Internal Revenue Service

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Department of the Treasury
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LEGEND

Foreign Parent =

Foreign Affiliate 1 =

Foreign Affiliate 2 =

Country A =

Taxpayer =

State B =

Holding =

Sub1 =

Sub2 =

Sub3 =

Year 1 =

Year 2 =

Year 6 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

x% =

Dear :

In a letter dated July 5, 2006, and supplemental letter dated August 25, 2006, you requested rulings under §§ 1502, 165, and 381 of the Internal Revenue Code (the "Code"). The information submitted for consideration is summarized below.

FACTS

Taxpayer is the domestic parent of an affiliated group that joins in the filing of a consolidated income tax return. Taxpayer is wholly owned both directly and indirectly by Foreign Parent, a Country A publicly traded corporation.

Holding, a State B corporation, is a holding company that is directly owned by Taxpayer, except that x% of its stock is held by Foreign Affiliate 1, a subsidiary of Foreign Parent. Holding conducts substantially all of its business operations through its subsidiaries.

Holding owes a significant amount of intercompany indebtedness to Foreign Affiliate 1 and Foreign Affiliate 2, and a relatively small amount to Taxpayer. This indebtedness was originally incurred in Year 1 to finance Taxpayer's acquisition of Holding, and additional intercompany indebtedness has been incurred subsequently by Holding to pay interest and operating expenses to date.

In Year 2, Taxpayer determined that it had overpaid to acquire Holding. Between Year 2 and Year 6, Holding sold a substantial portion of its operations and subsidiaries to pay down some of the intercompany debt. A portion of these sales (relevant for this letter ruling) can be grouped into one of the following three types of transactions:

(1) Sales of the stock of subsidiaries of Holding with joint seller and buyer elections made under § 338(h)(10), to treat the transaction as a sale of the subsidiaries' assets followed by a liquidation under § 332 (the "§ 338 Transactions");

(2) Asset sales by first-tier Holding subsidiaries followed by a § 332 liquidation and formal dissolution of the subsidiaries (the "§ 332 Transactions"); and,

(3) Asset sales by first-tier Holding subsidiaries followed by a distribution of the proceeds and all other assets but without formally liquidating (for example, due to potential contingent liabilities or contractual obligations) (the "De facto Liquidation Transactions").

Several of the subsidiaries involved in these three types of transactions had previously acquired assets from other directly or indirectly owned subsidiaries (which were previously acquired by purchase from unrelated parties) through internal group restructurings (the "Internal Restructurings"). For purposes of this memorandum, the § 338, § 332 and De facto Liquidation Transactions, and the Internal Restructurings are collectively referred to as the "§ 381(a) Transactions."

Currently, Holding is a holding company that conducts substantially all of its operations through operating subsidiaries in two lines of business. One business line operates through disregarded entities that are subsidiaries of Sub1, an entity disregarded from its owner for federal tax purposes that is owned by Holding. The other business line operates through subsidiaries of Sub2.

Prior to Date 1, Sub1 and Sub2 were unincorporated divisions of Sub3, a first-tier subsidiary of Holding that owned other operating businesses and subs. On Date 2, Sub1 was formed as a disregarded entity for federal tax purposes. On Date 3, Sub2 was formed as a corporation. Sub3 distributed Sub1 and Sub2 to Holding on Date 4. Also on Date 4, Holding sold Sub3 to an unrelated party for cash and recognized a taxable loss on the sale. On the distribution of Sub1 and Sub2 to Holding, Sub3 took into account its intercompany items that were triggered as a result of Sub3 leaving the Holding group.

Sub1 and Sub2's respective historic earnings and profits ("E&P") and gross receipts do not include any periods prior to Date 2 and Date 3, respectively, since each was previously an unincorporated division of Sub3.

PROPOSED TRANSACTION

Taxpayer proposes to have Holding convert to a limited liability company ("LLC"), which will change Holding's federal tax classification from a corporation to a disregarded entity under § 301.7701-3 of the Procedure and Administration Regulations. Due to Holding's insolvency, Taxpayer intends to take a worthless stock deduction with respect

to its Holding stock. Taxpayer has requested rulings to verify that it is entitled under § 165(g)(3) to treat that deduction as an ordinary loss.

