



Business Y =  
State A =  
z =  
a% =  
  
b% =  
c% =  
  
d% =  
  
e% =  
  
f% =  
F =  
AA =

Dear

This responds to your authorized representative's letter dated December 2, 2005, requesting rulings concerning the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated December 15, 2005 and December 28, 2005.

The rulings contained in this letter are predicated upon the 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 a ruling. 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 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 ("Distributing") or the controlled

corporation (“Controlled”) or both (see § I.R.C. 355(a)(1)(B) and Treas. Reg. § 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)(2)(A)(ii) and § 1.355-7T).

Distributing is a State A, calendar year, S corporation engaged in Business X and Business Y. With regard to Business Y, Distributing is the general partner or managing member of several business entities (“Business Entities”), each of which owns and operates certain AA assets. With regard to Business Y, Distributing’s officers and other employees have performed active and substantial management functions for at least five years with respect to the activities of those Business Entities in which Distributing is a member or a partner, including the decision-making regarding significant business matters for those Business Entities.

Distributing has one class of stock outstanding, of which z shares are owned approximately a% by Shareholder A, b% by Shareholder B, c% by Shareholder C, d% by Shareholder D, e% by Shareholder E and the remaining shares are owned by F other individual shareholders, each of which own no more than f%.

Distributing has supplied information indicating that it has had gross receipts and operating expenses representative of the active conduct of a trade or business for each business for each of the past five years.

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

- (i) Distributing will form a new corporation, Controlled, and will contribute to Controlled all the assets used in connection with Business X solely in exchange for the assumption of related liabilities and z shares of the Controlled common stock. Controlled will be an accrual basis taxpayer formed under the laws of State A.
- (ii) Distributing will distribute to its shareholders, pro rata, all of the Controlled stock (the “distribution”).
- (iii) Controlled will elect to be an S corporation pursuant to § 1362(a) on the first available date after the distribution.

Distributing will continue to operate Business Y following the distribution. It is planned that, in addition to having officers and a board of directors, Distributing will employ one or more individuals who will have continuing responsibility for carrying out the decisions of Distributing’s board of directors with regard to Business Y. Moreover to the extent needed, Distributing may engage Controlled or other third party vendors to provide other services for which Distributing’s

officers will have oversight and decision making responsibility. In particular, Distributing will engage Controlled (at fair market value rates) to provide certain auxiliary services such as financial record keeping and analysis.

Distributing has made the following representations with respect to 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 Distributing.
- (b) The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operations and with regard to Distributing, 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, except that Controlled will provide to Distributing at fair market value rates certain auxiliary services (such as financial record keeping).
- (d) The distribution of the stock of Controlled is carried out for the following corporate business purpose: To protect Business Y from the potential liabilities arising from Business X (risk reduction). The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (e) 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 Treas. Reg. § 1.355-7T) that includes the distribution of the Controlled stock.
- (f) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of this transaction.
- (g) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock.
- (h) No two parties to the transaction are investment companies as defined in § 368(a)(2)(f)(iii) and (iv).
- (i) The transaction is not used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.

- (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) The total adjusted bases 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 under section 357(d)) by Controlled plus the fair market value of any other property, and the amount of any money, transferred by Controlled to Distributing that is distributed to the shareholders of Distributing, or transferred to the creditors of Distributing, pursuant to the plan of reorganization.
- (l) The sum of the liabilities assumed (as determined under section 357(d)) by Controlled in the contribution were incurred in the ordinary course of business and are associated with the assets being transferred.
- (m) For purposes of section 355(d), immediately after the distribution, no person (determined after applying section 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 section 355(d)(5) and (8)) during the five-year period (determined after applying section 355(d)(6)) ending on the date of the distribution.
- (n) For purposes of section 355(d), immediately after the distribution, no person (determined after applying section 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 section 355(d)(5) and (8)) during the five year-period (determined after applying section 355(d)(6)) ending on the date of the distribution, or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in section 355(d)(5) and (8)) during the five year-period (determined after applying section 355(d)(6)) ending on the date of the distribution.
- (o) The total fair market value of the assets of Distributing transferred to Controlled will equal or exceed the aggregate adjusted basis of the transferred assets.

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

- (1) The transfer by Distributing of part of its assets in exchange for all of the issued and outstanding common stock of Controlled, followed by the distribution of all the Controlled stock to the Distributing shareholders, will constitute a reorganization within the meaning of § 368(a)(1)(D) of the Code. Distributing and Controlled will each be “a party to a reorganization” within the meaning of I.R.C. § 368(b).
- (2) No gain or loss will be recognized by Distributing upon its transfer of assets and liabilities to Controlled in exchange for all the stock of Controlled. (I.R.C. §§ 361(a) and 357(a)).
- (3) Controlled will recognize no gain or loss on the receipt of Distributing assets in exchange for all of the Controlled stock. (I.R.C. § 1032(a)).
- (4) The basis of each asset received by Controlled will be, in each instance, the same as the basis of such assets in the hands of Distributing immediately prior to the transaction. (I.R.C. § 362(b)).
- (5) The holding period of the Distributing assets received by Controlled will include the period during which such assets were held by Distributing. (I.R.C. § 1223(2)).
- (6) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) the Distributing shareholders on their receipt of the Controlled stock in the distribution. (I.R.C. § 355(a)(1)).
- (7) The aggregate basis of the Controlled stock and the Distributing stock in the hands of the Distributing shareholders immediately after the distribution will equal the aggregate basis in the Distributing stock held immediately prior to 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 Treas. Reg. § 1.358-2(a)(2). (I.R.C. §§ 358(a), 358(b) and 358(c)).
- (8) The holding period of the Controlled stock received by the Distributing shareholders will include the holding period of the Distributing stock held by such shareholders, provided that such shareholders held Distributing stock as a capital asset on the date of the distribution. (I.R.C. § 1223(1)).
- (9) No gain or loss will be recognized by Distributing upon the distribution of all of its stock in Controlled to its shareholders. (I.R.C. § 361(c)(1)).

- (10) As provided in I.R.C. § 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made in accordance with Treas. Reg. § 1.312-10(a).
- (11) Distributing's momentary ownership of the stock of Controlled as part of the proposed 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.

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 the 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 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)); 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 or implied as to whether Distributing is a valid S corporation and as to whether Controlled is otherwise eligible to be an S corporation.

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.

Each taxpayer involved in the proposed transaction should attach a copy of this ruling letter to the taxpayer's federal income tax return for the taxable year in which the proposed transaction is completed.

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,

*George R. Johnson*

---

George R. Johnson  
Assistant to the Chief, Branch 6  
Office of Associate Chief Counsel  
(Corporate)