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Date:  
October 14, 2005

Distributing =

Controlled =

Sub 1 =

Sub 2 =

Sub 3 =

LLC 1 =

LLC 2 =

LLC 3 =

LLC4 =

Partnership 1 =

Partnership 2 =

Limited Partnership =

State X =

State Y =

Shareholder A =

Business A =

Business B =

Date 2 =

a =

b =

c =

d =

e =

f =

g =

h =

Assets =

Dear :

We respond to your June 24, 2005, request for rulings on certain Federal income tax consequences of a proposed transaction. Additional information was submitted in a letter dated August 8, 2005. The information submitted is summarized below.

The rulings contained in this letter are based upon 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 material 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 any distribution described below satisfies the business purpose requirement of § 1.355-2(b) of the Income Tax Regulations, whether any of the distributions described below is used principally as a device for the distribution of earnings and profits of Distributing or Controlled or both (see § 355(a)(1)(B) of the Internal Revenue Code and § 1.355-2(d)), or whether any distribution described below 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 Distributing or Controlled (see § 355(e) and § 1.355-7).

### **Summary of Facts**

Since Date 2, Distributing has been a State X limited partnership that elected to be taxed as an association. Shareholder A, his wife, and children own Distributing, directly and beneficially through certain trusts and a wholly owned limited liability company that is disregarded for Federal income tax purposes. Distributing is the common parent of a group of corporations whose includible affiliates join in filing a

consolidated Federal income tax return. Distributing uses the accrual method of accounting on a calendar year basis.

Distributing conducts Business A and Business B, directly and through its a wholly-owned subsidiaries. Distributing wholly owns the stock of Sub 1, which owns a c percent general partnership interest in Sub 2. Sub 2 is a State X limited partnership that elected to be treated as an association and is a member of Distributing's consolidated group. Distributing owns the remaining d percent limited partnership interest in Sub 2. Distributing wholly owns the stock of Sub 3, a State Y corporation that supports the activities of Business B. Distributing also wholly owns LLC 1, LLC 2, and LLC 3, which are state law corporations treated as disregarded entities for Federal income tax purposes. LLC 3 owns f percent of the limited liability interests in LLC 4, with the remaining interest owned by an unrelated third party. Distributing owns e percent of the limited partnership interests of Partnership 1 and Partnership 2. The remaining percentage interests in Partnership 1 and Partnership 2 are owned by affiliates of Distributing. Distributing is looking to the Business A and Business B activities of Sub 2 to satisfy the active trade or business requirements of § 355(b).

The financial information submitted by Distributing on behalf of Sub 2 indicates that each of Business A and Business B has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Distributing wishes to separate Business B from Business A in order 1) to enable Controlled to obtain additional funding for Business B on better financial terms; 2) to provide opportunity for key employees of Business B to acquire an equity interest in Business B as a stand-alone company; and 3) to reduce the exposure of the assets of Business B to the legal liabilities of Business A. Accordingly, the following transaction is proposed.

#### **Proposed Transaction**

- (i) Distributing will cause Sub 1 to convert to a limited liability company under state law, causing Sub 1 to liquidate for Federal income tax purposes (the Election);
- (ii) Distributing will elect to treat Sub 2 as a disregarded entity for Federal income tax purposes, causing Sub 2 to liquidate for Federal income tax purposes (the Liquidation);
- (iii) Sub 3, LLC1, LLC2, LLC3, Partnership 1, and Partnership 2 will distribute Assets (loans due from third parties) to Distributing;

- (iv) Limited Partnership, a partnership beneficially owned by members of Shareholder A's family, will transfer Assets to Distributing in partial payment of outstanding indebtedness to Distributing;
- (v) Distributing will organize Controlled as a State X corporation and contribute the assets of Business B to Controlled in exchange for all of the shares of Controlled common stock (the Contribution). All employees of Distributing and Sub 2 that are involved in Business B will become employees of Controlled. Distributing will transfer Assets to Controlled. These Assets were held by Distributing prior to the proposed transaction, were received in steps (iii) and (iv) above, or were held by Sub 2 prior to step (ii) above. Controlled may transfer some or all of the assets received from Distributing to one or more limited liability companies, each of which will be treated as a disregarded entity for Federal income tax purposes;
- (vi) Distributing will distribute all of its Controlled stock pro rata to its shareholders (the Distribution);
- (vii) Immediately following the Distribution, Distributing shareholders will transfer all of their Distributing stock to a newly organized holding company (Holdco). Holdco will be organized as a state law general partnership but will elect to be treated as a corporation for Federal income tax purposes. Distributing will organize two wholly-owned limited liability companies, Holdco LLC and Newco LLC, each of which will be disregarded for Federal income tax purposes. Distributing will transfer g percent of the Distributing units to Holco LLC and h percent of the units to Newco LLC. Distributing will then elect to change its classification for Federal income tax purposes and will become a disregarded entity. This structure is being implemented for State X franchise tax purposes.

