

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:CORP:1-PLR-136379-02
Date:
November 5, 2002

Legend

Distributing =

Controlled =

Business A =

Business B =

Date 1 =

State M =

Shareholder 1 =

Shareholder 2 =

r =

s =

t =

u =

v =

w =

x =

y =

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z =

Dear :

This letter responds to your letter dated June 24, 2002, in which you requested rulings under § 355 of the Internal Revenue Code. Additional information regarding your request has been submitted in letters dated September 4, September 6, October 10, October 31, November 1, and November 5, 2002. The material information submitted for consideration is summarized below.

Distributing is an accrual method State M subchapter S corporation using a fiscal year ending Date 1. Distributing is engaged directly in Business A, which has been conducted for more than five years. Distributing has outstanding s shares of voting common stock, which is owned by Shareholder 1 (t percent) and Shareholder 2 (u percent). Distributing has outstanding v shares of nonvoting common stock, which is owned by Shareholder 1 (w percent) and Shareholder 2 (x percent). Combining both voting and nonvoting common stock, Shareholder 1 owns y percent and Shareholder 2 owns z percent.

Controlled is a State M corporation that is a wholly owned qualified subchapter S subsidiary (QSub) of Distributing treated as a disregarded entity under Treas. Reg. § 1.1361-4(a)(1). Controlled is directly engaged in Business B, which has been conducted for more than five years. Controlled has outstanding r shares of voting common stock, all of which are held by Distributing.

The taxpayer has supplied financial information that indicates that each of Business A and Business B had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

The hazardous nature of Business A exposes Business B to potential significant environmental liabilities under various state and federal statutes, including the Comprehensive Environmental Response Compensation and Liability Act (CERCLA) and the Resource Conservation and Recovery Act (RCRA). The insurance policy of Distributing does not include coverage for environmental liability. In addition, Distributing has demonstrated that additional insurance that might provide such coverage is either unavailable or prohibitively expensive.

Accordingly, in order to protect Business B from the risks of Distributing's Business A, Distributing proposes to distribute all the issued and outstanding stock of Controlled pro rata to Shareholder 1 and Shareholder 2.

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

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

(b) The five years of financial information submitted on behalf of Distributing is representative of its present operation, and with regard to such company, there have been no substantial operational changes since the date of the last financial statements submitted.

(c) The five years of financial information submitted on behalf of Controlled is representative of its present operation, and with regard to such company, there have been no substantial operational changes since the date of the last financial statements submitted.

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

(e) The distribution of the stock of Controlled is carried out for the following corporate business purpose: risk reduction. The distribution of the stock of Controlled is motivated in whole or substantial part by this corporate business purpose.

(f) Distributing is an S corporation (within the meaning of § 1361(a)). Controlled will elect to be an S corporation pursuant to § 1362(a) immediately after the distribution and there is no plan or intention to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

(g) There is no other 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 Controlled after the transaction.

(h) 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 § 4.05(1)(b) of Rev. Proc. 96-30, 1996-1 C.B. 696.

(i) 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.

(j) No liabilities will be assumed in the transaction and the total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds any liabilities to which the transferred assets are subject.

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(k) No liabilities will be 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.

(l) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.

(m) No continuing transactions between Distributing and Controlled are anticipated, but if there are any such transactions, payments made in connection therewith will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

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

(o) No Distributing shareholder or shareholders will hold immediately after the distribution disqualified stock within the meaning of § 355(d)(3) which constitutes a 50-percent or greater interest in Distributing or Controlled.

(p) 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 entitled to vote of either Distributing or Controlled, or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing or Controlled.

(q) The income tax liability for the taxable year in which investment credit property (including any building to which § 47(d) applies) is transferred will be adjusted pursuant to § 50(a)(1) or (a)(2) (or § 47, as in effect before amendment by Public Law 101-508, title 11, 104 Stat. 1388, 536 (1990), if applicable) to reflect an early disposition of the property.

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

(1) The distribution of all of the Controlled stock to Shareholder 1 and Shareholder 2 will cause the termination of the QSub election of Controlled, because Controlled will cease to be a wholly owned subsidiary of Distributing. As a result, Controlled will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from Distributing in exchange for stock of Controlled. Treas. Reg. § 1.1361-5(b)(1).

(2) The deemed exchange of Distributing's Business B assets, subject to liabilities, for Controlled stock resulting from the termination of the QSub election as set

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out above, followed by the distribution of all of the Controlled stock to Shareholder 1 and Shareholder 2, will be treated as 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).

(3) Distributing will recognize no gain or loss on the transfer of the Business B assets, subject to liabilities, to Controlled in exchange for Controlled common stock and the assumption by Controlled of the liabilities associated with the transferred assets. Sections 361(a) and 357(a).

(4) Controlled will recognize no gain or loss on the receipt of the Business B assets, subject to liabilities, in exchange for the Controlled common stock. Section 1032(a).

(5) The basis of each asset received by Controlled from Distributing will be equal to the basis of such asset in the hands of Distributing immediately prior to the transaction. Section 362(b).

(6) The holding period of each asset received by Controlled from Distributing will include the period during which such asset was held by Distributing. Section 1223(2).

(7) No gain or loss will be recognized by Distributing on the distribution of the Controlled stock to Shareholder 1 and Shareholder 2. Section 361(c).

(8) No gain or loss will be recognized by (and no amount will be included in the income of) Shareholder 1 or Shareholder 2 upon the receipt of the Controlled stock. Section 355(a)(1).

(9) The aggregate basis of the Distributing stock and the Controlled stock in the hands of Shareholder 1 and Shareholder 2 immediately after the distribution will be the same as the basis of the Distributing stock in the hands of Shareholder 1 and the shareholder 2 immediately prior to the distribution. Section 358(a)(1), Treas. Reg. § 1.358-1(a). Such aggregate basis will be allocated between the Distributing stock and the Controlled stock in proportion to the relative fair market value of each corporation's stock in accordance with Treas. Reg. § 1.358-2(a)(2). Section 358(b).

(10) The holding period of the Controlled stock received by Shareholder 1 and Shareholder 2 will 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 on the date of the distribution. Section 1223(1).

(11) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under Treas. Reg. § 1.312-10(a).

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(12) Provided that Controlled meets the requirements of § 1361(b) and provided that Distributing immediately distributes the stock of Controlled, Distributing's momentary ownership of the stock will not cause Controlled to have an ineligible shareholder under § 1361(b)(1)(B), and Controlled is eligible to make a timely election, without the consent of Distributing, to be an S corporation for the first taxable year.

No opinion is expressed or implied 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 requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

Lisa A. Fuller
Assistant Branch Chief, Branch 1
Office of Associate Chief Counsel (Corporate)