

INTERNAL REVENUE SERVICE
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November 2, 1998

Re:

Distributing =

Controlled =

Father =

Mother =

Brother A =

Brother B =

State C =

Business A =

Business B =

Dear :

This is in response to a letter dated February 10, 1998 requesting a ruling as to the federal income tax consequences of a proposed transaction. Additional information was submitted in a letter dated June 5, 1998, September 16, 1998, September 28, 1998, and October 1, 1998. The information submitted for

consideration is substantially as set forth below:

Distributing is a State C corporation. It currently has A shares of voting stock outstanding and B shares of nonvoting stock outstanding. Distributing is an S corporation.

Father is the principal shareholder of Distributing, owning 31.86 percent of the outstanding voting and nonvoting stock. Mother owns 16.25 percent of the voting and nonvoting stock of Distributing. Brother A owns 19.18 percent of the voting and nonvoting Distributing stock, while Brother B owns 11.30 percent of the Distributing voting and nonvoting stock. The children of Brother B also own small amounts of Distributing nonvoting stock.

Distributing has been engaged continuously in Business A for more than five years. Additionally, for more than five years, Distributing has had a separate division which has continually engaged in Business B.

Financial information has been received that reflects that Business A and Business B each have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Originally, Brother A and Brother B were both involved in both businesses. However, Brother A has become the primary operator and manager of Business A, and Brother B has become the primary operator and manager of Business B. Gradually, the interaction between the businesses has gotten smaller. Recently, Business B has relocated to its own premises in a building which it rents from a third party.

The Board of Directors is very concerned that the lack of interaction between the brothers will force either one or both to leave, with negative consequences to the corporation. Consequently, a decision has been made to permit Brother B to go his separate way. The transaction will be effected as follows:

- i. Distributing will form Controlled.
- ii. Distributing will transfer property to Controlled consisting of the assets of Business B. Controlled will also assume certain Distributing liabilities associated with the transferred assets.
- iii. Distributing will distribute pro rata all of the stock, voting and nonvoting, of Controlled to Brother B and the other Brother B family shareholders in exchange for all of their voting

and nonvoting stock in Distributing.

In connection with the proposed transaction, the following representations are made:

a.) The fair market value of the Controlled corporation stock to be received by each exchanging shareholder of the Distributing corporation will be approximately equal to the fair market value of the Distributing corporation stock surrendered by the shareholder in the exchange.

b.) No part of the consideration to be distributed by the Distributing corporation 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 the Distributing corporation is representative of the corporation's present operations, 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, the Distributing and Controlled corporations will each continue the active conduct of its business, independently and with its separate employees.

e.) The distribution of the stock of the Controlled corporation is carried out for the following corporate business purpose:

To avoid conflict in the management of the business of the corporation and to resolve management, systemic, or other problems that arise (or are exacerbated) by the operation of different businesses. This will enable a significant shareholder group to concentrate on a particular business.

The distribution of the stock of the Controlled corporation is motivated, in whole or substantial part, by this Corporate Business Purpose.

f.) There is no plan or intention by the shareholders of the Distributing corporation to sell, exchange, or otherwise dispose of any of their stock in either Distributing or Controlled after the transaction, except as noted. First, transfers of stock may continue to be made to Brother A and family for estate planning purposes. Second, Father and Mother are discussing with Brother A the possibility of entering into an option agreement, giving Brother A the right to purchase the shares of the two

shareholders after at least three years from the date of the option.

g.) 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.

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 income tax liability for the taxable year in which investment credit property (including any building to which section 47(d) applies) is transferred will be adjusted pursuant to section 50(a)(1) or (a)(2) (or section 47, as in effect before amendment by Public Law 101-508, Title 11, 1043 Stat. 1388, 536 (990), if applicable) to reflect an early disposition of the property.

j.) Distributing neither accumulated its receivables, nor made extraordinary payment of its payables in anticipation of the 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 section 368(a)(2)(F)(iii) and (iv) of the Internal Revenue Code.

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

o.) The total adjusted bases and the fair market value of

the assets transferred to Controlled each equals or exceeds the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject.

p.) 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.

Based solely on the information submitted and on the representations set forth above, it is held as follows:

(1) The transfer of assets by Distributing to Controlled solely in exchange for all of the stock of Controlled, followed by the distribution of the stock of Controlled to Brother B and the Brother B family shareholders in exchange for all of their stock in Distributing 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, subject to liabilities, to Controlled in exchange for Controlled stock, as described above (§§ 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 (§ 1032(a)).

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

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

(6) No gain or loss will be recognized to Distributing upon the distribution of all of the Controlled stock, as described above (§ 361(c)(1)).

(7) No gain or loss will be recognized to (and no amount will be included in the income of) Brother B and the Brother B family shareholders upon the receipt of Controlled stock in exchange for their Distributing stock (§ 355(a)(1)).

(8) The basis of the Controlled stock in the hands of

Brother B and the Brother B family shareholders will be the same as the respective bases of their Distributing stock surrendered in exchange therefor. (§ 358(a)(1)).

(9) The holding period of the Controlled stock received by Brother and the Brother B family shareholders will include the holding period of the Distributing stock surrendered in the exchange, provided that such stock is held as a capital asset on the date of the exchange. (§ 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).

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 transaction that are not specifically covered by the above rulings.

This ruling is directed only to the taxpayer who requested it. Section 6610(j)(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 taxpayer year in which the transaction covered by this ruling is consummated.

As requested in the Power of Attorney, a copy of this letter is being sent to the taxpayer.

Sincerely yours,
Assistant Chief Counsel (Corporate)

By _____
Howard Staiman
Assistant to the Chief, Branch 1