

## Internal Revenue Service

Number: **201429006**  
Release Date: 7/18/2014  
Index Number: 355.03-00

Department of the Treasury  
Washington, DC 20224

Third Party Communication: None  
Date of Communication: Not Applicable

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PLR-137873-13

Date:  
March 14, 2014

### Legend

Distributing =

Controlled =

RelatedCo1 =

RelatedCo2 =

Trust =

State A =

State B =

Business A =

Shareholder A =

Shareholder B =

Operational Employees =

Year 1 =

Contributed Assets =

Asset A =

a =

b =

c =

d =

Dear :

This letter responds to your August 23, 2013 request for rulings regarding certain federal income tax consequences of certain proposed transactions. The information provided in that request and in later correspondence is summarized below.

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

In particular, this office has not reviewed any information pertaining to, and has made no determination regarding, whether the Distribution (defined below): (i) satisfies the business purpose requirement of § 1.355-2(b) of the Income Tax Regulations; (ii) is used principally as a device for the distribution of the earnings and profits of any distributing corporation or any controlled corporation or both (see section 355(a)(1)(B) of the Internal Revenue Code and § 1.355-2(d)); and (iii) is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock or Distributing Interests (defined below) representing a 50-percent or greater interest in any distributing corporation or any controlled corporation (see section 355(e)(2)(A)(ii) and § 1.355-7).

## FACTS

Distributing is an unincorporated State A organization that is treated as an S corporation for U.S. federal income tax purposes. Distributing is a cash method taxpayer that employs a calendar year. Shareholder A and Shareholder B, both of whom are U.S. residents for U.S. federal income tax purposes, each directly own a% of the equity ownership interests of Distributing (the "Distributing Interests"). The remaining b% of the Distributing Interests are held by the Trust, the beneficial ownership of which is held equally by Shareholder A and Shareholder B. Additionally, Shareholder A (together with trusts for the benefit of Shareholder A's spouse and descendants) owns RelatedCo1, and Shareholder B owns RelatedCo2, each a State A corporation engaged in the same line of business as Distributing.

Distributing and RelatedCo1 have each been engaged in Business A since Year 1 (a date more than five years prior to the commencement of the Proposed Transaction, defined below). Distributing does not currently have any employees on its payroll. Rather, Shareholder A manages Distributing and the Operational Employees, who are formally employed by RelatedCo1 and perform Distributing's operational activities. Since Distributing's formation, Distributing and RelatedCo1 have had an unwritten employee-sharing arrangement in place (the "Employment Arrangement") under which the Operational Employees perform operational activities and some management services for both Distributing and RelatedCo1, RelatedCo1 compensates the Operational Employees for all of their work and provides them with benefits, and Distributing reimburses RelatedCo1 for a portion of the Operational Employees' compensation and benefits. Specifically, Distributing periodically makes payments to RelatedCo1 for c% of RelatedCo1's costs for the Operational Employees' salaries, benefits, workers' compensation insurance, health insurance, and other employment-related expenses. The c% is intended to approximate the portion of the Operational Employees' work hours spent working on behalf of Distributing. When performing services on behalf of Distributing, the Operational Employees hold themselves out to third parties as employees of Distributing.

The financial information submitted by Distributing indicates that Business A has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Shareholder A and Shareholder B propose to separate their interests in Distributing through the Proposed Transaction in order to avoid further disharmony in the management and operations of Business A, and to avoid litigation.

## PROPOSED TRANSACTION

For what have been represented to be valid business purposes, the following transaction (the "Proposed Transaction") has been proposed:

- (i) Distributing will form Controlled as a State B corporation. Controlled will adopt the cash method and the calendar year.
- (ii) In exchange for the issuance of all of Controlled's stock, Distributing will transfer to Controlled the Contributed Assets (a portion of its Business A assets) as well as the financial accounts and the liabilities associated with these business assets (the "Contribution").
- (iii) The Trust will distribute one-half of its Distributing Interests to Shareholder A and the other one-half of its Distributing Interests to Shareholder B (the "Trust Distribution").
- (iv) Distributing will distribute all of the outstanding Controlled stock to Shareholder B in exchange for all of Shareholder B's Distributing Interests (the "Distribution").
- (v) After the Distribution, Controlled will elect, pursuant to section 1362(a), to be an S corporation (within the meaning of section 1361(a)) effective as of the date of formation.

