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**Internal Revenue Service**

Department of the Treasury  
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Person To Contact:  
, ID No.

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Refer Reply To:  
CC:CORP:B02  
PLR-106472-06

Date:  
August 02, 2006

Distributing	=
State X	=
Business AN	=
Individuals	=
A	=
B	=
C	=
Controlled	=
QSub1	=
QSub2	=
QSub3	=
QSub4	=
QSub5	=
Business 1	=
Business 2	=
Business 3	=

.  
Dear :

This letter responds to your January 23, 2006, request for rulings on certain federal income tax consequences of a proposed transaction. The relevant information provided in your request and in correspondence of March 20, 2006; May 26, 2006; June 5, 2006; and June 7, 2006, is summarized below.

The rulings contained in this letter are based upon facts and representations submitted by the taxpayer and accompanied by penalties of perjury statements 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 the transaction described below satisfies the business purpose requirement of §1.355-2(b) of the Income Tax Regulations, whether the distribution 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 I.R.C. 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).

### **Statement of Facts**

Distributing is a State X, Subchapter S corporation that uses the accrual method of accounting and has been engaged in Business AN in three locations through wholly owned QSubs in State X for more than five years. ("QSub" means a corporation intended to be a qualified Subchapter S subsidiary). Individuals A, B, and C each own one-third of Distributing's voting common stock, which is the only stock of Distributing that is issued and outstanding. Distributing owns all of the stock of QSub1, QSub2, and QSub3. QSub1 and QSub2 each own one-half of QSub4. QSub2 owns QSub5.

The financial information submitted by Distributing indicates that Business AN has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years. QSub1, QSub2, and QSub3 are each engaged in Businesses 1, 2, and 3, respectively at different locations. QSub4 owns realty used in Business1 and 3. QSub5 owns realty used in Businesses 2 and 3.

A, B, and C desire to provide for continuity in the management and operation of Businesses 1, 2, and 3, and QSub4.

### **Proposed Transaction**

In order to achieve that goal, the following transaction has been proposed to separate the ownership and conduct of Business 1 from Distributing:

- (i) QSub4 will distribute its assets leased to and used in Business 3 to a new corporation ("X"), which will become a QSub ("QSub6") of QSub3.
- (ii) QSub2 will contribute fifty percent (50%) of the issued and outstanding stock in QSub4 to QSub4 which will then retire such stock, leaving QSub1 as the sole stockholder of QSub4.
- (iii) Distributing will distribute all of the stock of QSub1 ("Controlled") to A in exchange for all of A's stock of Distributing (the "Distribution" or "Split-off") within one year of the issuance of this letter.

- (iv) Ownership of the stock of Controlled by A will result in the disqualification of Controlled and its subsidiary ("Controlled Sub" (formerly QSub4)) as QSubs and a deemed contribution ("Contribution") of their assets and liabilities to a new corporation (Controlled) followed by a deemed contribution from Controlled to a new corporation (Controlled Sub) of QSub4's assets and liabilities.

### **Representations**

The parties have made the following representations concerning the proposed transaction.

- (a) Distributing, Controlled, A, B, and C each will pay its, his or her own expenses, if any, incurred in the transaction.
- (b) No part of the consideration to be distributed by Distributing will be received by A as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.
- (c) Following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees.
- (d) The Split-off is being carried out for the following business purpose: (1) to retain management in respect of Business 1 and QSub4; (2) to facilitate the attraction of new management to Business 1; and (3) to avoid management, operational, and business issues caused by the admission to management of new owners within the same S corporation group. The distribution of the Controlled stock in the Split-off is motivated, in whole or substantial part, by that business purpose.
- (e) The Split-off will not be used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.
- (f) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing each equal or exceed the sum of any liabilities assumed (as determined under § 357(d)) by Controlled, and (2) any liabilities 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.
- (g) The total adjusted basis and the fair market value of the assets transferred to Controlled Sub by Controlled each equal or exceed the sum of any liabilities

assumed (as determined under § 357(d)) by Controlled Sub, and (2) any liabilities 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.

- (h) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (i) The five years of financial information submitted on behalf of Distributing and its Qualified Subchapter S subsidiaries represent present operations, and there have been no substantial operational changes since the date of the last financial statements submitted.
- (j) There is no plan or intention to liquidate Distributing, Controlled, or Controlled Sub, to merge any such corporation with any other corporation, or to sell or otherwise dispose of the assets of any such corporation after the transaction, except in the ordinary course of business.
- (k) Payments made in all 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.
- (l) The Distribution is 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 fifty percent (50%) or more of the total combined voting power of all classes of either Distributing's or Controlled's stock entitled to vote or stock possessing fifty percent (50%) or more of the total value of all classes of stock of either Distributing or Controlled.
- (m) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 355(d)(7)) will hold stock possessing fifty percent (50%) or more of the total combined voting power of all classes of Distributing stock entitled to vote, or fifty percent (50%) 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 (d)(8)) during the five (5) year period (determined after applying § 355(d)(6)) ending on the distribution date.
- (n) For purposes of § 355(d), immediately after the Distribution, no person (determined after applying § 355(d)(7)) will hold stock possessing fifty percent (50%) or more of the total combined voting power of all classes of Controlled stock entitled to vote, or fifty percent (50%) 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)(5) and (d)(8)) during the five (5) year period (determined after applying § 355(d)(6)) ending on the Distribution date,

- or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in §§ 355(d)(5) and (d)(8)) during the five (5) year period (determined after applying § 355(d)(6)) ending on the Distribution date.
- (o) The fair market value of the Controlled stock and other consideration to be received by A, a shareholder of Distributing, will be approximately equal to the fair market value of Distributing stock surrendered by A in the exchange.
- (p) After the Distribution, Controlled will elect to be an S corporation within the meaning of § 1361(a) and Controlled Sub (formerly QSub4) will seek approval as a Qsub pursuant to § 1361(b)(3)(B).

