

Private Letter Ruling 9234035, IRC Section 42

**EXCHANGING SHAREHOLDERS RECOGNIZE NO GAIN OR LOSS IN 'D'
REORGANIZATION.**

A corporation (Distributing) is in the business of purchasing, raising, and selling cattle. Its principal assets consist of four tracts of land. One shareholder owns 49,990 of the corporation's 50,000 shares of Class A voting common stock, while the other two shareholders each own 109,500 of the corporation's 219,000 shares of Class B nonvoting common stock. The two holders of Class B stock wish to go their separate ways from the holder of the majority of Class A common stock. Accordingly, a new corporation (Controlled) will be formed, to which Distributing will transfer one of the tracts of land and two-thirds of another tract of land. Distributing will then distribute all of the Controlled stock to the two Class B common shareholders in exchange for their Distributing stock.

The Service has ruled that the transaction will qualify as a reorganization under section 368(a)(1)(D). Citing section 355(a)(1), the Service ruled that the exchanging shareholders will recognize no gain or loss.

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CC:CORP:5 -- TR-31-183-92

Dear ***

This is in response to a letter dated January 30, 1992, requesting rulings as to the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated March 24, 1992 and May 5, 1992. The information submitted for consideration is substantially as set forth below.

Distributing is generally a cash basis corporation, except for inventory items that are accounted for on the accrual method of accounting. Distributing is engaged in the business of purchasing, raising and selling cattle. Distributing's principal assets consist of four tracts of land: Tract 1, Tract 2, Tract 3 and Tract 4.

Distributing has 750,000 shares of authorized Class A Voting Common stock, 50,000 of which are issued and outstanding. Distributing also has 250,000 shares of authorized

Class B Non-voting Common stock, 219,000 of which are issued and outstanding. These shares are held as follows:

Shareholder Class A Voting Class B Nonvoting

Shareholder A 49,990 0

Shareholder B 5 109,500

Shareholder C 5 109,500

Total 50,000 219,000

Controlled is to be formed as a cash basis corporation. It will have 50,000 shares of outstanding Voting Common stock, all of which will initially be held by Distributing.

Financial information has been received which indicates that Distributing has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Shareholders B and C want to go their separate way from Shareholder A. Accordingly, the following transaction is proposed:

- (i) Distributing will form a new wholly owned subsidiary, Controlled.
- (ii) Distributing will transfer Tract 2 and 2/3 of Tract 4 to Controlled. No inventory will be transferred to Controlled.
- (iii) Distributing will distribute all of the Controlled stock to Shareholders B and C in exchange for all of their Distributing stock.

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

- (a) Distributing, Controlled and their respective shareholders will each pay their own expenses, if any, incurred in connection with the transaction.
- (b) The fair market value of the Controlled stock received by each shareholder of

Distributing approximately equals the fair market value of Distributing stock surrendered by the shareholder in the exchange.

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

(d) Following the transaction, Distributing and Controlled will each continue

independently and with their separate officers and employees (including in the case of Distributing, employees hired by Shareholder A who work for and whose salaries are borne by Distributing) the active conduct of all the integrated activities of the business conducted by Distributing prior to the consummation of the transaction.

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

(f) No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv) of the Code.

(g) The five years of financial information submitted on behalf of Distributing is

representative of its present operations, and there have been no substantial operational changes since the date of the last financial statement submitted.

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

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

(j) 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 subsequent to the proposed transaction.

(k) 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.

(l) Distributing is eligible to elect under section 1361 of the Code to be treated as an S corporation but has never done so.

(m) Following the transaction, if either Distributing or Controlled elect to be treated as S corporations under section 1361 of the Code, both corporations will file such an election.

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 solely in exchange for all of the stock of Controlled, followed by the distribution of 50 percent of Controlled stock to each of Shareholder B and C in exchange for all of their respective stock in Distributing, will be 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 to Distributing upon the transfer of assets to

Controlled in exchange for Controlled stock (section 361(a)).

(3) No gain or loss will be recognized to Controlled on the receipt of assets in exchange for Controlled stock (section 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 (section 362(b)).

(5) The holding period of the Distributing assets received by Controlled will include the period during which such assets were held by Distributing (section 1223(2)).

(6) No gain or loss will be recognized to Distributing upon the distribution of all of the stock of Controlled to Shareholders B and C (section 361(c)).

(7) No gain or loss will be recognized to (and no amount will be included in the income of) Shareholders B and C upon receipt of the Controlled stock (section 355(a)(1)).

(8) The basis of the Distributing stock and Controlled stock in the hands of Shareholders B and C will be the same as their basis in the Distributing stock held immediately before the Spinoff, allocated in proportion to the respective fair market values of such stock at the time of the Spinoff (sections 258(a)(1) and 358(b)(2) of the Code and section 1.358-2(a)(2) of the Income Tax Regulations).

(9) The holding period of the Controlled stock received by Shareholders B and C will include the holding period of the Distributing stock, provided that such stock is held as a capital asset on the date of the Spinoff (section 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 section 1.312-10(a) of the Income Tax Regulations.

Section 1362(a)(1) of the Code provides that a small business corporation may elect to be an S corporation.

Section 1361(b)(1) of the Code defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not have (i) more than 35 shareholders; (ii) as a shareholder a person (other than an estate and certain types of trusts) who is not an individual; (iii) a nonresident alien as a shareholder; and (iv) more than one class of stock.

Section 1361(b)(2)(A) of the Code provides that the term "ineligible corporation" includes any corporation that is a member of an affiliated group (determined under section 1504 without regard to the exceptions contained in subsection (b) thereof).

Rev. Rul. 72-320, 1972-1 C.B. 270, holds that the momentary ownership by an S corporation of all the stock in another corporation in connection with a divisive reorganization described in section 368(a)(1)(D) does not terminate the S election of the S corporation.

(11) Accordingly, we conclude that Distributing will be eligible to make an S election under section 1362(a) effective for its tax year beginning July 1, 1992, provided that it meets the definition of a small business corporation under section 1361(b).

(12) Further, we conclude that Controlled will be eligible to make an S election under section 1362(a) effective for its tax year coinciding with the year of the reorganization provided that it meets the definition of a small business corporation under section 1361(b).

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 proposed transaction that are not specifically covered by the above rulings.

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(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 transaction covered by this letter is consummated.

Pursuant to the powers of attorney on file in this office, a copy of this letter has been sent to the taxpayer.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By: William Alexander

Senior Technical Reviewer, Branch 5