Following the Distribution, Distributing will continue to operate Business A, and Controlled will operate Business B. Distributing intends to provide administrative services to Controlled after the distribution.

### **Representations**

Distributing has made the following representations concerning the Liquidation:

- (a) Distributing, on the date of adoption of the plan of complete liquidation, and at all times until the Merger is completed, will be the owner of 100 percent of the single outstanding class of stock of Sub 2.
- (b) No shares of Sub 2 stock will have been redeemed during the three years preceding the adoption of the plan of complete liquidation.

- (c) All distributions from Sub 2 to Distributing pursuant to the plan of complete liquidation will be made on a single date and within the same taxable year of Sub 2.
- (d) As soon as the first liquidating distributions occur, Sub 2 will cease to be a going concern and its activities will be limited to winding up its affairs, paying its debts, and distributing its remaining assets to its shareholders.
- (e) Sub 2 will retain no assets following its liquidating distribution.
- (f) Sub 2 will not have acquired assets in any nontaxable transaction at any time, except for acquisitions occurring more than three years before the date of the adoption of the plan of liquidation.
- (g) No assets of Sub 2 have been, or will be, disposed of by either Sub 2 or Distributing except for dispositions in the ordinary course of business and dispositions occurring more than three years before the adoption of the plan of liquidation.
- (h) The liquidation of Sub 2 will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation (Recipient) of any of the businesses or assets of Sub 2, if persons holding, directly or indirectly, more than 20 percent in value of the Sub 2 stock also hold, directly or indirectly, more than 20 percent in value of the stock in Recipient, other than for assets transferred to Controlled in the transaction described herein. For purposes of this representation, ownership will be determined by application of the constructive ownership rule of § 318(a) as modified by § 304(c).
- (i) Before the adoption of the plan of liquidation, no Sub 2 assets will have been distributed in kind, transferred, or sold to Distributing, except for transactions occurring in the normal course of business and transactions occurring more than three years before the adoption of the plan of liquidation.
- (j) Sub 2 will report all earned income represented by assets that will be distributed to Distributing.
- (k) The fair market value of the Sub 2 assets will exceed its liabilities both at the date of the adoption of the plan of complete liquidation and immediately before the time the liquidating distribution is made.
- (l) Immediately before the Liquidation, all items of income, gain, loss, deduction, or credit will be taken into account as required by the applicable intercompany transaction regulations (see § 1.1502-13 and

§ 1.1502-14 as in effect before the publication of T.D. 8597 and, as currently in effect, § 1.1502-13 as published by T.D. 8597).

- (m) There is intercorporate indebtedness existing from Distributing to Sub 2, and it will be extinguished for Federal income tax purposes as a result of the liquidation. No intercorporate debt between Distributing and Sub 2 has been canceled, forgiven, or discounted, except for transactions that occurred more than three years prior to the date of adoption of the plan of liquidation.
- (n) Distributing is not an organization that is exempt from Federal income tax under § 501 or any other provision of the Code.
- (o) All other transactions undertaken contemporaneously with, in anticipation of, in conjunction with, or in any way related to, the proposed Merger of Sub 1 have been fully disclosed.

Distributing has made the following representations concerning the Distribution:

- (p) 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.
- (q) The five years of financial information submitted on behalf of Business A and Business B of Sub 2 are representative of Sub 2's present operations, and, with regard to Sub 2, there have been no substantial operational changes since the date of the last financial statements submitted.
- (r) Following the transaction, Distributing and Controlled each will continue the active conduct of its businesses, independently and with its separate employees.
- (s) The Distribution is being carried out for one or more of the following corporate business purposes: 1) to enable Controlled to obtain additional funding for Business B on better financial terms, 2) to provide opportunity for key employees of Business B to acquire an equity interest in Business B as a stand alone company, and 3) to reduce the exposure of the assets of Business B to the legal liabilities of Business A. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.
- (t) The Distribution will not be used principally as a device for the distribution of earnings and profits of Distributing or Controlled or both.

- (u) The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed (within the meaning of § 357(d)) by Controlled.
- (v) The liabilities assumed (within the meaning of § 357(d)) were incurred in the ordinary course of business and are associated with the assets being transferred.
- (w) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Distribution.
- (x) 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 § 1.1502-13 and § 1.1502-14 as in effect before the publication of T.D. 8597, 1995-2 I.R.B. 6, and, as currently in effect; § 1.1502-13 as published by T.D. 8597). Further, Distributing's excess loss account with respect to the Controlled stock, if any, will be included in income immediately before the distribution (see § 1.1502-19).
- (y) 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.
- (z) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (aa) The distributions are 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 value or total combined voting power of all classes of stock of Distributing or Controlled.
- (bb) The transaction described in paragraph (vii) is a reorganization within the meaning of § 368(a)(1)(F) of the Code.
- (cc) Controlled intends to make an election under § 1362 to be treated as an S corporation following the Distribution.

