

Internal Revenue Service

Department of the Treasury

Index Number: 355.00-00
355.04-00

Washington, DC 20224

Number: **199940013**
Release Date: 10/8/1999

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:CORP: 1- PLR-100393-99
Date:
July 2, 1999

Re:

Distributing =

State X =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Shareholder E =

Controlled =

Main Business =

n =

Business 2 =

Business 3 =

Dear :

This letter responds to your letter dated December 31, 1998, requesting rulings concerning the federal income tax consequences of proposed transactions. A somewhat similar plan approved in a private letter ruling over 10 years ago was never consummated. The information submitted for consideration is summarized below.

Distributing, a State X corporation, is an S corporation that uses the accrual method of accounting and a calendar year. Distributing is engaged in three businesses, Main Business, Business 2, and Business 3. Distributing has outstanding voting Class A and nonvoting Class B common stock, almost all of which is held by Shareholders A and B (the "Controlling Shareholders") and their families. Shareholders A and B were actively engaged in the management and operation of Distributing's businesses for many years. They are now retired from active management but remain directors. At present, Main Business is managed by Shareholder C, Business 2 by Shareholder D, and Business 3 by Shareholder E. In addition, Shareholder C is the president of Distributing. Shareholders C, D, and E each hold under one percent of the Distributing stock, and each holds an interest in a phantom equity plan. Distributing has no securities outstanding.

The shareholders of Distributing have entered into several agreements with regard to their stock. An Irrevocable Proxy provides that the Controlling Shareholders, though holding different amounts of stock, are each entitled to a nearly identical vote in Distributing. A new Disposition of Common Stock Agreement provides that upon the death of either Controlling Shareholder, the survivor is required to purchase the deceased's estate's Class A stock, and, on the death of the survivor, Distributing is required to purchase the Class A stock from the survivor's estate. Should either Controlling Shareholder desire to sell Class A stock, the stock first must be offered for sale to the other Controlling Shareholder, Distributing, and the managers of Distributing's three businesses, in that order.

Shareholder D, who has significantly contributed to the success of Business 2 and who is uniquely experienced and essential to Business 2, is dissatisfied with the present corporate structure in which he has no significant shareholder vote and no presence on Distributing's Board of Directors. In addition, Shareholder D does not wish

to be a shareholder in a subsidiary where Distributing would be the single dominant shareholder and Distributing's president would be involved in decisions regarding the subsidiary's business. Shareholder D's objectives are to currently have a significant shareholder vote in a stand-alone company and to eventually have the opportunity of controlling his own business. Shareholder D has indicated that, if these objectives are not met, he will seriously consider terminating his employment with Distributing. In order to retain Shareholder D as the manager of Business 2, it is planned to terminate Shareholder D's phantom equity plan and, instead, give Shareholder D the opportunity to acquire stock in a stand-alone company engaged in Business 2.

The parties have already completed or intend to complete the following steps in the proposed transaction:

- (I) Distributing recently recapitalized, issuing one share of Class A stock and 99 shares of Class B stock to its shareholders in exchange for each share of common stock held by the shareholders.
- (II) Distributing will form Controlled, which will have outstanding voting Class A stock and nonvoting Class B stock. The Controlled Class B stock will be identical in all respects to the Controlled Class A stock, except for voting rights. After the proposed transaction, Controlled will elect to be an S Corporation. Controlled and its shareholders will also enter into a Stock Disposition Agreement similar to Distributing's Stock Disposition Agreement described above.
- (III) Distributing will transfer to Controlled its Business 2 assets and liabilities in exchange for Controlled Class A and Class B stock. At this point, Distributing will hold all the outstanding stock in Controlled.
- (IV) Distributing will distribute all the Controlled stock to Shareholders A and B and their families and Shareholder D. In exchange, Shareholder D will surrender all his Distributing stock. Shareholders A and B and their families will receive Controlled stock without surrendering Distributing stock. Other Distributing shareholders (employees) will receive no stock in Controlled, but will receive additional Distributing stock.
- (V) Within 30 days of completing step (IV): Shareholder D, in exchange for a 10-year \$n promissory note, will buy from Controlled an amount of stock constituting at least 10 percent of all the outstanding Controlled stock; and Shareholder D will become a member of Controlled's three member board of directors.
- (VI) Shareholders C and E will buy additional shares of Distributing stock.
- (VII) In accordance with the Controlling Shareholders' longstanding practice of

charitable giving, Shareholders A and B likely will donate some of their Distributing and Controlled Class B stock to charities which stock then likely will be gradually redeemed from the charities.

Following step (V), the ownership of the Controlled Class A and B stock will be: Shareholder A family, 48.2 percent; Shareholder B family, 35.3 percent; and Shareholder D, 16.5 percent.

