

**Internal Revenue Service**

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:CORP:B04

PLR-134297-05

Date:

December 21, 2005

Legend

Distributing =

Controlled =

Business 1 =

Business 2 =

A =

B =

C =

D =

E =

F =

G =

a =

Dear :

This letter responds to your July 25, 2005 request for rulings on certain federal income tax consequences of a Proposed Transaction (defined below). The information submitted in that letter and in later correspondence is summarized below.

The rulings contained in this letter are based on facts and representations submitted by the taxpayers and accompanied by penalty of perjury statements executed by the appropriate parties. 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 will: (i) satisfy the business purpose requirement of § 1.355-2(b) of the Income Tax Regulations, (ii) is being used principally as a device for the distribution of the 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 (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 Distributing or Controlled (see § 355(e) and § 1.355-7).

#### Summary of Facts

Distributing is an S corporation that has conducted Business 1 for more than five years. Distributing has voting and nonvoting common stock outstanding. The voting stock is owned by A, B, C, D, E, and F, and the nonvoting stock is owned by G.

Controlled is a wholly owned qualified subchapter S subsidiary (Q Sub) of Distributing treated as a disregarded entity under § 1.1361-4(a)(1) of the Federal Income Tax Regulations. Controlled has conducted Business 2 for more than five years.

Financial information has been submitted indicating that Business 1 and Business 2 each has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

#### The Proposed Transaction

For what is represented to be a valid business reason, the following transactions have been proposed (collectively, the "Proposed Transaction"):

(i) Distributing will distribute the stock of Controlled pro rata to the Distributing voting and nonvoting shareholders (the "Distribution").

(ii) After the Distribution, Controlled will elect to be an S corporation pursuant to § 1362(a) for its first taxable year.

After the Distribution, Controlled will lease a to Distributing for fair market rental value.

### Representations

The following representations have been made regarding the Proposed Transaction:

(a) Distributing, Controlled, and the shareholders of Distributing will each pay their own expenses, if any, incurred in connection with the Proposed Transaction.

(b) 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.

(c) The five years of financial information submitted on behalf of Business 1 is representative of its present operations, and there have been no substantial operational changes to Business 1 since the date of the last financial statements submitted.

(d) The five years of financial information submitted on behalf of Business 2 is representative of its present operations, and there have been no substantial operational changes to Business 2 since the date of the last financial statements submitted.

(e) Following the Distribution, Distributing and Controlled will each continue the active conduct of its respective business, independently and with its own employees.

(f) The Proposed Transaction is not being used principally as a device for the distribution of earnings and profits of Distributing or Controlled, or both.

(g) No indebtedness has been or will be cancelled in connection with the Proposed Transaction. No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the Distribution.

(h) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

(i) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 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 § 355(d)(6)) ending on the date of the Distribution or (ii) attributable to distributions on Distributing stock or securities that were acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Distribution.

(j) 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 representing a 50-percent or greater interest (within the meaning of § 355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation).

(k) The Distribution is being carried out for the following corporate business purpose: (i) to facilitate the purchase of Distributing shares by new investors interested in only Business 1. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.

(l) No parties to the Proposed Transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).

(m) The total adjusted basis and the fair market value of the assets deemed to be transferred to Controlled by Distributing will equal or exceed the sum of the liabilities assumed (as defined in § 357(d)) by Controlled plus any liabilities to which the transferred assets are subject.

(n) The liabilities of Distributing to be assumed (within the meaning of § 357(d)) by Controlled were incurred in the ordinary course of business and are associated with the assets being transferred.

(o) The total fair market value of the assets deemed transferred to Controlled by Distributing will equal or exceed the aggregate adjusted basis of the transferred assets.

(p) Any payments made in connection with continuing transactions 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.

(q) Distributing is an S corporation within the meaning of § 1361(a). Controlled will elect to be an S corporation pursuant to § 1362(a) on the first available date after the Distribution and there is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.

(r) The income tax liability for the taxable year in which investment credit property (if any) (including any building to which § 47(d) applies) is transferred will be adjusted pursuant to § 50(a)(1) or (a)(2) (or § 47, as in effect before amendment by

Pub. L. No. 101-508, title 11, 104 Stat. 1388, 536 (1990), if applicable) to reflect an early disposition of the property.

