Internal Revenue Service

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Distributing =

Controlled =

business m =

business n =

shareholder A =

shareholder B =

shareholder C =

shareholder D =

shareholder E =

state R =

This is in response to a letter dated October 22, 1998, in which rulings were requested on behalf of Distributing regarding certain federal income tax consequences of a proposed transaction. The information submitted is summarized below.

Distributing is a state R corporation engaged in business m and business n.

Distributing has outstanding 100 shares of voting common stock, 30 shares of which are owned by shareholder D and 20 of which are owned by his son, shareholder E. Shareholder A owns 10 shares and his sons, shareholders B and C own 20 shares each. Since beginning operations in 1984, Distributing has conducted business m and business n as separate divisions within a single corporation. Each division has had separate managers and employees. Shareholder A oversees the operation of business m and shareholder D oversees business n. Financial information has been provided showing that each division has receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Shareholder A operates business m with his sons, shareholders B and C. B and C are expected to assume a greater role in the management of business m as shareholder A nears retirement. Neither B nor C has ever been involved in the operation or management of business n, which is run by shareholder D and his son E. All of the shareholders are concerned that when A and D are no longer involved in the operations of the company, there will be problems arising from the lack of cooperation between the younger shareholders. In addition, the management of business n would like to expand its office space, the cost of which would be financed. The management of business m would like the financing to be the liability of business n alone. Similarly, business m needs a new piece of equipment, which would also be financed, and the management of business n would not like to share in that liability. Finally, the customer list for business m is very diverse, which makes the management of business n concerned about exposure to problems with Year 2000 compliance. The customer list for business n is far more limited, and the management of business m is anxious about the result of any drop in sales to business n's limited number of customers.

The following transaction has been proposed:

Distributing will form Controlled as a wholly owned subsidiary by transferring all of the assets of business n to Controlled in exchange for stock of Controlled. Immediately after the formation of Controlled and the transfer of the business n assets to Controlled, all of the outstanding stock of Controlled will be distributed by Distributing to D and E in exchange for all of D and E's stock in Distributing. Immediately after the distribution A, B, and C will own all of the outstanding stock of Distributing and D and E will own all of the outstanding stock of Controlled. Distributing uses the accrual method of accounting. After the transaction, Distributing and Controlled will use the accrual method of accounting and will have a tax year ending December 31.

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

(a) The fair market value of the Controlled stock and other consideration received by each shareholder of Distributing stock approximately equals the fair market value of Distributing stock surrendered by the shareholder in exchange.

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

(c) Following the proposed transaction, Distributing and Controlled will each continue the active conduct of their respective businesses, independently and with their separate employees.

(d) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing will each equal or exceed the sum of the liabilities to be assumed by Controlled plus any liabilities to which the transferred assets are subject. The liabilities to be assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of the business and are associated with the assets being transferred.

(e) 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.

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

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

(h) The investment tax credit previously computed with respect to the section 38 property transferred will be adjusted in the year of transfer to reflect an early disposition of the property pursuant to §§ 47(a)(1) and (5).

(i) The five years of financial information submitted on behalf of Distributing is representative of the corporations's present operations, and there have been no substantial operational changes since the date of the last financial statement submitted.

(j) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.

(k) 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 subsequent to the transaction, except in the ordinary course of business.

(l) 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 Controlled prior to the transaction.

(m) Following the transaction, Distributing and Controlled do not intend to transact any material business with each other. If, however, there are any continuing transactions, then payments made in connection with all continuing transactions 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.

(n) No shareholder plans to dispose of stock in Distributing or Controlled. If, however, a shareholder disposes of stock in Distributing or Controlled, the shareholder disposition will not violate the requirement of a 50% in value continuing interest in stock ownership as specified in section 3.02 of Rev. Proc. 77-37. See § 1.355-2(c).

(o) Distributing is not an S corporation (within the meaning of § 1361(a)), and there is no plan or intention by Distributing or Controlled to make an S corporation election pursuant to § 1362(a).

(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 total combined voting power of all classes of stock 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 distribution of the stock, or stock and securities, of Controlled is carried out for the following corporate business purpose: to enhance the success of both Distributing and Controlled by resolving management problems that arise by virtue of the Distributing's operating two businesses within a single corporation, while allowing shareholders D and E to concentrate on business n and allowing shareholders A, B and C to concentrate on business m. The distribution of the stock, or stock and securities, of Controlled is motivated, in whole or substantial part, by one or more of these corporate business purposes.

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

(1) The transfer by Distributing to Controlled of the assets described above in exchange for all the stock of Controlled and the assumption of certain liabilities followed by the distribution of Controlled stock to D and E will qualify 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).

(2) No gain or loss will be recognized to Distributing upon the transfer of assets to Controlled in exchange for Controlled stock and the assumption of liabilities (§§

361(a) and 357(a)).

(3) No gain or loss will be recognized to Controlled on the receipt of the assets in exchange for all the shares of Controlled (§ 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 each asset received by Controlled will include the period during which Distributing held the asset (§ 1223(2)).

(6) No gain or loss will be recognized to Distributing upon the distribution of the Controlled stock in exchange for the Distributing stock surrendered by D and E (§ 361(c)).

(7) No gain or loss will be recognized to D and E (and no amount will be included in the income of D and E) upon receipt of Distributing stock (§ 355(a)(1)).

(8) The basis of the Controlled stock to be received by D and E will equal the basis of the Distributing stock exchanged therefor (§ 358(a)(1)).

(9) The holding period of the Controlled stock in the hands of D and E will include the period for which such shareholder held his Distributing stock, provided that such stock was held as a capital asset by such shareholder on the day of distribution (§ 1223(1)).

(10) As provided in section 312(h) of the Code, 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 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 transaction that are not specifically covered by the above rulings.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code 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 taxable year in which the transaction covered by this ruling letter is consummated.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By Victor Penico

Victor Penico
Branch Chief, Branch 3