

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Person To Contact:  
, ID No.

Telephone Number:

Refer Reply To:  
CC:CORP:B05  
PLR-134538-08

Date:  
October 29, 2008

In Re:

**LEGEND:**

Distributing =

Shareholder =

A

Shareholder =

B

Shareholder =

C

Controlled =

Sub1 =

Manage Co =

State X =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Business =

Location1 =

Location2 =

a% =

b% =

c% =

d% =

x =

y =

Dear :

This letter responds to your July 23, 2008, request for rulings regarding certain federal income tax consequences of a proposed transaction. The information submitted in that request and in later correspondence dated October 10, 2008, is summarized below. Unless otherwise indicated, references herein to code sections and regulations sections are to the applicable Internal Revenue Code and Income Tax Regulations.

The rulings contained in this letter are based on facts and representations submitted by the taxpayer and accompanied by a penalty 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 the distribution (described below): (i) satisfies the business purpose requirement of § 1.355-2(b), (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) 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).

### Facts

Distributing was incorporated as a State X corporation on Date 1. Distributing has a single class of voting common stock owned by three individual shareholders. Shareholder A and Shareholder C each own a%, and Shareholder B owns b% of Distributing's stock. On Date 2 (more than ten years ago), the shareholders elected to treat Distributing as an S corporation. Distributing has directly conducted its Business for more than five years in two locations, Location 1 and Location 2. On Date 3 (more than five years ago), Distributing purchased one hundred percent of the stock of Sub1, which expanded Distributing's Location 2 Business. On Date 4, Distributing made an ineffective election to treat Sub1 as an S corporation. On Date 5, Distributing's election to treat Sub1 as a qualified subchapter S subsidiary became effective. Distributing is an accrual method taxpayer filing its returns on a calendar year.

Controlled will be formed by Distributing as a State X corporation in the transactions proposed below. Controlled will be an accrual method taxpayer filing its returns on a calendar year.

Prior to the transactions proposed below, Distributing plans to sell x Business assets in Location 1. Prior to or after the transactions proposed below, Distributing plans to sell y Business assets in Location 2. Distributing has either held the x and y assets for more than ten years, or acquired them in a transaction that would not qualify as a § 1374(d)(8) transaction. The assets will be sold for cash. The cash received for the x assets will be reinvested in Location 1. The cash received for the y assets will be reinvested in Location 2.

After the transactions proposed below, Distributing and Controlled will form, with nominal capital, an administrative management company, Manage Co. Manage Co will hire the administrative employees formerly employed by Distributing, and lease such employees to Distributing and Controlled to perform back-office financial and administrative services. Distributing and Controlled will pay an arm's length fee for the services provided by Manage Co.

The continued success of the Business depends on the shareholders complying with two contractual terms. First, the x assets in Location 1 and y assets in Location 2

must be sold to improve cash flow that must be reinvested in the Business's respective locations. Second, the Business must be separated by location. The financial information submitted indicates that, taking into account the proceeds from the sale of the  $\underline{x}$  and  $\underline{y}$  assets, the Location 1 Business and the Location 2 Business have had gross receipts and operating expenses representing the active conduct of a trade or business for at least each of the past five years.

### **The Proposed Transaction**

To comply with the two contractual terms governing the Business, and for what are represented to be valid business reasons, Distributing proposes to complete the following transactions on the same day:

- (i) Distributing will form Controlled.
- (ii) Distributing will contribute to Controlled all the assets (including cash from the sales of  $\underline{x}$  assets) and Controlled will assume all the liabilities associated with the Location 1 Business (the contribution) in exchange for Controlled stock.
- (iii) Distributing will distribute all the Controlled stock to Shareholder B and Shareholder C (the exchanging shareholders) in exchange for all or part of their Distributing stock (the distribution). Shareholder B will exchange one-half of his Distributing stock for Controlled stock, while Shareholder C exchanges all of his Distributing stock for Controlled stock. Following the distribution, Shareholder A will own c% of the common stock of Distributing, but no Controlled stock. Shareholder B will own d% of the common stock of Distributing and Controlled. Shareholder C will own c% of the common stock of Controlled, but no Distributing stock.
- (iv) Controlled will make an S election under § 1362(a), effective immediately, following the distribution. Thereafter, Controlled will elect to be taxed as a subchapter S corporation on the first available date after the distribution.

### **Representations**

The taxpayer has made the following representations in connection with the transaction described above:

- (a) Distributing is an S corporation (within the meaning of § 1361(a) of the Code). Immediately following the proposed transaction, Controlled will elect to be an S corporation pursuant to § 1362(a). There is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or Controlled.
- (b) Distributing, Controlled, and each of the shareholders will each pay his or its own expenses incurred in connection with the proposed transaction.

