

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

**CC:CORP:B06 PLR-107372-01**

Date:

June 12, 2001

Legend:

Distributing =  
Controlled =  
State =  
Business M =  
  
Business N =  
  
Date 1 =  
Date 2 =  
Amount 1 =  
Amount 2 =  
Amount 3 =  
Shareholder A =  
Shareholder B =  
Shareholder C =  
Shareholder D =  
Shareholder E =  
aa =  
bb =  
cc =  
dd =  
Distribution =

We respond to your letter dated January 24, 2001, requesting rulings as to the federal income tax consequences of a proposed and partially consummated series of transactions. You also submitted supplemental information by fax, dated June 7, 2001. The information submitted for consideration is summarized below.

Distributing, organized in State on Date 1, is engaged directly in Business M and indirectly through its sole subsidiary in Business N. Controlled was organized in State on Date 2. Controlled is wholly owned by Distributing and is engaged solely in Business N. Distributing and Controlled together file consolidated income tax returns.

Both Distributing and Controlled use the accrual method of accounting, and both have a fiscal taxable year ending May 31.

Currently, Distributing has four shareholders, Shareholder A, B, C and D (collectively "the Shareholders"), who own aa%, bb%, cc% and dd% interests, respectively. Shareholder E no longer holds an interest in Distributing; Distributing recently redeemed all of his shares (the "Redemption"). Shareholder E held at the time of the Redemption, a 1/3rd interest in Distributing.

Shareholder A is primarily involved in Business M, the active business conducted by Distributing. Shareholders B is involved in both Business M and Business N, the active businesses conducted by Distributing and Controlled, respectively. Shareholders C and D are related to Shareholder B and received their stock in Distributing by gift from Shareholder B. Neither Shareholder C nor D actively participate in either business.

We have received financial information indicating that Distributing and Controlled each had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

The principal purpose of the proposed split-off transaction is to resolve certain differences in the management styles, business philosophies and industry focuses of the principal shareholders (*i.e.*, Shareholder A and Shareholder B). To eliminate these differences, the following series of transactions are proposed. (Note that number (1) below has already been completed).

(1) The Redemption. Shareholder E surrendered all of his stock in Distributing and received in exchange a promissory note (the "Redemption Note") in Amount 1, an amount equal to 1/3rd of Amount 2, the consolidated value of Distributing and Controlled.

(2) Controlled owes a debt in Amount 3 to Distributing (the "Subsidiary Debt"). At the time of the Distribution, Distributing will cancel the Subsidiary Debt prior to the Distribution and such cancellation will be treated as a contribution to the capital of Controlled in the amount of the cancelled debt. Distributing will cancel the Subsidiary Debt to eliminate Distributing's excess loss account with respect to its stock in Controlled under the rules of Section 1.1502-19 of the Regulations.

(3) In order to accomplish the equalization of the value of the 2 corporations, the corporation with the higher value, Controlled will (1) assume the Redemption Note, and (2) issue the Value Equalization Note to Distributing (the corporation with the lower value). The principal amount of the Value Equalization Note will be 50% of the value differential between the two corporations (taking into account for this purpose the

assumption by Controlled of the Redemption Note).

(4) In exchange for all of their stock in Distributing, Distributing will then distribute all of Controlled's stock to Shareholders B, C and D, proportionately according to their individual interests (the "Distribution").

Following the proposed transactions, Distributing will be wholly owned by Shareholder A, and Controlled will be wholly owned by Shareholder B, C and D. Also, Distributing will continue, independently and with its separate employees, to be directly engaged in the active conduct of Business M. Likewise, Controlled will continue, independently and with its separate employees, to be directly engaged in the active conduct of Business N.

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

(a) The Value Equalization Note owed by Controlled to Distributing after the distribution of Controlled stock will not constitute stock or securities.

(b) The fair market value of the Controlled stock to be received by Shareholders B, C and D will be approximately equal to the fair market value of the Distributing stock surrendered by each 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 5 years of financial information submitted on behalf of Distributing is representative of the corporation's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.

(e) The 5 years of financial information submitted on behalf of Controlled is representative of the corporation's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.

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

(g) The proposed distribution of the stock of Controlled is carried out for the "Fit and Focus" corporate business purpose: to resolve the

fundamental differences among the principal shareholders with regard to their management styles and business philosophies; and to permit Shareholder A to focus exclusively on Business M by restricting his investment to that business, and to permit Shareholder B to focus exclusively on Business N by restricting his investment (and the minority investments of Shareholders C and D) to that business. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.

(h) 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, or securities of, either Distributing or Controlled after the transaction.

(i) 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.

(j) 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.

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

(l) Subject to the cancellation of the Subsidiary Debt discussed above, no indebtedness has been or will be cancelled in connection with the transaction.

(m) Immediately before the Distribution, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable intercompany transaction regulations. (See Section 1.1502-13 and Section 1.1502-14 as in effect before the publication of T.D. 8597, 1995-32 I.R.B. 6, and as currently in effect; Section 1.1502-13 as published by T.D. 8597). Further, Distributing's excess loss account, if any, with respect to the Controlled stock will be included in income immediately before the Distribution. (See Section 1.1502-19).

(n) There are no continuing, planned, or intended transactions between Distributing and Controlled following the distribution, either directly or indirectly.

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

(p) The Distribution is not part of a plan or series of related transactions (within the meaning of section 355(e)) pursuant to which one or more persons will acquire directly or indirectly stock possessing 50% or more of the total combined voting power of all classes of stock of either Distributing or Controlled, or stock possessing 50% or more of the total value of all classes of stock of either Distributing or Controlled.

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

(r) Controlled is not a S corporation (within the meaning of section 1361(a)), however Controlled does plan to make an S corporation election pursuant to section 1362(a) after the Distribution.

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

(1) Distributing will recognize no gain or loss upon the distribution of all the stock of Controlled to Shareholders B, C and D (Section 361(c)(1) of the Code).

(2) Distributing will not recognize income upon the assumption by Controlled of the Redemption Note.

(3) Distributing will not recognize income upon its receipt of the Value Equalization Note from Controlled or upon its receipt of principal payments thereunder.

(4) Shareholders B, C and D will recognize no gain or loss (and no amount will be included in their income) upon the receipt of all of the Controlled stock in exchange for all of their Distributing stock. (Section 355(a)(1) of the Code).

(5) The basis of Shareholders B, C and D in his or her Controlled stock will equal the basis of the Distributing Stock each of them surrenders in the exchange (Section 358(a)(1) of the Code).

(6) The holding period of the Controlled stock received by Shareholders B, C and D will include the holding period of the Distributing stock surrendered in the exchange, provided that the Distributing stock is held as a capital asset on the date of the exchange (Section 1223(1) of the Code).

(7) As provided in Section 312(h) of the Code, proper allocation of earnings and profits between Distributing and Controlled will be made under Section 1.312-10(a) of the Income Tax Regulations.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the proposed transaction under any other provision 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. Further, no opinion is expressed regarding the federal tax consequences of the Redemption.

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.

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

Sincerely yours,  
Associate Chief Counsel (Corporate)

By: *Steven J. Hankin*  
Senior Technical Reviewer  
Branch 6