on behalf of Distributing is representative of its present operation, and with regard to Distributing, there have been no substantial operational changes since the date of the last financial statements submitted.
3. The 5 years of financial information submitted on behalf of Controlled is representative of its present operation, and with regard to Controlled, there have been no substantial operational changes since the date of the last financial statements submitted.
4. Following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees.
5. The distribution of the stock of Controlled is to facilitate a stock offering by Controlled, and specifically is carried out for the following corporate business purposes: (1) the need for Controlled to raise capital in the near future to fund operations and for capital expenditures; (2) the stock offering will raise more funds per share or is otherwise more advantageous if Distributing and Controlled are separated in connection with the stock offering; and (3) funds raised in stock offering will under all circumstances be used for the business of Controlled. The distribution of the stock of Controlled is motivated, in whole or substantial part, by one or more of these corporate business purposes.

6. 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.
7. 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, other than through stock purchases meeting the requirements of Section 4.05(1)(b) of Rev. Proc. 96-30.
8. 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.
9. The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject.
10. 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.
11. The offering pursuant to the Private Placement Memorandum will be completed within one year of the date of distribution.
12. Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
13. No indebtedness of either Distributing or Controlled will be cancelled in connection with this transaction.
14. 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.
15. No parties to the transaction are investment companies as defined in I.R.C. § 368(a)(2)(F)(iii) and (iv).

16. Distributing is currently a Subchapter S corporation (within the meaning of § 1361(a)) and intends to remain a Subchapter S corporation after the distribution. Controlled is currently a Subchapter C corporation, and intends to remain a Subchapter C corporation after the distribution.

Based solely on the information submitted and the representations made, we have concluded that:

- (1) The transfer of all of the Business B assets and liabilities to Controlled followed by the Distribution, constitutes a reorganization within the meaning of section 368(a)(1)(D) of the Internal Revenue Code and a tax-free distribution of the stock of Controlled within the meaning of section 355. Distributing and Controlled will each be a “party to the reorganization” within the meaning of section 368(b).
- (2) No gain or loss will be recognized by Distributing upon its receipt of Controlled stock in exchange for the transfer of assets to, and the assumption of liabilities by, Controlled in the Transfer. Section 361(a) and section 357(a).
- (3) No gain or loss will be recognized by Controlled upon its receipt of assets of Distributing in exchange for its issuance of shares of Controlled stock in the Transfer. Section 1032(a).
- (4) Controlled’s basis in each asset received from Distributing in the Transfer will equal the basis of such asset in the hands of Distributing immediately prior to the Transfer. Section 362(b).
- (5) The holding period of each asset acquired by Controlled from Distributing in the Transfer will include the period during which Distributing held such asset. Section 1223(2).
- (6) No gain or loss will be recognized to (and no amounts will be included in the income of) the shareholders of Distributing upon their receipt of Controlled stock. Section 355(a)(1).
- (7) Distributing will not recognize gain or loss upon the Distribution to its shareholders of the stock in Controlled. Section 361(c)(1).
- (8) The holding period of the Controlled stock received by the shareholders of Distributing will, in each instance, include the holding period of the

Distributing stock with respect to which the Distribution will be made, provided that the Distributing stock is held as a capital asset, as defined in section 1221, by the respective shareholder of Distributing on the day of the Distribution. Section 1223(1).

- (9) Each shareholder's basis in the Distributing stock held before the transaction will be allocated between the Distributing stock and the Controlled stock held by such shareholders immediately after the transaction in proportion to their relative fair market values as provided by Treas. Reg. § 1.358-2(a)(2).
- (10) As provided in section 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made in accordance with § 1.312-10.

No opinion is expressed as to the tax treatment of the transactions under other provisions of the Code or regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions that are not specifically covered by the above ruling. In particular, no opinion is expressed concerning whether Distributing is a Subchapter S corporation for federal tax purposes.

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

Sincerely yours,  
Associate Chief Counsel (Corporate)  
By: Steven J. Hankin  
Senior Technical Reviewer, Branch 6  
(Corporate)