

## Internal Revenue Service

Department of the Treasury

Number: **200306014**  
Release Date: 02/07/2003  
Index Number: 355.01-02

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

**CC:CORP:B06-PLR146304-02**

Date:

**October 30, 2002**

### LEGEND:

Distributing =

Controlled 1 =

Controlled 2 =

Business A =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

Shareholder 4 =

Shareholder 5 =

Shareholder 6 =

Shareholder 7 =

Shareholder 8 =

Shareholder 9 =

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Shareholder 10 =

Shareholder 11 =

Shareholder 12 =

Shareholder 13 =

Shareholder 14 =

Shareholder 15 =

Shareholder 16 =

Date 1 =

Date 2 =

State A =

ww =

xx =

yy =

zz =

a =

b =

c =

d =

e =

f =

g =

Note 1 =

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Note 2 =

Dear :

This letter is in response to your authorized representative's letter dated August 9, 2002, requesting rulings on certain federal income tax consequences of a proposed transaction. Additional information was received in a letter dated October 11, 2002. The material information submitted is summarized below.

The rulings contained in this letter are predicated upon the facts and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of the request for a ruling. Verification of the information, representations, and other data may be required as part of the audit process.

#### SUMMARY OF FACTS

Distributing is a domestic corporation that was incorporated on Date 1 in State A. Distributing has one class of stock issued and outstanding. Distributing engages in Business A.

Distributing has sixteen shareholders. Shareholders 1, 7 and 10 each own a ww percent interest. Shareholders 8 and 9 each own an xx percent interest. Shareholders 2-6 and Shareholders 11-15 each own a yy percent interest. Shareholder 16 owns a zz percent interest.

Financial information has been received indicating that Distributing has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Shareholders 1-6 (hereinafter "Group 1"), Shareholders 7-15 (hereinafter "Group 2") and Shareholder 16 have engaged in protracted, contentious, antagonistic and irreconcilable disputes. These disputes adversely have affected the strategic direction and day-to-day and financial operations of Business A.

Accordingly, the following transaction has been proposed (and the taxpayer has completed some of the steps, as noted below):

- (i) On Date 2, Distributing formed Controlled 1, and contributed a of its assets and any liabilities associated with those assets to Controlled 1 in exchange for Note 1 and 100 percent of the stock of Controlled 1. Likewise on Date 2, Distributing formed Controlled 2, and contributed b of its assets and any liabilities associated with those assets to Controlled 2

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in exchange for Note 2 and 100 percent of the stock of Controlled 2.

- (ii) Distributing will redeem its stock owned by Shareholder 16 (the “Redemption”). Shareholder 16 will receive e in cash, Note 1 and Note 2 in consideration for the Distributing stock surrendered. Note 1 and Note 2 each is payable in f equal annual installments of principal, together with interest at a rate of g percent.
- (iii) Following the Redemption, Distributing will distribute the stock of Controlled 1 to Group 1 and the stock of Controlled 2 to Group 2 (the “Distribution”). Group 1 and Group 2 will surrender their stock in Distributing on the Distribution date.
- (iv) After the Distribution, Distributing will liquidate.

Currently, it is contemplated that Controlled 2 will redeem the shares owned by c of its shareholders on the d anniversary of the Distribution, so as to provide for a transfer of Controlled 2 to a new generation. Concurrently with these anticipated redemptions, there will be a cross purchase of Controlled 2 shares among the remaining Controlled 2 shareholders to equalize ownership among all remaining Controlled 2 shareholders.

## REPRESENTATIONS

Distributing has made the following representations regarding the proposed transaction:

- (a) The indebtedness owed by Controlled 1 and Controlled 2 (hereinafter “the Controlled corporations”) to Distributing after the Distribution will not constitute stock or securities.
- (b) The fair market value of the Controlled corporations’ stock and other consideration to be received by each shareholder of Distributing will be approximately equal to the fair market value of Distributing stock surrendered by the shareholder in the exchange.
- (c) 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.
- (d) The five years of financial information submitted on behalf of Distributing is representative of Distributing’s present operation, and with regard to such corporation, there have been no substantial operational changes

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since the date of the last financial statements submitted.

- (e) Immediately before the Distribution, the gross assets of Controlled 1 used in Business A will have a fair market value that is at least 5 percent of Controlled 1's gross assets. Immediately after the Distribution, the gross assets of Controlled 1 used in Business A will have a fair market value that is at least 5 percent of Controlled 1's gross assets.
- (f) Immediately before the Distribution, the gross assets of Controlled 2 used in Business A will have a fair market value that is at least 5 percent of Controlled 2's gross assets. Immediately after the Distribution, the gross assets of Controlled 2 used in Business A will have a fair market value that is at least 5 percent of Controlled 2's gross assets.
- (g) Following the Distribution, each of the Controlled corporations will continue independently and with its separate employees the active conduct of its share of all the integrated activities of Business A, which was conducted by Distributing before the Distribution.
- (h) The Distribution is carried out for the following corporate business purpose: to settle all outstanding disputes and to avoid threatened litigation among the shareholders of Distributing which directly and adversely affect Distributing's operations and threaten the continued efficient operation of Business A. By effecting a separation of ownership and management of Business A through a split-up, the Group 1 shareholders exclusively will own and operate Controlled 1, and the Group 2 shareholders exclusively will own and operate Controlled 2. The Distribution is motivated, in whole or substantial part, by the foregoing corporate business purpose.
- (i) There is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in either Distributing or either of the Controlled corporations after the Distribution, except as otherwise discussed above.
- (j) Except for the redemption that Controlled 2 is contemplating and that is discussed in the flush language following section (iv) of the SUMMARY OF FACTS, there is no plan or intention by either Distributing or either of the Controlled corporations, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the Distribution, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30.
- (k) There is no plan or intention to liquidate either of the Controlled

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corporations, to merge Distributing or either of the Controlled corporations with any other corporation, or to sell or otherwise dispose of the assets of the Controlled corporations after the Distribution, except in the ordinary course of business. (Distributing will be liquidated after the Distribution.)