### **Rulings**

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



- (1) The election to treat Sub 2 as a disregarded entity for Federal income tax purposes will qualify as a complete liquidation of Sub 2 under § 332 and § 1.332-2(d).
- (2) No gain or loss will be recognized by Distributing or Sub 2 on the Liquidation (§§ 332(a), 336(d)(3), 337(a) and 337(b)).
- (3) Distributing's basis in each asset received from Sub 2 in the Liquidation will equal Sub 2's basis in that asset immediately before the Liquidation (§ 334(b)(1)).
- (4) Distributing's holding period in each asset received from Sub 2 as a result of the Liquidation will include the period during which that asset was held by Sub 2 (§ 1223(2)).
- (5) Distributing will succeed to and take into account the items of Sub 2 described in § 381(c), subject to the conditions and limitations specified in §§ 381, 382, 383 and 384 and the regulations thereunder (§ 381(a); § 1.381(a)-1).
- (6) Distributing will succeed to and take into account the earnings and profits, or deficit in earnings and profits, of Sub 2 as of the date of the Liquidation (§ 381(c)(2)(A); § 1.381(c)(2)-1). Any deficit in the earnings and profits of Sub 2 or Distributing will be used only to offset earnings and profits accumulated after the date of the Liquidation (§ 381(c)(2)(B)). Notwithstanding the above, to the extent that Sub 2's earnings and profits are reflected in Distributing's earnings and profits, the Sub 2 earnings and profits to which Distributing succeeds must be adjusted to prevent duplication (§ 1.1502-33(a)).

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

- (7) The Contribution by Distributing to Controlled, followed by the pro-rata distribution of the Controlled stock to Distributing shareholders will qualify as a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled each will be a party to the reorganization within the meaning of § 368(b).
- (8) No gain or loss will be recognized by Distributing on the Contribution in exchange for Controlled stock (§§ 361(a) and 357(a)).
- (9) No gain or loss will be recognized by Controlled on the Contribution in exchange for Controlled stock (§ 1032(a)).

- (10) The basis of each asset received by Controlled in the Contribution will equal the basis of that asset in the hands of Distributing immediately before the Contribution (§ 362(b)).
- (11) The holding period of each asset received by Controlled in the Contribution will include the holding period of that asset in the hands of Distributing (§ 1223(2)).
- (12) Distributing will recognize no gain or loss on the Distribution (§ 361(c)).
- (13) No gain or loss will be recognized by (and no amount will be included in the income of) the Distributing shareholders on the Distribution (§ 355(a)(1)).
- (14) The aggregate basis of the Distributing stock and the stock of Controlled in the hands of each Distributing shareholder after the Distribution will equal the basis of the Distributing stock held by the shareholder immediately before the Distribution. This aggregate basis will be allocated between the Distributing and Controlled stock in proportion to the fair market values of the Distributing and Controlled stock immediately after the Distribution in accordance with § 1.358-2(a)(2) (§ 358(a)(1), (b) and (c)).
- (15) The holding period of the Controlled stock received by each Distributing shareholder in the Distribution will include the holding period of the Distributing stock on which the Distribution will be made, provided the Distributing stock is held as a capital asset on the date of the Distribution (§ 1223(1)).
- (16) Proper allocation of earnings and profits between Distributing and Controlled will be made under §§ 1.312-10(a) and 1.1502-33.

We express no opinion about the tax treatment of any transaction described above under other provisions of the Code and regulations or the tax treatment of any condition existing at the time of, or effect resulting from, any of these transactions that is not specifically covered by the above rulings. In particular, no opinion is requested and no opinion is expressed regarding (A) the Election described in paragraph (i), above; (B) the tax treatment of the transaction described in paragraph (vii) (see § 3.01(31) of Rev. Proc. 2005-3, 2005-1 I.R.B. 118, 120); (C) whether dividend treatment or gain, if any, will be recognized by the transferors when they transfer Assets to Distributing in paragraphs (iii) and (iv), above; or (D) whether Controlled is eligible to be treated as an S corporation under § 1362.

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

It is important that a copy of this ruling letter be attached to the Federal income tax return of each party 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 Distributing's authorized representative.

Sincerely yours,

*Filiz A. Serbes*

Filiz A. Serbes  
Chief, Branch 3  
Office of Associate Chief Counsel  
(Corporate)