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Department of the Treasury

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[Third Party Communication:

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PLR-111841-05

Date:

July 13, 2005

Distribution =

Controlled =

M =

D =

S =

State X =

Business A =

Town B =

c =

d =

e =

Date 1 =

Dear :

We respond to your request dated February 25, 2005, for rulings on the federal income tax consequences of a partially consummated transaction. Additional information was received in letters dated March 28, May 23, and July 11, 2005. The material information submitted for consideration is summarized below.

The rulings contained in this letter are based on facts and representations submitted by the taxpayer and accompanied by a penalties 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 proposed transaction: (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 the distributing corporation or the controlled corporation or both (see §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 representing a 50-percent or greater interest in the distributing corporation or the controlled corporation (see §355(e)(2)(A)(ii) and §1.355-7).

Distributing is a State X, S corporation engaged directly in Business A. Distributing has c shares of voting common stock outstanding that are owned by M (d shares), D (e shares), and S (e shares). Financial information has been submitted indicating that Distributing's Business A has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Controlled, a State X corporation and wholly owned subsidiary of Distributing, was incorporated on Date 1 in order to effectuate the proposed transaction.

For what are represented to be valid business purposes, the following transaction has been proposed and partially consummated:

- (i) Distributing will transfer all of the assets and liabilities, if any, of the Business A located in Town B to Controlled in exchange for all of the outstanding shares of common stock of Controlled (c shares).
- (ii) Distributing will distribute all of Controlled's outstanding stock to D in exchange for all of D's shares of Distributing stock.

- (iii) After the distribution, Controlled will elect to be an S corporation pursuant to §1362(a) of the Internal Revenue Code for its first taxable year.

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

- (a) No part of the consideration to be distributed by Distributing will be received by D as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.
- (b) The five years of financial information submitted on behalf of Distributing 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.
- (c) Following the transaction, Distributing and Controlled each will continue, independently and with its separate employees, the active conduct of its share of all the integrated activities of the business conducted by Distributing prior to consummation of the transaction.
- (d) The distribution of the stock of Controlled is being carried out for the following corporate business purposes: (1) to allow the shareholders of each of Distributing and Controlled to have control over their respective entity's operations and profitability; and (2) to eliminate friction among the shareholders with respect to operation and management of the business. The distribution of the stock, or stock and securities, of Controlled is motivated, in whole or in substantial part, by one or more of these corporate business purposes.
- (e) The fair market value of the Controlled stock to be received by D will be approximately equal to the fair market value of the Distributing stock surrendered by D in exchange therefor.
- (f) The transaction is not used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.
- (g) The total adjusted bases and the fair market value of the assets to be transferred to Controlled by Distributing will, in each instance, equal or exceed the liabilities to be assumed (as determined under §357(d)) by Controlled.
- (h) The liabilities to be assumed (as determined under § 357(d)) in the transaction were incurred in the ordinary course of business and are associated with the assets being transferred.

- (i) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock.
- (j) 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.
- (k) No two parties to the transaction are investment companies as defined in §368(a)(2)(F)(iii) and (iv).
- (l) There is no acquisition of stock of Distributing or Controlled (including any predecessor or successor of any such corporation) that is part of a plan or series of related transactions (within the meaning of §1.355-7T) that includes the distribution of the Controlled stock.
- (m) Distributing is an S corporation (within the meaning of §1361(a)). Controlled will elect to be an S corporation pursuant to §1362(a) effective immediately after the Distribution. There is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

Based solely on the information submitted and representations made, we hold as follows:

- (1) The transfer by Distributing of the Business A assets located in Town B to Controlled in exchange for all of the issued and outstanding stock of Controlled and the assumption by Controlled of the liabilities associated with the transferred Business A assets, if any, followed by the distribution of the stock of Controlled, as described above, will qualify as a reorganization under §368(a)(1)(D). Distributing and Controlled each will be a "party to a reorganization" under §368(b).
- (2) Distributing will recognize no gain or loss upon the transfer of the Business A assets to Controlled in exchange for Controlled stock and the assumption of liabilities, if any, as described above (§§361(a) and 357(a)).
- (3) Controlled will recognize no gain or loss on the receipt of the Business A assets in exchange for Controlled stock, as described above (§1032(a)).
- (4) Controlled's basis in each asset received from Distributing will equal the basis of such asset in the hands of Distributing immediately prior to the transfer (§362(b)).
- (5) Controlled's holding period for each asset received from Distributing will include the period during which Distributing held such asset (§1223(2)).

- (6) Distributing will recognize no gain or loss on the distribution of the Controlled stock, as described above (§361(c)(1)).
- (7) D will recognize no gain or loss (and no amount will be included in her income) upon her receipt of the Controlled stock in exchange for all of her Distributing stock, as described above (§355(a)(1)).
- (8) The basis of the Controlled stock in the hands of D will be the same as the basis of the Distributing stock surrendered in exchange therefor (§358(a)(1)).
- (9) D's holding period of the Controlled stock received in the distribution will include the holding period of the Distributing stock surrendered in exchange therefor, provided such stock is held by D as a capital asset on the date of the transaction (§1223(1)).
- (10) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under §1.312-10(a) of the Income Tax Regulations.
- (11) Controlled will be subject to § 1374 with respect to any asset transferred to Controlled from Distributing to the same extent Distributing was subject to § 1374 with respect to such asset. For purposes of § 1374, Controlled's recognition period will be reduced by the portion of Distributing's recognition period that expires prior to Distributing's transfer of these assets to Controlled (§ 1374(d)(8) and Ann. 86-128, 1986-51 I.R.B. 22).

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, no opinion is expressed regarding: (i) whether the distribution satisfies the business purpose requirement of §1.355-2(b); (ii) whether the transaction is used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both; and (iii) whether the distribution and an acquisition or acquisitions are part of a plan (or series of related transactions) under §355(e)(2)(A)(ii). Further, no opinion is expressed concerning whether Distributing's S election is valid; whether Controlled is otherwise eligible to be taxed as an S corporation; and whether Controlled's election to be an S corporation will be valid under §1362(a).

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.

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 power of attorney on file in this office, a copy of this letter has been sent to the taxpayers' authorized representative.

Sincerely,

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Richard E. Coss  
Senior Counsel, Branch 3  
Office of Associate Chief Counsel (Corporate)

cc: