

**Internal Revenue Service**

Number: **200622035**

Release Date: 6/2/2006

Index Number: 355.01-01, 368.04-00

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

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CC:CORP:B03

PLR-158044-05

Date:

February 27, 2006

Distributing =

Controlled =

Shareholder A =

Shareholder B =

Shareholder C =

Shareholder D =

Business A =

a =

c =

d =

State X =

Year 1 =

Date 1 =

Date 2 =

Date 3 =

Dear :

This letter responds to your November 11, 2005, request for rulings on certain Federal tax consequences of a proposed transaction. Additional information was received in letters dated December 20, 2005, January 18, 2006, and February 9, 2006. The information submitted for consideration is substantially as set forth 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) 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 the distributing corporation or the controlled corporation (see § 355(e) and § 1.355-7).

Distributing, a State X corporation, was formerly a C corporation. Distributing converted to a subchapter S corporation effective for Year 1. Distributing is engaged in Business A. Shareholder A, Shareholder B, Shareholder C, and Shareholder D hold a%, a%, c% and d%, respectively, of Distributing's single class of voting common stock.

We have received financial information indicating that 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.

On Date 1, Controlled was incorporated as a State X corporation and wholly-owned subsidiary of Distributing. It has been represented that Controlled is currently a qualified subchapter S subsidiary under § 1361(b)(3) and as such is not treated as a separate corporation, independent of its parent, Distributing, under § 1361(b)(3). Distributing and Controlled each use, and will continue to use, the accrual method of accounting.

Shareholder A, on one hand, and the remaining shareholders on the other hand, have significant differences of opinion over strategic direction of the business and fundamental business matters. Accordingly, the shareholders have divided Distributing into two separate businesses pursuant to a plan of reorganization (the "Plan") executed on Date 2.

In accordance with the Plan, the following transaction has been proposed and partially consummated.

- (i) Distributing's business lines, assets, and obligation were divided proportionately among Distributing and Controlled based on the shareholders' relative share interests. The business interests allocated to Shareholder A were contributed to Controlled effective Date 3. The business allocated to the remaining shareholders was retained directly in Distributing.
- (ii) Distributing will distribute all of the Controlled stock to Shareholder A in exchange for all of Shareholder A's Distributing stock.

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

- (a) The fair market value of the Controlled stock and other consideration to be received by Shareholder A will be approximately equal to the fair market value of the Distributing stock surrendered by Shareholder A in the exchange.
- (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 Distributing is representative of the corporation's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted (other than the division of the business for state law purposes on Date 3).
- (d) Following the transaction, Distributing and Controlled will each continue, independently and with 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.
- (e) The distribution of the stock of Controlled is carried out for the following corporate business purpose: To end shareholder disputes over the operation of Distributing and to resolve management, systemic, and other problems that have arisen because of irreconcilable differences between Shareholder A, on

- one hand, and Shareholder B, Shareholder C, and Shareholder D, on the other. The distribution of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (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 of the assets to be treated as transferred to Controlled by Distributing for federal tax purposes will each equal or exceed the sum of the liabilities assumed (as determined under § 357(d)) by Controlled.
  - (h) The liabilities to be treated as assumed (as determined under § 357(d)) by Controlled in the transaction for Federal tax purposes 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 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 the distributing corporation or any controlled corporation (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 the controlled corporation stock.

Based solely on the information submitted and on the representations set forth above, it is held as follows:

- (1) Distributing's distribution of all of its Controlled stock to Shareholder A in exchange for all of Shareholder A's Distributing stock will cause a termination of the qualified subchapter S subsidiary 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 transfer by Distributing to Controlled of the assets in constructive exchange for all the Controlled stock and the assumption of liabilities followed by the distribution of all of the Controlled stock to Shareholder A in exchange for all of Shareholder A's Distributing stock, as described above, will be 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).
- (3) Distributing will recognize no gain or loss upon the transfer of assets to Controlled in exchange for Controlled stock and the assumption of liabilities, as described above (§§ 361(a) and 357(a)).
- (4) Controlled will recognize no gain or loss on the receipt of assets in exchange for Controlled stock (§ 1032(a)).
- (5) 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)).
- (6) Controlled's holding period for each asset received from Distributing will include the period during which Distributing held such asset (§ 1223(2)).
- (7) Shareholder A will recognize no gain or loss (and no amount will be included in the income of Shareholder A) upon receipt of the Controlled stock in exchange for all of Shareholder A's Distributing stock, as described above (§ 355(a)(1)).
- (8) Distributing will recognize no gain or loss on the distribution of the Controlled stock, as described above (§ 361(c)(1)).
- (9) The basis of the Controlled stock in the hands of Shareholder A will be the same as the basis of the Distributing stock surrendered in exchange therefor (§ 358(a)(1)).
- (10) Shareholder A'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 the Distributing stock is held as a capital asset on the date of the exchange (§ 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) 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)) (§1.1368-2(d)(3)).

- (13) 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 qualified subchapter S subsidiary election.

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). In addition, no opinion is expressed concerning the application of § 1374 to either Distributing or Controlled.

This ruling is directed only to the taxpayer(s) 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 should be attached to the Federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated. 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,

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Ken Cohen  
Senior Technician Reviewer, Branch 3  
Office of Associate Chief Counsel