Distributing has submitted financial and employee information that indicates that both Main Business and Business 2 had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past 5 years.

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

- (a) Distributing, Controlled, and each of the shareholders will each pay their own expenses in the transaction.
- (b) There is no plan or intention for any Distributing shareholder to transfer any assets to Distributing, Controlled, or any related corporation (except for the shareholders' transfers of Distributing stock to Distributing).
- (c) With regard to each Distributing shareholder, the total fair market value of all the Distributing stock and Controlled stock held by such shareholder after step (IV) (before any stock purchases) will be approximately equal to the fair market value of the Distributing stock held by such shareholder prior to such step.
- (d) Any gifts by either Shareholder A or B of Class B stock in Distributing and Controlled to charities will consist of identical percentages of the outstanding Distributing and Controlled stock.
- (e) None of the consideration being received by any of Distributing's shareholders in the proposed transaction is being received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.
- (f) The 5 years of financial information submitted on behalf of Distributing's Main Business and Business 2 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.

- (g) Following the step (IV) spin-off of Controlled stock, Distributing will continue to be directly engaged in the active conduct of Main Business independently and with its own employees. Main Business will have been actively conducted (within the meaning of § 1.355-3(b)) by Distributing independently and with its own employees at all times in the 5-year period prior to the distribution of Controlled stock. For each of the past 5 years, Distributing's Main Business has employed over 50 full-time employees and following the step (IV) spin-off will continue to have a minimum of 50 full-time employees who will continue to conduct the operational and managerial activities of Main Business.
- (h) Following the step (IV) spin-off, Controlled will be directly engaged in the active conduct of Business 2, independently and with its own employees. Business 2 will have been actively conducted (within the meaning of § 1.355-3(b)) by Distributing independently and with its own employees throughout the 5-year period immediately preceding the spin-off. For each of the past 5 years, Distributing's Business 2 has employed over 50 full-time employees and, following the proposed transaction, Controlled will have a minimum of 50 full-time employees who will continue to conduct the operational and managerial activities of Business 2.
- (i) The distribution of Controlled stock is being carried out for the corporate business purpose of keeping Shareholder D as the manager of Business 2. The distribution of Controlled stock is motivated, in whole or substantial part, by this corporate business purpose.
- (j) There is no plan or intention for any Distributing shareholder to sell, exchange, transfer by gift, have redeemed, or otherwise dispose of any stock in either Distributing or Controlled, except as described in steps (l), (IV), and (VII) above.
- (k) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock in conjunction with or after the transaction, except, possibly, for redemptions of up to 4 percent annually of the stock held by charities.
- (l) 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, except for: (i) dispositions in the ordinary course of business; (ii) transfers described in steps (III) and (IV) above; and (iii) small redemptions of stock held by charities (annually, up to 4 percent of the amount of stock held by the charity).
- (m) 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 assumed by Controlled plus any liabilities to which the transferred assets are subject.

- (n) The liabilities of Distributing assumed by Controlled 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 transferred.
- (o) The property being transferred by Distributing to Controlled will not be subject to any investment tax credit capture.
- (p) No intercorporate debt will exist between Distributing and Controlled at the time of the proposed transaction, or subsequent thereto.
- (q) It is not expected that there will be any transactions between Distributing and Controlled after the proposed transaction, except that Controlled probably will purchase some raw materials from Distributing. All payments made in connection with such purchases, or any other transactions between Distributing and Controlled, will be for fair market value based on terms and conditions arrived at by the parties bargaining at arms length.
- (r) No two parties to the step (III) transfer are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (s) The transaction will not constitute a disqualified distribution within the meaning of § 355(d).
- (t) The step (IV) spin-off 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 in either Distributing or Controlled, or stock possessing 50 percent or more of the total value of all classes of stock in either Distributing or Controlled.
- (u) Except for transfers to members of the same family as defined in § 267(c) (4), and except for exchanges or issuances of Distributing or Controlled stock in exchange for or as a result of owning stock in Distributing or Controlled pursuant to a § 355(e)(3)(A) transaction, Shareholders A and B each have represented that neither he nor any person related to him within the meaning of § 267(c)(4): (i) has any plan or intention to sell, give, redeem, transfer, receive, or in any way change his

