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Department of the Treasury

Washington, DC 20224

[Third Party Communication:

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:CORP:B06

PLR-139256-05

Date:

November 16, 2005

Legend

Distributing =

Controlled =

State =

Business A =

Business B =

Dear

This ruling is in reply to your representative's letter dated July 21, 2005 for rulings concerning the Federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated September 15, October 24 and November

11, 2005. The material 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.

Moreover, no information provided by the taxpayer has been reviewed and no determination has been made regarding whether the transaction, as proposed: (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, the controlled corporation 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 the distributing corporation or the controlled corporation (see § 355(e)(2)(A)(ii) and § 1.355-7T).

Distributing is a State corporation that has elected to be treated as a subchapter S corporation under § 1361(a). Distributing is engaged in Business A and Business B, and has one class of common stock that has been issued to four shareholders. Financial information has been received which indicates that Distributing has had receipts and operating expenses representative of the active conduct of Business A and Business B for each of the past five years.

For what has been represented as a valid business purpose, the taxpayer has proposed the following transaction:

- (i) Distributing will form Controlled and contribute the operating assets relating to Business B to Controlled in exchange for all of the stock of Controlled and the assumption by Controlled of certain of the liabilities related to the assets transferred ("the Contribution").
- (ii) Distributing will distribute all the outstanding shares of Controlled to its shareholders pro rata ("the Distribution").
- (iii) Immediately following the Distribution, the shareholders will cause Controlled to file Form 2553, "Election by a Small Business Corporation," for the purpose of causing Controlled to be treated as an S corporation from its inception.

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

- (a) 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.
- (b) 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.
- (c) Following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees.
- (d) The distribution of the stock of Controlled is carried out for the following corporate business purposes: to consolidate all of Distributing's present and future Business B operations, to segregate those operations from the Business A operations, and thus to simplify financial reporting with respect to such operations, as well as to comply with a request by Distributing's franchisor to separate Business A from Business B. The distribution of stock is motivated, in whole or in substantial part, by one or more of these corporate business purposes.
- (e) The proposed transaction is not used principally as a device for the distribution of the earnings and profits of the distributing corporation, the controlled corporation or both.
- (f) The total adjusted basis and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed (as determined by § 357(d)) by the Controlled corporation.
- (g) The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.
- (h) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (i) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the stock of Controlled.
- (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 § 1.355-7T) that includes the distribution of the controlled corporation stock.
- (m) Distributing is an S corporation (within the meaning of § 1361(a)). Controlled will elect to be treated as an S corporation pursuant to section 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.

Based solely on the information and representations set forth herein, we rule as follows:

- (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) Distributing will recognize no gain or loss upon the transfer to Controlled of those assets relating to Business B in exchange for Controlled stock and the assumption by Controlled of liabilities related to the assets transferred (§§ 361(a) and 357(c)).
- (3) Controlled will recognize no gain or loss on the receipt of the assets relating to Business B in exchange for Controlled stock (§ 1032(a)).
- (4) The basis of each asset received by Controlled will equal the basis of that asset in the hands of Distributing immediately before the Contribution (§ 362(b)).
- (5) The holding period of each asset received by Controlled will include the period during which Distributing held that asset (§ 1223(2)).
- (6) No gain or loss will be recognized by Distributing on the Distribution (§ 361(c)).
- (7) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) any shareholder of Distributing on the Distribution (§ 355(a)(1)).

- (8) The aggregate basis of Controlled stock and Distributing stock in the hands of the shareholders will equal the aggregate basis of the Distributing stock held immediately prior to the transaction, allocated between the Controlled and Distributing stock in proportion to the fair market value of each in accordance with Treas. Reg. § 1.358-2(a)(2) and § 358 of the Code.
- (9) The holding period of the Controlled stock received by the shareholders of Distributing will include the period during which the Distributing stock was held (§ 1223(1)).
- (10) Earnings and profits will be allocated between Distributing and Controlled in accordance with § 1.312-10(a).
- (11) As provided in § 312(h), the accumulated adjustments account of Distributing 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.
- (12) Provided that, immediately after the transfer of the assets, Distributing distributes the Controlled stock it receives to its shareholders, Distributing's momentary ownership of the stock of Controlled, as a part of the divisive reorganization under § 368(a)(1)(D), will not, in itself, render Controlled ineligible to elect to be an S corporation for its first taxable year. Controlled will be eligible to make an S corporation election under § 1362(a) for its first taxable year, provided that Controlled otherwise meets the requirements under § 1361(b).
- (13) Section 1363(d) is applicable to an S corporation that was a C corporation for the last taxable year before the effective S election. Distributing has been an S corporation. If Controlled makes an effective S election under § 1362(a) for its first taxable year, Controlled will have no history of being a C corporation. Moreover, the assets of Controlled do not have a C history. Provided that Controlled makes an effective S election for its first taxable year, Controlled is not subject to § 1363(d).
- (14) Neither Distributing nor Controlled will recognize any LIFO recapture tax pursuant to § 1363(d) and the regulations thereunder as a result of the transaction described.

No opinion is expressed about the tax treatment of the proposed transactions under other provisions of the Code or regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transactions 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 used principally as a device for the distribution of earnings and profits of the distributing corporation, the controlled corporation or both (see § 355(a)(1)(B) and § 1.355-2(d)); 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).

This ruling is directed on to the taxpayer requesting it. Section 6110(k)(3) of the Code 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 the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Steven J. Hankin
Senior Technical Reviewer, Branch 6
(Corporate)