- (c) The fair market value of Controlled stock received by each shareholder of Distributing will be approximately equal to the fair market value of the Distributing stock surrendered by the shareholder in the exchange.
- (d) No part of the Controlled stock 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.
- (e) The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operation, and with regard to Distributing there have been no substantial operational changes since the date of the last financial statements submitted.
- (f) Following the distribution, Distributing and Controlled will each continue, independently and with its separate employees, the active conduct of the business in Location 2 and Location 1, respectively.
- (g) The distribution of the stock of Controlled is carried out for the corporate business purpose of complying with contractual obligations. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (h) The transaction is not being used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.
- (i) Distributing did not acquire any of the x or y assets, or any of the property transferred in the contribution to Controlled in a transaction described in § 1374(d)(8).
- (j) The total adjusted bases of the assets that Distributing will transfer to Controlled equals or exceeds the sum of the liabilities assumed (as determined under § 357(d)) by Controlled.
- (k) The total fair market value of the assets that Distributing will transfer to Controlled will exceed the sum of: the amount of any liabilities assumed (as determined under § 357(d)) by Controlled in connection with the exchange.
- (l) The fair market value of the assets of Controlled will exceed the amount of its liabilities immediately after the contribution.

- (m) The liabilities assumed (within the meaning of § 357(d)) in the contribution were incurred in the ordinary course of business and are associated with the assets being transferred.
- (n) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (o) No investment credit has been (or will be) claimed with respect to the transferred property.
- (p) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.
- (q) 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.
- (r) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (s) 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 value of the total combined 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.
- (t) 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 value of the total combined shares of all classes of Controlled stock, that was either (i) 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 distribution, or (ii) attributable to distributions on 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 distribution
- (u) 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 § 1.355-7) that includes the distribution of Controlled stock.

- (v) Immediately after the transaction (as defined in § 355(g)(4)), and taking into account the cash received from the sales of  $x$  and  $y$  assets, and all other investment assets (within the meaning of § 355(g)(2)(B)), neither Distributing nor Controlled is a disqualified investment company within the meaning of § 355(g)(2).

### **Rulings**

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

- (1) The transfer by Distributing to Controlled of its Location 1 assets in exchange for all Controlled stock and assumption of liabilities followed by the distribution of all Controlled stock to the exchanging shareholders will constitute a reorganization within the meaning of § 368(a)(1)(D). Distributing and Controlled will each be "a party to a reorganization" within the meaning of § 368(b).
- (2) Distributing will recognize no gain or loss upon the transfer of property to Controlled in exchange for Controlled stock (§§ 357(a) and 361(a)).
- (3) Controlled will recognize no gain or loss on the receipt of property in exchange for Controlled stock (§ 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 transaction (§ 362(b)).
- (5) Controlled's holding period of each asset received from Distributing will include the period during which Distributing held such asset (§ 1223(2)).
- (6) The exchanging shareholders will recognize no gain or loss (and no amount will otherwise be included in their income) upon receipt of Controlled stock (§ 355(a)).
- (7) Distributing will recognize no gain or loss on the distribution of the Controlled stock to the exchanging shareholders (§ 361(c)).
- (8) The aggregate basis of the Distributing stock and the Controlled stock in the hands of the exchanging shareholders immediately after the distribution will equal each shareholder's aggregate basis in the

Distributing stock held immediately before the distribution. Such aggregate basis will be allocated between the Distributing stock and the Controlled stock in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) (§ 358(b)).

- (9) The holding period of the Controlled stock received by the exchanging shareholders will include the holding period of the Distributing stock exchanged, provided such stock is held as a capital asset on the date of the distribution (§ 1223(1)).
- (10) Distributing's earnings and profits will be allocated between Distributing and Controlled in accordance with §§ 312(h) and 1.312-10(a).
- (11) Distributing's accumulated adjustments account immediately before the transaction will be allocated between Distributing and Controlled in a manner similar to the manner in which Distributing's earnings and profits will be allocated under § 312(h) (§§ 1.312-10(a) and 1.1368-2(d)(3)).
- (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 elect to be a subchapter S corporation under § 1362(a) for its first taxable year.
- (13) The assets of Sub1 that are presently subject to the built-in gain provisions of § 1374 continue to be subject to the built-in gain provisions of § 1374 on the same basis as they were subject to such provisions since Date 5 when Distributing's election to treat Sub1 as a qualified subchapter S subsidiary became effective (§ 1374(d)(8)).

### **Caveats**

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. 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 any 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).

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.

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,

*Debra L. Carlisle*

Debra L. Carlisle  
Chief, Branch 5  
Office of Associate Chief Counsel  
(Corporate)