holding of stock in Distributing or Controlled; or (ii) has any plan or intention to take any action that would result in any other shareholder changing their holding of stock in Distributing or Controlled. The sole exceptions to the prior sentence are: (i) the possible transfers by Shareholders A and/or B of nonvoting stock in Distributing and Controlled to charities, with the total amount of stock transferred to charities over the next 5 years not exceeding 10 percent, for each such shareholder, of the outstanding stock of any class in Distributing or Controlled; (ii) the step (V) sale by Controlled to Shareholder D of Controlled stock, but for each class of stock in an amount constituting no more than 16.5 percent of the Controlled stock outstanding after the sale; (iii) the step (VI) sale by Distributing to each of Shareholders C and E of Distributing stock, but for each class of stock a total for both shareholders of no more than 10 percent of the Distributing stock outstanding after the sale; and (iv) the possible redemption of stock held by retiring employees in a total amount for the post-transaction 5-year period of not more than 5 percent of any class of Distributing or Controlled stock. In addition, no more than 4 percent of the Distributing stock was redeemed in the past 5 years. If the 4 percent of the stock previously redeemed is aggregated with the other possible or proposed changes in stock ownership noted in items (i) through (iv) of the second preceding sentence, these changes would not, by themselves, result in a 50 percent or greater acquisition of the vote or the value in either Distributing or Controlled.

Based solely on the information submitted and the representations set forth above, we hold as follows:

- (1) The transfer in step (III) by Distributing to Controlled of Business 2 assets, in exchange for all the stock in Controlled and the assumption by Controlled of liabilities associated with the assets and business transferred followed by the distribution in step (IV) of all the Controlled stock to Distributing shareholders constitutes a reorganization within the meaning of §§ 368(a)(1)(D) and 355. Distributing and Controlled are each a “party to a reorganization” within the meaning of § 368(b).
- (2) No gain or loss is recognized by Distributing on the transfer of assets, subject to liabilities, to Controlled in exchange for all the stock in Controlled and the assumption of liabilities (§§ 361(a) and 357(a)).
- (3) No gain or loss is recognized by Controlled on its receipt of assets in exchange for Controlled stock (§ 1032(a)).
- (4) Controlled’s basis in the assets received from Distributing equals the basis

of such assets in the hands of Distributing immediately prior to the transfer (§ 362(b)).

- (5) Controlled's holding period for assets received from Distributing includes the period during which Distributing held such assets (§ 1223(2)).
- (6) No gain or loss will be recognized to Distributing upon the distribution to Shareholders A, B, members of their families, and D of all the stock in Controlled (§ 361(c)(1)).
- (7) No gain or loss will be recognized to (and no amount will be included in the income of) Shareholders A, B, members of their families, and D upon the receipt of Controlled stock (§ 355(a)(1)).
- (8) Shareholder D's basis in the Controlled stock received will equal his basis in the Distributing stock surrendered in exchange therefore (§358(a)(1)).
- (9) Shareholder A's, Shareholder B's, and members' of their families total basis in the Controlled stock and the Distributing stock held by each shareholder after the distribution will be the same as the basis of the Distributing stock held by such shareholder immediately before the distribution. The total basis will be allocated in proportion to the relative fair market values of the Controlled stock and Distributing stock in accordance with § 1.358-2(a)(2).
- (10) The holding period of the Controlled stock received by the shareholders will include the period during which the shareholders held the Distributing stock exchanged therefor, or the Distributing stock with regard to which the Controlled stock is received, provided that the Distributing stock is a capital asset in the hands of the shareholders on the date step (IV) is consummated (§ 1223(1)).
- (11) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a).
- (12) As provided by § 1.1368-2(d)(3), the "accumulated adjustments account" (as defined in § 1368(e)(1)) of Distributing immediately prior to the step (IV) distribution of the Controlled stock will be allocated between Distributing and Controlled in a manner similar to the manner in which the earnings and profits of Distributing are allocated (see ruling (11) above).

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 transaction that are not specifically covered by the above rulings. In particular, no opinion is expressed about the tax treatment of: (i) the step (I) exchange of Distributing voting common stock for Distributing Class A voting common stock and Class B nonvoting common stock; (ii) the proposed termination of the phantom equity plan with regard to Shareholder D (or any other person); (iii) the proposed issuance by Distributing in step (IV) of additional shares of Distributing stock to those Distributing shareholders who do not receive any Controlled stock; (iv) the possible gifts of stock to charities by Shareholders A and B; and (v) the possible redemption by Distributing and/or Controlled of its stock from charities.

In addition, no opinion is expressed as to whether the transfer of any trade name, trademark, know-how, or similar items from Distributing to Controlled constitutes the transfer of property (see Rev. Rul. 69-156, 1969-1 C.B. 101). Further, no opinion is expressed or implied regarding the validity of Distributing's S corporation election under § 1362(a) or the eligibility of Controlled under § 1361(b) to elect S corporation status.

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

It is important that a copy of this letter be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transactions covered by this letter are consummated.

Sincerely yours,
Assistant Chief Counsel (Corporate)

By _____
Mark S. Jennings
Senior Technician Reviewer, Branch 1