Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:BR05 – PLR-134165-08
Date:
November 21, 2008

In Re:

LEGEND:

Company A =

Company B =
State M =
Amounts:
m =
n =
Dates:
1 =
2 =
3 =
4 =
5 =
6 = (Month)
7 =

Dear

This is in response to your authorized representative's letter of August 1, 2008, and other correspondence and submissions, in which he requested on your (sometimes herein Company A, or "the Taxpayer") behalf private letter rulings regarding the proper federal income tax treatment of a certain proposed distribution of property, as more fully discussed below. We are pleased to address your concerns.

FACTS

The information submitted indicates that Taxpayer, A, is a State M corporation and that, on Date 1, Taxpayer elected S corporation status effective for its taxable year beginning Date 2, and ending Date 3. This was the first taxable year for which the

Taxpayer was an S corporation pursuant to its most recent election under section 1362. Taxpayer has elected to be on a 52-53 week taxable year ending always on the last Saturday to occur in . Taxpayer's current taxable year will end on Date 5.

Taxpayer has owned for some time m shares of the common stock of Company B, all of which was held as of the beginning of the first taxable year in which the Taxpayer was an S corporation (Date 5); the fair market value of the stock exceeded its adjusted basis at that time. The stock is held for investment purposes.

Taxpayer plans to make a distribution of some of these appreciated investment securities to its shareholders. The board of directors of Taxpayer has decided to distribute not more than n shares of the stock (the Stock) pro rata to Taxpayer's shareholders.

Taxpayer would like the gain recognized on the distribution not to be taxable to it pursuant to section 1374. Taxpayer also intends to cause the gain on the Stock to be recognized in its taxable year and taxable to its shareholders in their taxable years. For reasons discussed below, Date 5, is the only date in Taxpayer's taxable year on which the distribution can be made to achieve these intended results. This distribution would be accomplished by Taxpayer transferring the Stock to a newly-formed limited liability company (the LLC), of which Taxpayer will initially be the sole owner, prior to Date 5. On Date 5, Taxpayer will distribute Taxpayer's sole membership interest in LLC pro rata to its shareholders. The fair market value of the Stock held by the LLC is expected to exceed its adjusted basis on Date 5.

Taxpayer requests that the following rulings be issued:

1. Upon the distribution of the LLC pro rata to the shareholders of Taxpayer on Date 5, gain on the deemed sale of the Stock shall be recognized to Taxpayer in its taxable year ending at that time.

2. The gain recognized to Taxpayer upon the deemed sale of Stock held in the LLC on Date 5, will not be taxable under section 1374 of the Code because the recognition period with respect to the Stock will end on Date 4, ten years after the Taxpayer's election to be taxable as an S corporation.

3. In the case of a shareholder of Taxpayer whose taxable year ends in Month 6, (e.g., on Date 7), the shareholder's pro rata share of the gain recognized to Taxpayer upon the deemed sale of the Stock on Date 5, shall be taken into account in the shareholder's taxable year that is deemed to end on Date 5.

LAW & ANALYSIS

Section 441 of the Code provides that taxable income shall be computed on the basis of the taxpayer's taxable year, that the term "taxable year" means the taxpayer's annual accounting period, and that the term "annual accounting period" means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.

Section 441(f) and sections 1.441-1(b) and 1.441-2(a) of the regulations provide for the election of a 52-53 week fiscal year, as described therein. Section 1.441-2(c) provides rules for determining certain effective dates in the case of taxpayers employing 52-53 week taxable years.

Section 1.442-2(e) provides special rules for the treatment of the taxable years of a pass-through entity (including an S corporation) and the owner of a pass-through entity, where one or both employ a 52-53 week taxable year ending with reference to the same calendar month. Section 1.441-2(e)(1) provides that, if a pass-through entity (as defined in section 1.441-2(e)(3)(i)) or an owner of a pass-through entity (as defined in section 1.441-2(e)(3)(ii)), or both, use a 52-53-week taxable year and the taxable year of the pass-through entity and the owner end with reference to the same calendar month, then, for purposes of determining the taxable year in which items of income, gain, loss, deductions, or credits from the pass-through entity are taken into account by the owner of the pass-through, the owner's taxable year will be deemed to end on the last day of the pass-through's taxable year. Thus, if the taxable year of an S corporation and a shareholder end with reference to the same calendar month, then for purposes of determining the taxable year in which that shareholder takes into account items described in section 1366(a) and items that are deductible by the S corporation and includible in the income of that shareholder, that shareholder's taxable year will be deemed to end on the last day of the S corporation's taxable year.

Section 1371(a) provides that, except as otherwise provided in the Code, and except to the extent inconsistent with subchapter S, subchapter C shall apply to an S corporation and its shareholders.

Section 311(b) provides that, if a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A of Part I of subchapter C applies, and the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation), then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value. In the instant case, Taxpayer acknowledges that the gain on the subject distribution, which is viewed as a deemed sale of the Stock, is taxable to Taxpayer under section 311(b).