REPRESENTATIONS

Taxpayer has made the following representations in connection with the proposed transaction:

(a) Holding is insolvent and Holding's stock is worthless within the meaning of § 165(g)(1);

(b) Taxpayer owns directly more than 80 percent of the voting power and value of Holding within the meaning of § 1504(a)(2);

(c) The Holding subsidiaries involved in the De facto Liquidation Transactions have liquidated under § 332;

(d) The Internal Restructurings were tax-free under § 332 or § 368; and,

(e) Taxpayer has no excess loss account ("ELA") in its Holding stock, and Holding has no ELA in the stock of any of its subsidiaries.

LAW AND ANALYSIS

Section 381(a) generally provides that an acquiring corporation shall succeed to and take into account certain items of the distributor or transferor corporation. Section 381(a) applies to the acquisition of the assets of one corporation by another corporation which involves either a distribution to such other corporation to which § 332 applies, or which involves a transfer to which § 361 applies (but only in the context of a reorganization as described in § 368(a)(1)(A), (C), (D), (F), or (G)).

Section 301.7701-3(g)(1)(iii) provides that if an eligible entity classified as an association (and thus a corporation under § 301.7701-2(b)(2)) properly elects under § 301.7701-3(c)(1)(i) to be classified as a disregarded entity, the association is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the association.

Section 301.7701-3(g)(3) provides that any transaction deemed to occur as a result of a change in classification is treated as occurring immediately before the close of the day before the election is effective.

Under § 332(a), no gain or loss shall be recognized by a corporation on the receipt of property distributed in complete liquidation of another corporation. Section 332(b) provides, in part, that a distribution shall be considered to be in complete

liquidation only if the corporation receiving such property was, on the date of the adoption of the plan of liquidation and at all times thereafter up to and including the date of receipt of the property, the owner of stock meeting the requirements of § 1504(a)(2), and the distribution is made in complete cancellation or redemption of all of the stock of the liquidating corporation.

Section 1.332-2(b) of the Income Tax regulations provides that § 332 does not apply to a liquidation where a shareholder receives no payment for its stock upon the liquidation of the corporation.

Under § 165(g)(1), if a security which is a capital asset becomes worthless during the taxable year, the resulting loss is treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. Section 165(g)(2)(A) provides that for purposes of a worthless security deduction, the term "security" includes a share of stock in a corporation.

Under § 165(g)(3), any security in a corporation affiliated with a taxpayer that is a domestic corporation is not treated as a capital asset. For purposes of § 165(g)(3), a corporation is treated as "affiliated" with the taxpayer (a domestic corporation) only if the taxpayer directly owns stock of the corporation that meets the requirements of § 1504(a)(2), and more than 90 percent of the aggregate of the corporation's gross receipts ("gross receipts") for all taxable years have been from sources other than royalties, certain rents, dividends, certain interest, annuities, and gains from sales of stocks and securities ("gross receipts from passive sources").

Section 1.165-1(b) generally provides that, to be allowable as a deduction under § 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year.

Rev. Rul. 2003-125, 2003-2 C.B. 1243, indicates that when a shareholder corporation receives no distribution in liquidation on its stock of the lower-tier corporation because such shareholder's stock is worthless, the liquidation is an identifiable event that fixes the loss with respect to the stock. Rev. Rul. 2003-125 holds that when an entity classification election is made to change an entity from a corporation to a disregarded entity, the former shareholder of such corporation is allowed a worthless security deduction under § 165(g)(3) if the fair market value of the assets of the corporation does not exceed the total amount of the corporation's liabilities, such that on the deemed liquidation of the corporation, the former corporate shareholder receives no payment on its stock in the liquidated corporation.

Treasury regulations under § 1502 provide general guidance applicable to taxpayers who join in the filing of a consolidated income tax return. Section 1.1502-80(c) states that stock of a member is not treated as worthless for purposes of § 165 before such stock is treated as being disposed of under § 1.1502-19(c)(1)(iii).