### **Rulings**

Based solely on the information submitted and the representations set forth above, we rule as follows with respect to the proposed Contribution and Distribution:

- (1) The Contribution followed by the Distribution will be a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each be “a party to the reorganization” within the meaning of § 368(b).
- (2) No gain or loss will be recognized by Distributing upon the Contribution. §§ 357(a) and 361(a).
- (3) No gain or loss will be recognized by Controlled upon the Contribution in exchange for Controlled stock. § 1032(a).
- (4) The Distribution by QSub4 of the assets leased to and used by QSub3, to QSub6 will be disregarded for Federal tax purposes. § 1361(b)(3)(A)(i) and Reg. § 1.1361-4(a)(1).
- (5) The contribution by QSub2 of fifty percent (50%) of the issued and outstanding stock in QSub4 to QSub4 and its retirement will be disregarded for Federal tax purposes. § 1361(b)(3)(A)(i) and Reg. § 1.1361-4(a)(1).
- (6) The basis of each asset received by Controlled will equal the basis of such asset in the hands of Distributing immediately prior to the Contribution. § 362(b).
- (7) Controlled’s holding period for each asset received in the Contribution will include the period during which such asset was held by Distributing. § 1223(2).
- (8) Distributing will recognize no gain or loss on the Distribution. § 361(c)(1).

- (9) A will recognize no gain or loss (and no amount will be included in A's income) upon the receipt of the Controlled stock in the Split-off. § 355(a)(1).
- (10) The aggregate basis of the Controlled stock in the hands of A will equal the aggregate basis in the Distributing stock surrendered by A in the exchange. § 358(a)(1).
- (11) The holding period of Controlled stock received by A in the Distribution will include the holding period of the Distributing stock exchanged therefor, provided that such Distributing stock is held as a capital asset on the date of the Distribution. § 1223(1).
- (12) Distributing's distribution of all its Controlled stock to A 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 the stock of Controlled. Reg. § 1.1361-5(b)(1)(i).
- (13) Distributing's distribution of all its Controlled stock to A will cause a termination of the QSub election of QSub4 because it will cease to be a wholly owned subsidiary of an S corporation. As a result, Controlled Sub (formerly QSub4) will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from Controlled in exchange for stock of Controlled Sub. § 1.1361-5(b)(1)(i). Controlled Sub's formation and its acquisition of assets (and assumption of liabilities) from Controlled will be deemed to have occurred after the termination of Controlled's QSub election, Controlled's formation and Controlled's acquisition of assets (and assumption of liabilities) from Distributing. Reg. § 1.1361-5(b)(1)(ii).
- (14) No gain or loss will be recognized by Controlled on the deemed transfer of property and liabilities to Controlled Sub in exchange for Controlled Sub stock. §§ 351(a) and 357(a).
- (15) The aggregate basis in Controlled Sub stock received by Controlled will be the same as its aggregate basis in the property transferred. § 358(a).
- (16) The holding period in the Controlled Sub stock received by Controlled will include the period during which Controlled the property transferred, provided that such property was held as a capital asset at the time of the transfer. § 1223(1).

- (17) No gain or loss will be recognized by Controlled Sub on the deemed receipt of property in exchange for its stock. § 1032(a).
- (18) The basis in property received by Controlled Sub will be the same as the basis of such property in the hands of Controlled. § 362(a).
- (19) The holding period of the property received by Controlled Sub will include the holding period during which such property was held by Controlled. § 1223(2).
- (20) 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 Controlled's original QSub election.
- (21) Distributing's momentary ownership of the stock of Controlled, as part of the reorganization under section 368(a)(1)(D), will not cause Controlled Sub to be ineligible for a QSub election. If Controlled Sub otherwise meets the requirements of a qualified subchapter S subsidiary under § 1361(b)(3)(B), Controlled may make a QSub election with respect to Controlled Sub for Controlled Sub's first taxable year, provided that such election is made effective immediately following the termination of QSub4's original QSub election.
- (22) The accumulated adjustments account of Distributing 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 § 312(h) (see § 1.312-10(a)). Reg. § 1.1368-2(d)(3).
- (23) Distributing's earnings and profits will be allocated among Distributing and Controlled in accordance with § 312(h) and § 1.312-10(a).

### **Caveats**

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

Moreover as stated above, this office has not reviewed any information pertaining to, and has made no determination regarding, whether the transaction described below satisfies the business purpose requirement of § 1.355-2(b) of the Income Tax Regulations, whether the distribution 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 I.R.C. 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).

### **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 representative.

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,

Gerald B. Fleming  
Senior Technician Reviewer, Branch 2  
(Corporate)