Section 1366(a) provides in part that, in determining the tax under chapter 1 of the Code of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends, there shall be taken into account the shareholder's pro rata share of the corporation's items of income.

Section 1374(a) provides that, if for any taxable year beginning in the recognition period an S corporation has a net recognized built-in gain, there is imposed a tax (computed under section 1374(b)) on the income of such corporation for such taxable year.

Section 1374(d)(2) provides that the term “net recognized built-in gain” means, with respect to any taxable year in the recognition period, the lesser of (i) the amount which would be the taxable income of the S corporation for such taxable year if only recognized built-in gains and recognized built-in losses were taken into account, or (ii) such corporation's taxable income for such taxable year (determined as provided in section 1375(b)(1)(B)).

Section 1374(d)(3) provides that the term “recognized built-in gain” means any gain recognized during the recognition period on the disposition of any asset except to the extent that the S corporation establishes that (A) such asset was not held by the S corporation as of the beginning of the 1st taxable year for which it was an S corporation, or (B) such gain exceeds the excess (if any) of (i) the fair market value of such asset as of the beginning of such 1st taxable year, over (ii) the adjusted basis of the asset as of such time.

Section 1.1374-4(a)(1) 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 treated as a sale or exchange for Federal income tax purposes.

Section 1374(d)(7) provides that the term “recognition period” means the 10-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation.

Section 1374(d)(9) provides that any reference in section 1374 to the 1st taxable year for which the corporation was an S corporation shall be treated as a reference to the 1st taxable year for which the corporation was an S corporation pursuant to its most recent election under section 1362.

Section 1.1374-1(d) provides that the recognition period is the 10-year (120-month) period beginning on the first day the corporation is an S corporation and that, for example, if the first day of the recognition period is July 14, 1996, the last day of the recognition period is July 13, 2006.

Accordingly, in the instant case, since the first day of the recognition period is Date 2 (i.e., the first day of the first taxable year for which Taxpayer was an S corporation), it follows that the last day of the recognition period will be Date 4. The provisions of section 1.442-2(c) do not apply in these circumstances.

Thus, Taxpayer's built-in gain in the appreciated securities will no longer be taxable under section 1374 after Date 4. However, section 311(b) still applies, which provides that, if a corporation distributes appreciated property to a shareholder, the distributing corporation will recognize gain as if the property were sold to the distributee at its fair market value.

Section 301.7701-2(c)(2)(i) of the Procedure and Administration Regulations provides that, except as otherwise provided in section 301.7701-2(c), a business entity that has a single owner, and is not a corporation under section 301.7701-2(b), is disregarded as an entity separate from its owner.

Rev. Rul. 99-5, 1999-1 C.B. 434, describes the federal income tax consequences when a single member limited liability company that is disregarded as an entity separate from its owner under section 301.7701-3 becomes an entity with more than one owner that is classified as a partnership for federal tax purposes. Where B, who is not related to A, purchases 50% of A's ownership interest in the LLC for $5,000, A does not contribute any portion of the $5,000 to the LLC, and A and B continue to operate the business of the LLC as co-owners of the LLC, the ruling holds that B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

CONCLUSIONS

Based upon the facts and representations presented and the above analysis of applicable law, we conclude as follows:

1. Upon the distribution of the LLC interests pro rata to the shareholders of Taxpayer on Date 5, a distribution of property to which section 311(b) applies, gain on the deemed sale of the Stock shall be recognized to Taxpayer in its taxable year ending at that time.

2. The gain recognized to Taxpayer upon the deemed sale of Stock held in the LLC on Date 5, will not be taxable under section 1374 because the recognition period with respect to the Stock will end on Date 4, ten years after the Taxpayer's election to be taxable as an S corporation.

3. In the case of a shareholder of Taxpayer whose taxable year ends in Month 6 (e.g., on Date 7), the shareholder's pro rata share of the gain recognized to Taxpayer upon the deemed sale of the Stock on Date 5, shall be taken into account in

the shareholder's taxable year that is deemed, with respect to such distribution, to end on Date 5.

This letter ruling is based on facts and representations furnished by the Taxpayer and its authorized representatives, and is limited to the matters specifically addressed. Except as specifically ruled upon, we express or imply no opinion concerning the federal tax consequences of the transactions described in the facts under any other provision of the Code. Specifically, we express or imply no opinion regarding whether Taxpayer is eligible to be an S corporation, and whether transactions with respect to any assets in the corporation other than the Stock result in a recognized built-in gain. Further, we express or imply no opinion regarding the treatment of any items of income or deductions that may be realized by the Taxpayer during or after the recognition period pursuant to section 1374 or any other provision of the Code.

Because it could help resolve future federal tax issues, a copy of this letter should be maintained with the Taxpayer's permanent records, and attached to any federal income tax return to which it might be relevant.

Pursuant to a power of attorney on file with this office, copies of this letter ruling are being sent to the Taxpayer's authorized representatives.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

Associate Chief Counsel
(Income Tax & Accounting)

/s/ William A. Jackson

By ___________________________
William A. Jackson
Chief, Branch 5

Enclosures:
Copy of this letter
Copy for section 6110 purposes