(s) The total fair market value of the assets deemed contributed to Controlled will exceed the sum of (a) the amount of any liabilities assumed (within the meaning of § 357(d)) by Controlled in connection with the exchange, (b) the amount of any liabilities owed to Controlled by Distributing that are discharged or extinguished in connection with the exchange, and (c) the amount of any cash and the fair market value of any other property (other than stock and securities permitted to be received under § 361(a) without the recognition of gain) received by Distributing in connection with the exchange. The fair market value of the assets of Controlled will exceed the amount of its liabilities immediately after the exchange.

### Rulings

Based solely on the facts submitted and on the representations set forth above, and subject to the caveats set forth below, we rule as follows:

(1) Distributing's distribution of all of its Controlled stock to its shareholders will cause a termination of the QSub election of Controlled because Controlled will cease to be a wholly owned subsidiary of an S corporation. As a result, Controlled will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from Distributing in exchange for stock of Controlled (§ 1.1361-5(b)(1)(i)).

(2) The deemed exchange of Distributing's Business 2 assets, subject to liabilities, for Controlled stock resulting from the termination of the QSub election, as set forth above, followed by the Distribution will be treated as a reorganization under § 368(a)(1)(D). Distributing and Controlled each will be "a party to a reorganization" under § 368(b).

(3) No gain or loss will be recognized by Distributing on its deemed transfer of the Business 2 assets, subject to liabilities, to Controlled in exchange for Controlled common stock and the assumption by Controlled of the liabilities associated with the transferred assets (§§ 361(a) and 357(a)).

(4) No gain or loss will be recognized by Controlled on the deemed receipt of the Business 2 assets, subject to liabilities, in exchange for Controlled common stock (§ 1032(a)).

(5) The basis of each Business 2 asset deemed received by Controlled from Distributing will be equal to the basis of that asset in the hands of Distributing immediately prior to its transfer (§ 362(b)).

(6) The holding period of each Business 2 asset deemed received by Controlled from Distributing will include the period during which that asset was held by Distributing (§ 1223(2)).

(7) No gain or loss will be recognized by Distributing on the Distribution (§ 361(c)).

(8) No gain or loss will be recognized by (and no amount will be included in the income of) the Distributing shareholders upon their receipt of the Controlled stock in the Distribution (§ 355(a)(1)).

(9) Each Distributing shareholder's basis in a share of Distributing common stock (as adjusted under § 1.358-1) shall be allocated between the share of Distributing common stock with respect to which the Distribution is made and the share or shares of Controlled common stock (or allocable portions thereof) received with respect to the share of Distributing common stock in proportion to their fair market values. If one share of Controlled common stock is received with respect to more than one share of Distributing common stock, the basis of each share of Distributing common stock must be allocated to the shares of Controlled common stock received in a manner that reflects that, to the greatest extent possible, a share of Controlled common stock received is received with respect to shares of Distributing common stock acquired on the same date and at the same price. If a Distributing shareholder that purchased or acquired shares of Distributing common stock on different dates or at different prices is not able to identify which particular share of Controlled common stock (or portion thereof) is received with respect to a particular share of Distributing common stock, the shareholder may designate which share of Controlled common stock is received with respect to a particular share of Distributing common stock, provided the terms of the designation are consistent with the terms of the Distribution.

(10) The holding period of the Controlled stock received by each Distributing shareholder will include the holding period of the Distributing stock with respect to which the Distribution will be made, provided that the Distributing stock is held as a capital asset on the date of the Distribution (§ 1223(1)).

(11) As provided in § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under § 1.312-10(a).

(12) Distributing's momentary ownership of the stock of Controlled, as part of the reorganization under § 368(a)(1)(D), will not cause Controlled to have an ineligible shareholder for any portion of its first taxable year under § 1361(b)(1)(B). If Controlled otherwise meets the requirements of a small business corporation under § 1361, Controlled will be eligible to make a subchapter S election under § 1362(a) for its first taxable year, provided such election is made effective immediately following the termination of the original QSub election.

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, no opinion is expressed regarding: (i) whether the Distribution satisfies the business purpose requirement of § 1.355-2(b); (ii) whether the Proposed Transaction is being used principally as a device for the distribution of earnings and profits of any or all of Distributing or Controlled (see § 355(a)(1)(B) and § 1.355-2(d)); and (iii) whether the Proposed Transaction is part of a plan (or series of related transactions) under § 355(e)(2)(A). Additionally, no opinion is expressed regarding the validity of Controlled's S corporation election when made.

Procedural Statements

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

A copy of this letter must be attached to any federal income tax return to which it is relevant.

In accordance with a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

*Marc A. Countryman*

Marc A. Countryman  
Senior Technician Reviewer, Branch 4  
Associate Chief Counsel (Corporate)

cc: