

**Internal Revenue Service**

Department of the Treasury  
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Person To Contact:

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Telephone Number:

In Re:

Refer Reply To:

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Date:

May 24, 2004

Distributing =

Controlled =

Shareholder A =

Shareholder B =

Individual A =

Individual B =

State X =

State Y =

Year 1 =

Business X =

Business Y =

Dear \_\_\_\_\_ :

This is in response to a letter dated January 14, 2004, submitted on behalf of Distributing, requesting rulings under § 355 of the Internal Revenue Code (the "Code") with respect to a proposed transaction. Additional information was received in letters dated March 29, 2004, May 11, 2004 and May 20, 2004.

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 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) of the Internal Revenue Code and § 1.355-2(d)), and (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, an accrual method taxpayer, is a State X corporation engaged in Business X. It is the common parent of an affiliated group that files its income tax return on a consolidated basis using a tax year ending December 31. Distributing has one class of common stock outstanding, 100 percent of which is owned by Shareholder A, a grantor trust that is jointly owned by Individual A and Individual B (who are husband and wife). Shareholder A owns either stock or membership interests in several other entities engaged in Business Y. Distributing provides Business X services to all of these entities.

Controlled, an accrual method taxpayer, is a State Y corporation engaged in Business Y. Controlled joins in the consolidated federal income tax return filed by Distributing. Controlled has one class of stock outstanding, 80 percent of which is owned by Distributing, and 20 percent of which is owned by Shareholder B, the General Manager of Controlled.

Distributing and Controlled have supplied information indicating Distributing's Business X and Controlled's Business Y each have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years. Distributing elected to be taxed as an S corporation effective January 1,

Year 1 and Controlled will elect to be taxed as S corporation on the first available date after the proposed transaction described below.

Distributing represents that it wants to protect Controlled from the risks and liabilities posed by Distributing's conduct of Business X. Therefore, Distributing has proposed separating Distributing and Controlled by effecting a spin-off of Controlled to Shareholder A. Accordingly, for what is represented to be a valid business purpose, the following transaction is proposed:

Distributing will distribute to Shareholder A all of its Controlled stock (the "Distribution" or "transaction"). Distributing will not retain any stock or securities of Controlled.

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 operation and with regard to Distributing, there have been no substantial operational changes since the date of the last financial statements submitted.
- (c) The five years of financial information submitted on behalf of Controlled is representative of Controlled's present operation, and with regard to Controlled, there have been no substantial operational changes since the date of the last financial statements submitted.
- (d) Following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees.
- (e) The distribution of the stock of Controlled is carried out for the following corporate business purpose: risk reduction. The distribution of the stock of Controlled is motivated, in whole or substantial part, by this corporate business purpose.
- (f) There is no plan or intention by the shareholders or security holders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any

of their stock in, or securities of, either Distributing or Controlled after the transaction.

- (g) There is no plan or intention to liquidate either Distributing or Controlled, or to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation after the transaction, except in the ordinary course of business.
- (h) 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 § 1.355-7T) that includes the distribution of the Controlled stock.
- (i) Controlled is not assuming any liabilities of Distributing or receiving any assets subject to liabilities from Distributing.
- (j) There will be no surrender of Distributing stock or Controlled stock.
- (k) Distributing neither accumulated its receivables nor made any extraordinary payment of its payables, nor will it accumulate receivables or make any extraordinary payment of payables in anticipation of the proposed transaction.
- (l) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock.
- (m) 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.
- (n) Immediately before the Distribution, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable intercompany transaction regulations. Further, Distributing's excess loss account, if any, with respect to Controlled stock will be included in income immediately before the Distribution.
- (o) The transaction is not being used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.
- (p) Distributing is an S corporation (within the meaning of § 1361(a)). Controlled will elect to be an S corporation pursuant to § 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.

- (q) Proper allocation of earnings and profits between Distributing and Controlled will be made under §§ 1.312-10(b) and 1.1502-33(e) of the Treasury Regulations.

Based solely on the information submitted and the representations set forth above, we have concluded that:

- (1) No gain or loss will be recognized by Distributing upon the distribution of its Controlled stock to its shareholder. (Section 355(c)(1)).
- (2) No gain or loss will be recognized by (and no amount will otherwise be included in the income of) the Distributing shareholder on its receipt of Controlled stock in the Distribution. (Section 355(a)(1)).
- (3) The aggregate basis of the Distributing stock and of the Controlled stock in the hands of the Distributing shareholder after the Distribution will equal the aggregate basis of the Distributing stock held by the Distributing shareholder immediately before the Distribution, allocated between the Distributing stock and Controlled stock in proportion to the fair market value of each corporation's stock in accordance with § 1.358-2(a)(2). (Sections 358(a)(1), (b) and (c)).
- (4) The holding period of the Controlled stock received by the Distributing shareholder will include the holding period of the Distributing stock held by such shareholder, provided that such shareholder held the Distributing stock as a capital asset on the date of the Distribution. (Section 1223(1)).

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 (see, §§ 355(a)(1)(B) and 1.355-2(d));

- (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);
- (iv) Whether Distributing's S election is valid or whether Controlled's election to be an S corporation will be valid under § 1362(a);
- (v) Whether salaries and bonuses paid to Individual A by Distributing are excessive compensation within the meaning of § 162 and the regulations thereunder; and
- (vi) Whether the amounts paid to Distributing by Controlled for Business X services are excessive compensation within the meaning of § 162 and the regulations thereunder.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Distributing.

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.

Sincerely yours,

*Alison G. Burns*

Alison G. Burns  
Senior Counsel, Branch 5  
Office of Associate Chief Counsel  
(Corporate)

cc: