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:
, ID No.

Telephone Number:

Refer Reply To:
CC:CORP:B06
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Date:
December 21, 2007

Return Period:

Company =

Subsidiary 1 =

Subsidiary 2 =

Subsidiary 3 =

State X =

Date 1 =

Date 2 =

Business A =

Mineral A =

Mineral B =

Product D =

Product E =

Product F =

M =

N =

X:

Y:

Z:

Dear :

This letter responds to your August 24, 2007 request for a ruling on behalf of Company regarding the proper treatment of income recognized from the sale of certain minerals during the 10-year “recognition period” set forth under Section 1374(d)(7) of the Internal Revenue Code of 1986, as amended ("Code"). Additional information was received in a letter, dated October 15, 2007. The material information is summarized below.

Company, a domestic C corporation was organized on Date 1 under the laws of State X. Company's primary business consists of mining and processing of minerals from quarries and making such minerals ready for commercial use.

Company has three wholly-owned subsidiaries, all of which are domestic State X corporations. Subsidiary 1’s business operation is the manufacture of Product D. Subsidiary 2 operates Business A which provides transportation between Company’s and Subsidiary 1’s locations as well as to outside parties. Subsidiary 3 owns a Business A line, which is currently not in operation.

Company mines Mineral A and Mineral B. Company also manufactures construction material such as Product D, Product E and Product F. Company is not in the business of selling its unexploited property for buyers to extract and process the minerals.

Company owns two properties that contain reserves of Mineral A that can be mined by Company to produce crushed Mineral A. The total available tonage of Mineral A at the first of these two locations is estimated to be approximately X tons. Company has currently mined approximately M percent of those reserves. The other location is not currently being mined. There are estimated to be approximately Y tons at that location.

Company owns one property that contains Mineral B reserves which are currently being used to produce washed Mineral B and natural Mineral A. The total tonage of Mineral B at this location is stated to be approximately Z tons, of which approximately N percent has been mined.

Company computes its federal income tax liability using an accrual method of accounting and files its federal income tax returns on a fiscal year ending March 31st. Company has one class of stock and less than 100 shareholders. Company proposes making an election to be taxed as an S corporation within the meaning of Section 1361 ("Election"). Such election to be effective for tax years beginning on Date 2.

Following the Company's election of S Corporation status, Company will elect to treat Subsidiary 1, Subsidiary 2 and Subsidiary 3 as Qualified Subchapter S Subsidiaries (Q-Subs). As a result of such Q-Sub elections, the three subsidiaries will each be treated as a disregarded entity for federal income tax purposes.

Company requests a ruling that any income from the disposition of Mineral A and Mineral B which had been mined and processed after the effective S conversion date, yet properly recognized during the 10-year "recognition period," will not constitute recognized built-in gain within the meaning of Section 1374(d)(3) of the Internal Revenue Code.

Section 1374(a) imposes a corporate-level tax on any of an S corporation's net recognized built-in gain which is properly taken into account during the recognition period (generally 10 years) where such gain is recognized (a) after a C corporation's conversion to S corporation status or (b) relates to an S corporation's acquisition of assets in a transaction in which the S corporation's basis in the acquired assets is determined by reference to the basis of such assets in the hands of the C corporation.

Section 1374(d)(2) provides that an S corporation's net recognized built-in gain for any tax year is generally its taxable income for the year computed as if it was a C corporation, but only taking into account items that are treated as recognized built-in gain or recognized built-in loss.

Section 1374(d)(3) provides that recognized built-in gain includes any gain recognized on the disposition of an asset during the recognition period, except to the extent the S corporation shows that (a) it did not hold the asset as of the beginning of the first taxable year for which it was an S corporation (the "Conversion Date"), or (b) the gain recognized was greater than the excess of the asset's fair market value over its adjusted basis on the Conversion Date.

Section 1.1374-4(a) of the Income Tax Regulations provides that Section 1374(d)(3) applies to any gain or loss recognized during the "recognition period" in a transaction that is treated as a sale or exchange for federal tax purposes.

In Example 1 of §1.1374-4(a)(3), X is a C corporation that converts to an S corporation as effective on January 1, 1996. On the conversion date, X owns a working interest in an oil and gas property, but on which production of oil and gas has not yet begun, and the fair market value of the working interest exceeds X's adjusted basis in the working interest by $200,000. During the recognition period, X produces and sells oil from the working interest, and includes $75,000 in income from the sale. X's $75,000 of income is not recognized built-in gain, because as of the beginning of its “recognition period” X held only a working interest in the oil and gas property and not the oil itself since the oil had not yet been extracted from the ground.

Rev. Rul. 2001-50, 2001-2 C.B. 343, provides that if an S corporation that holds timber property on the conversion date cuts the timber and sells the resulting wood products during the recognition period, in a transaction to which Section 631 does not apply, the tax consequences to the S corporation under Section 1374 are determined using the same analysis contained in Example 1 of §1.1374-4(a)(3). Under Rev. Rul. 2001-50, such wood products sold as inventory during the recognition period do not constitute separate assets held by an S corporation on the conversion date and thus their production and sale do not constitute a partial disposition of the timber property. Accordingly, the S corporation's income on the sale of the resulting wood products during the recognition period is not recognized built-in gain within the meaning of Section 1374(d)(3).

Based solely on the information submitted and on the authority set forth above, we rule that income from dispositions by Company of Mineral A and Mineral B that are mined and processed after the effective S conversion date, during the 10-year recognition period will not constitute recognized built-in gain within the meaning of Section 1374(d)(3) of the Internal Revenue Code.

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 ruling. In particular, no opinion is expressed concerning whether Company qualifies as a subchapter S corporation, or whether Subsidiary 1, Subsidiary 2 or Subsidiary 3 otherwise qualifies as a qualified subchapter S subsidiary for federal tax purposes. Further, other than any income realized by Company during the applicable “recognition period’ of section 1374(d)(7) from a disposition of Mineral A or Mineral B which was mined after the Conversion Date, no opinion is expressed about the tax treatment of any other income or deduction that may be realized by Company during or after the “recognition period” pursuant to either section 1374 or any other provision of the Internal Revenue Code.

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.

A copy of this letter must be attached to Company's federal income tax returns for Company's final tax year as a C corporation and for each recognition period year in which a disposition of Mineral A and/or Mineral B occurs.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to the first representative listed on that power of attorney and to the taxpayer.

Sincerely,

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Steven J. Hankin
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel (Corporate)

cc :