- (l) The Distribution is not part of a plan or a series of related transactions (within the meaning of section 355(e) of the Internal Revenue Code (the "Code")) pursuant to which one or more persons has acquired or will acquire, directly or indirectly, stock possessing 50 percent or more of the total combined voting power of all classes of stock of either Distributing or any of the Controlled corporations entitled to vote, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or any of the Controlled corporations.
- (m) The total adjusted bases and the fair market value of the assets transferred to the Controlled corporations by Distributing each equals or exceeds the sum of the liabilities assumed (as defined under section 357(d)) by the Controlled corporations. The liabilities assumed (as defined under section 357(d)) in the Distribution were incurred in the ordinary course of business and are associated with the assets being transferred.
- (n) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the Distribution.
- (o) No intercorporate debt will exist between Distributing and the Controlled corporations at the time of, or subsequent to, the Distribution.
- (p) Payments made in connection with all continuing transactions, if any, between Distributing and the Controlled corporations will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (q) No two parties to the Distribution are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (r) Distributing is not an S corporation (within the meaning of § 1361(a)), but immediately before the Distribution, Distributing will be eligible to make an S corporation election pursuant to § 1362(a). Controlled 1 and Controlled 2 each 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 intent to revoke or otherwise terminate the S corporation election of either Controlled 1 or Controlled 2.

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## RULINGS

- (1) Amounts received by Shareholder 16 in the Redemption will be treated as full payment in exchange for the Distributing stock surrendered. Section 331(a).
- (2) The transfer of the Distributing assets by Distributing to the Controlled corporations in exchange for all of the stock of the Controlled corporations and the assumption of liabilities as well as Note 1 and Note 2, as described above, followed by the distribution of the Controlled corporations' stock to the Group 1 and Group 2 shareholders, respectively, in exchange for the stock in Distributing owned by those shareholders will be a reorganization within the meaning of § 368(a)(1)(D) of the Code. Distributing and both Controlled corporations will each be "a party to the reorganization" within the meaning of § 368(b) of the Code.
- (3) No gain or loss will be recognized by Distributing upon the transfer of assets, subject to liabilities, to the Controlled corporations in exchange for Note 1, Note 2 and stock in the Controlled corporations, provided that Note 1 and Note 2 are transferred by Distributing to Shareholder 16 in connection with the reorganization described above, the stock of Controlled 1 is distributed to Group 1, and the stock of Controlled 2 is distributed to Group 2. Sections 357(a), 361(a) and 361(b)(1)(A).
- (4) The Controlled corporations will recognize no gain or loss on the receipt of the Distributing assets in exchange for the Controlled corporations' stock. Section 1032(a).
- (5) The basis of each asset received by the Controlled corporations will be the same as the basis of such asset in the hands of Distributing immediately before the Distribution. Section 362(b).
- (6) The holding period of each Distributing asset received by the Controlled corporations will include the period during which such asset was held by Distributing. Section 1223(2).
- (7) Group 1 will recognize no gain or loss (and no amount will be included in their income) upon the exchange of their Distributing stock for stock in Controlled 1. Section 355(a)(1). Furthermore, Group 2 will recognize no gain or loss (and no amount will be included in their income) upon the exchange of their Distributing stock for stock in Controlled 2. Section 355(a)(1).

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- (8) Distributing will recognize no gain or loss on the distribution of Controlled 1 stock to Group 1 and Controlled 2 stock to Group 2 in exchange for Group 1 and Group 2's stock in Distributing, and Distributing will recognize no gain or loss on the distribution of Note 1 and Note 2 to Shareholder 16 in exchange for Shareholder 16's stock in Distributing. Section 361(c).
- (9) The basis of stock of Controlled 1 in the hands of Group 1 and the basis of stock of Controlled 2 in the hands of Group 2 immediately after the Distribution will be the same as the basis of the Distributing stock held by those groups immediately before the Distribution. Sections 358(a)(1) and (b).
- (10) The holding period of Controlled 1's stock in the hands of Group 1 and Controlled 2's stock in the hands of Group 2 will include the holding period of their Distributing stock exchanged, provided that the Distributing stock is held as a capital asset on the date of the Distribution. Section 1223(1).
- (11) As provided in § 312(h) of the Code, proper allocation of earnings and profits between Distributing and the Controlled corporations will be made under § 1.312-10(a) of the Income Tax Regulations.

#### CAVEATS

No opinion is expressed about the tax treatment of the transaction under any other provision of the Code or Regulations, or 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. In particular, no opinion is given regarding the possible redemption by Controlled 2 of shares owned by c of its shareholders on the d anniversary of the Distribution.

#### PROCEDURAL STATEMENTS

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

A copy of this letter must be attached to the federal income tax return of each taxpayer involved for the taxable year in which the transaction is consummated.

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In accordance with the Power of Attorney on file with this office, a copy of this letter has been sent to your authorized representative.

Sincerely yours,

*Alfred C. Bishop, Jr.*

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Alfred C. Bishop, Jr.  
Branch Chief, Branch 6  
Associate Chief Counsel  
(Corporate)