After the Distribution, RelatedCo1 might transfer its d% interest in Asset A to Controlled in exchange for one or more operating assets of Controlled in a transaction intended to qualify for non-recognition treatment under section 1031 (the "Asset Exchange").

## REPRESENTATIONS

- (a) Any indebtedness owed by Controlled to Distributing after the Distribution will not constitute stock or securities.
- (b) The fair market value of the Controlled stock and other consideration, if any, to be received by Shareholder B will be approximately equal to the fair market value of the Distributing Interests surrendered by Shareholder B 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 Distributing.
- (d) The 5 years of financial information submitted on behalf of Distributing is representative of its present business operation, and with regard to such

business, there have been no substantial operational changes since the date of the last financial statements submitted.

- (e) Following the Proposed Transaction, Distributing and Controlled will each continue, independently and with its separate employees (or with operational employees of RelatedCo 1 or RelatedCo 2, respectively), the active conduct of its share of all of the integrated activities of Business A conducted by Distributing prior to consummation of the Proposed Transaction.
- (f) The Distribution is carried out for the following corporate business purposes: to avoid further disharmony in the management and operations of Business A, and to avoid litigation. The Distribution is motivated, in whole or substantial part, by one or more of these corporate business purposes.
- (g) The Distribution is not used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.
- (h) The total adjusted basis and the fair market value of the assets transferred to Controlled in the Contribution will each equal or exceed the sum of: (i) the total liabilities assumed (within the meaning of section 357(d)) by Controlled, and (ii) the liabilities to which the Contributed Assets are subject. These liabilities were incurred in the ordinary course of business and are associated with the assets being transferred.
- (i) The aggregate fair market value of the assets transferred to Controlled in the Contribution will equal or exceed the aggregate adjusted basis of these assets.
- (j) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the Proposed Transaction.
- (k) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Distribution.
- (l) No two parties to the Proposed Transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).
- (m) Immediately after the Distribution, neither Distributing nor Controlled will be a disqualified investment corporation (within the meaning of section 355(g)(2)).
- (n) Distributing, Controlled, and the shareholders of Distributing will each pay their separate expenses, if any, incurred in connection with the Proposed Transaction.
- (o) Payments made in connection with all continuing transactions, if any, 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.

- (p) For purposes of section 355(d), immediately after the Distribution, no person (determined after applying section 355(d)(7)) will hold Distributing Interests possessing 50 percent or more of the total combined voting power of Distributing Interests entitled to vote, or 50 percent or more of the total value of Distributing Interests, that was acquired by purchase (as defined in section 355(d)(5) and (8)) during the five-year period (determined after applying section 355(d)(6)) ending on the date of the Distribution.
- (q) For purposes of section 355(d), immediately after the Distribution, no person (determined after applying section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Controlled stock, that was either: (i) acquired by purchase (as defined in section 355(d)(5) and (8)) during the five-year period (determined after applying section 355(d)(6)) ending on the date of the Distribution or (ii) attributable to distributions on Distributing Interests that were acquired by purchase (as defined in section 355(d)(5) and (8)) during the five-year period (determined after applying section 355(d)(6)) ending on the date of the Distribution.
- (r) Distributing did not acquire Business A or control of any entity conducting Business A during the five-year period ending on the date of the Distribution in a transaction in which gain or loss was recognized in whole or in part (within the meaning of § 1.355-3(b)(3)(ii)).
- (s) The Distribution is not part of a plan or series of related transactions (within the meaning of § 1.355-7) pursuant to which one or more persons will acquire directly or indirectly stock or Distributing Interests representing a 50-percent or greater interest (within the meaning of section 355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation).
- (t) No investment credit determined under section 46 has been (or will be) claimed with respect to any of the Contributed Assets.
- (u) No party to the Contribution or Distribution is under the jurisdiction of a court in a Title 11 or similar case within the meaning of section 368(a)(3)(A).
- (v) The basis of each shareholder in the Distributing interest received in the Trust Distribution will be determined with reference to the Trust's adjusted basis before the Trust Distribution under section 643(e)(1). No election under section 643(e)(3) to recognize gain or loss will be made.