Section 1.1502-19(c)(1)(iii) provides that the holder of stock (P) is treated as disposing of a share of its stock in another group member (S) at the time that the stock is deemed worthless. Section 1.1502-19(c)(1)(iii)(A) states that S's stock is considered worthless at the time when substantially all of S's assets are treated as disposed of, abandoned, or destroyed for federal income tax purposes (e.g., under § 165(a) or § 1.1502-80(c)). This section also provides, however, that S's assets are not considered to be disposed of or abandoned to the extent that the disposition is in *complete liquidation* (emphasis added) of S. As discussed above, "complete liquidation" refers to a liquidation in which at least a nominal distribution (greater than zero) was made by the liquidating corporation and received by the distributee corporation.

Section 1.1502-13 provides guidance regarding intercompany transactions, including distributions paid on the stock of a lower-tier subsidiary (S) to a higher-tier consolidated group member (P) which holds the stock of such subsidiary. Under § 1.1502-13(a)(2), the amount of P and S's respective corresponding intercompany items are determined on a separate entity basis. The regulation also provides that the timing, source, character and other attributes of these intercompany items are initially determined on a separate entity basis but are redetermined to be treated as transactions between divisions of a single corporation (single entity treatment).

Section 1.1502-13(b)(1)(D) defines "intercompany transaction" as a transaction between corporations that are members of the same consolidated group immediately after the transaction, including distributions from S made to P with respect to the stock of S (dividend distributions). Section 1.1502-13(b)(2) defines "intercompany items" as income, gain, deduction and loss from an intercompany transaction.

Section 1.1502-13(c)(1)(i) provides for the separate entity attributes of P and S's respective corresponding intercompany items to be redetermined to the extent necessary to produce the same effect on consolidated taxable income and tax liability, as if P and S were divisions of a single corporation and the intercompany transaction was between these divisions.

RULINGS

Based upon the information submitted, representations made, and application of the above standards, we conclude as follows:

(1) Assuming the requirements for claiming a worthless stock deduction under § 165(g) are otherwise satisfied, Taxpayer may claim a worthless stock deduction under the consolidated return regulations (specifically, § 1.1502-19(c)(1)(iii) and § 1.1502-80(c)) upon the conversion of Holding to an LLC and the consequent change of Holding's federal tax classification from a

corporation to a disregarded entity under § 301.7701-3. See Rev. Rul. 2003-125;

(2) For purposes of computing the “more than 90 percent gross receipts” test under § 165(g)(3)(B), Holding will take into account the historic gross receipts of the transferor corporations in the § 381 Transactions provided, however, that Holding will eliminate intercompany distributions from the transferor corporations, as appropriate, to prevent duplication;

(3) For purposes of computing the “more than 90 percent gross receipts” test under § 165(g)(3)(B), Holding will include in its aggregate gross receipts all dividends received from lower-tier subsidiary members of its consolidated group, and such dividends will be treated as “gross receipts from passive sources” to the extent they are attributable to the respective distributing member’s “gross receipts from passive sources.” § 1.1502-13(a), (b), and (c). Only dividends that are attributable to “gross receipts from passive sources,” as defined herein, are counted as dividends for purposes of computing the “more than 90 percent gross receipts” test under § 165(g)(3)(B).

(4) In applying Ruling 3 above, dividends will be attributed pro rata to the gross receipts that gave rise to the E&P from which the dividend was distributed. In the event a distributing consolidated group member has in turn received a dividend from a directly or indirectly owned lower-tier subsidiary member, the determination whether the dividend will be treated as "gross receipts from passive sources" will be made by applying the principles of Ruling 3 first at the level of the lowest-tier subsidiary member and then at each subsequent higher-tier level of shareholder member to characterize the dividend received by such member from its subsidiary member.

CAVEATS

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 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.

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code or Income Tax 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. Specifically, we express or imply no opinion whether Taxpayer otherwise meets the requirements of § 165, or whether the § 381 Transactions qualify for tax-free treatment under any section of the Code including § 332 and § 368.

PROCEDURAL STATEMENTS

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. 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.

In accordance with the power of attorney on file in this office, a copy of this ruling letter will be sent to your authorized representative.

Sincerely,

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Gerald B. Fleming
Senior Technician Reviewer, Branch 2
Office of Associate Chief Counsel (Corporate)