

**Internal Revenue Service**

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

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Person To Contact:

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CC:CORP:B05

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Date:

January 23, 2007

Legend

Distributing =

Controlled =

State A =

Individual A =

Individual B =

Year 1 =

Business A =

Sub 1 =

Sub 2 =

Sub 3 =

State B =

Year 2 =

Business B =

Year 3 =

Business C =

State C =

Year 4 =

Business D =

Year 5 =

Business E =

A% =

Individual C =

Dear :

We respond to your authorized representative's November 2, 2006 letter requesting rulings regarding the tax treatment of a proposed transaction. 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. The pertinent facts, as described in your letter, are set forth below.

#### Summary of Facts

Distributing, a State A corporation, is owned by two individual shareholders, Individual A and Individual B, and is treated as an S Corporation for federal income tax purposes. Since Year 1, Distributing has engaged in Business A. Distributing owns all of the stock of Sub 1, Sub 2, Sub 3, and Controlled. Sub 1, a State B corporation, is treated as a qualified subchapter S subsidiary ("QSub") for federal income tax purposes. Since Year 2, Sub 1 has engaged in Business B. Sub 2, a State B corporation, is treated as a

QSub for federal income tax purposes. Since Year 3, Sub 2 has engaged in Business C. Sub 3, a State C corporation, is treated as a QSub for federal income tax purposes. Since Year 4, Sub 3 has engaged in Business D. As QSubs, all of the assets, liabilities, and items of income, deduction, and credit of Sub 1, Sub 2, and Sub 3 are treated as items of Distributing.

Controlled, a State A corporation, is wholly-owned by Distributing and is treated as a C Corporation for federal income tax purposes. Since Year 5, Controlled has engaged directly in Business E. Although Controlled provides Business E services to Distributing and its subsidiaries, the substantial portion of its income arises out of Business E services performed for third parties.

### Proposed Transaction

Distributing proposes to distribute the stock of Controlled to its shareholders pro rata. The proposed transaction is being carried out to permit Individual C, a key employee of Controlled, to become a A% shareholder in Controlled. The proposed transaction will be accomplished through the following steps:

1. Distributing will distribute all of the shares of Controlled to its shareholders (the "Distribution") on a pro rata basis.
2. Controlled will make an election under section 1362(a) to be treated as an S corporation (within the meaning of section 1361(a)).
3. Within three (3) months of the Distribution, Controlled will issue its key employee A% of its common stock for cash and/or installment notes.

### Representations

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

1. No part of the shares of Controlled 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.
2. The five years of financial information submitted on behalf of Distributing's Business A is representative of its present operations and, with regard to Distributing's Business A, there have been no substantial operational changes since the date of the last financial statements submitted.
3. The five years of financial information submitted on behalf of Controlled's Business E is representative of its present operations and, with regard to

Controlled's Business E, there have been no substantial operational changes since the date of the last financial statements submitted.

4. Following the Distribution, each of Distributing and Controlled will continue the active conduct of its business, independently and with its separate employees. Notwithstanding the preceding sentence, following the Distribution, the managerial services of Individual A and Individual B on an as needed basis will be shared by Distributing and Controlled.
5. The Distribution is being undertaken for the corporate business purpose of retaining the services of a key employee. The Distribution is motivated, in whole or substantial part, by this key employee corporate business purpose.
6. The Distribution is not used principally as a device for the distribution of earnings and profits of Distributing or Controlled, or both.
7. Except for certain trade debt, if any, no other indebtedness will exist between Distributing and Controlled at the time of, or subsequent to, the Distribution.
8. The indebtedness owed by Controlled to Distributing, if any, after the Distribution will not constitute stock or securities.
9. Payments made in connection with all continuing transactions, if any, between Distributing and Controlled will be for fair market value and based on terms and conditions arrived at by the parties bargaining at arm's length.
10. 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.
11. 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 stock entitled to vote of Controlled, or 50 percent or more of the total value of shares of all classes of stock of Controlled, 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 any stock of Distributing 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.

12. The Distribution is not part of a plan or series of related transactions (within the meaning of Treas. Reg. § 1.355-7) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest (within the meaning of section 355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation).
13. Each of Distributing and Controlled will pay its own expenses, if any, incurred in connection with the Distribution.

### Rulings

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

1. No gain or loss will be recognized by (and no amount will be included in the income of) the shareholders of Distributing upon the receipt of the stock of Controlled in connection with the Distribution. Section 355(a)(1).
2. No gain or loss will be recognized by Distributing on the distribution of the stock of Controlled in connection with the Distribution. Section 355(c)(1).
3. The aggregate basis of the Distributing shares and the Controlled shares in the hands of the shareholders of Distributing after the Distribution will be the same as the basis of the Distributing shares in the hands of its shareholders immediately before the Distribution, allocated in the manner described in Treas. Reg. § 1.358-2(a)(2). Section 358(a), (b) and (c); Treas. Reg. § 1.358-1(a).
4. The holding period of the stock of Controlled to be received by the Distributing shareholders will include the holding period of the Distributing stock held by each such shareholder prior to the Distribution, provided that the shares of Distributing were held as a capital asset on the date of the Distribution. Section 1223(1).
5. As provided in section 312(h), proper allocation of earnings and profits between Distributing and Controlled will be made under Treas. Reg. § 1.312-10(b).

### Caveats

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code and 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 whether the proposed transaction: (i) satisfies the business purpose requirement of Treas. Reg. § 1.355-2(b); (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 section 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 fifty percent or greater interest in the distributing corporation or the controlled corporation under section 355(e)(2)(A)(ii).

#### Procedural Statements

This ruling letter 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 ruling letter must be attached to the federal income tax return of each taxpayer 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 ruling letter.

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,

*T. Ian Russell*  
T. Ian Russell  
Senior Counsel, Branch 5  
Office of Associate Chief Counsel  
(Corporate)