- (w) The Asset Exchange is intended to qualify as a section 1031(a) exchange for which no gain or loss will be recognized.

#### RULINGS

1. The Contribution, followed by the Distribution, will qualify as a reorganization within the meaning of section 368(a)(1)(D). Distributing and Controlled will each be “a party to a reorganization” within the meaning of section 368(b).
2. No gain or loss will be recognized by Distributing on its transfer of the Contributed Assets to Controlled in exchange for the assumption of liabilities and the issuance of Controlled’s stock in the Contribution. Sections 357(a) and 361(a).
3. No gain or loss will be recognized by Controlled on its receipt of the Contributed Assets from Distributing in exchange for its assumption of liabilities and the issuance of its stock in the Contribution. Section 1032(a).
4. Controlled’s basis in each asset received in the Contribution will be the same as the basis of such asset in the hands of Distributing immediately before the Contribution. Section 362(b).
5. Controlled’s holding period in each asset received in the Contribution will include the period during which Distributing held such asset. Section 1223(2).
6. No gain or loss will be recognized by Distributing on the distribution of the Controlled stock to Shareholder B in the Distribution. Section 361(c).
7. No gain or loss will be recognized by (and no amount will be included in the income of) Shareholder B upon the receipt of Controlled stock in exchange for the Distributing Interests in the Distribution. Section 355(a)(1).
8. The basis of the Controlled stock received by Shareholder B in the Distribution will equal the basis of the Distributing Interests exchanged therefor. Section 358(a)(1); § 1.358-2(a)(2).
9. The holding period in the Controlled stock received by Shareholder B in the Distribution will include the holding period of the Distributing Interests surrendered in exchange therefor, provided that such Distributing Interests are held as a capital asset on the date of the Distribution. Section 1223(1).
10. Earnings and profits of Distributing (if any) will be allocated between Distributing and Controlled in accordance with Section 312(h) and § 1.312-10(a).

11. Distributing's accumulated adjustments account will be allocated between Distributing and Controlled in a manner similar to the manner in which the earnings and profits of Distributing will be allocated under section 312(h). See §§ 1.312-10(a) and 1.1368-2(d)(3)).
12. Provided that the Distribution is undertaken immediately after the Contribution, Distributing's momentary ownership of the stock of Controlled, as part of the reorganization under section 368(a)(1)(D), will not cause Controlled to have an ineligible shareholder for any portion of its first taxable year under section 1361(b)(1)(B) and will not, in itself, render Controlled ineligible to elect to be an S corporation for its first taxable year.

### CAVEATS

No opinion is expressed about the tax treatment of the Proposed Transaction under other provisions of the Code or regulations or 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.

In particular, we neither express nor imply any opinion regarding:

- (i) whether the Distribution satisfies the business purpose requirement of § 1.355-2(b);
- (ii) whether the Distribution is being used principally as a device for the distribution of the earnings and profits of Distributing, Controlled, or both (see section 355(a)(1)(B) and § 1.355-2(d));
- (iii) whether the Distribution is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock or Distributing Interests representing a 50 percent or greater interest in Distributing or Controlled (see section 355(e) and § 1.355-7);
- (iv) the U.S. federal income tax treatment of the Trust and the Trust Distribution;
- (v) the validity of any S corporation election or the continuing eligibility for S corporation status of either Distributing or Controlled; and
- (vi) the U.S. federal income tax treatment of the Asset Exchange.



## PROCEDURAL STATEMENTS

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely

*Maury Passman*

Maury Passman  
Acting Chief, Branch 4  
Office of Associate Chief Counsel (Corporate)