

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Date:  
February 27, 2009

Legend:

Taxpayer =

Business A =

Business B =

Professionals =

Task C =

Clients =

M =

N =

O =

Date 1 =

Year 1 =

State X =

Dear :

This letter responds to your August 14, 2008, request for rulings regarding certain federal income tax consequences of a proposed transaction. The information submitted

in that request and in subsequent correspondence is summarized below. Unless otherwise indicated, references herein to code sections and regulations sections are to the applicable Internal Revenue Code and Income Tax Regulations.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

#### Facts

Taxpayer is a State X cash basis C Corporation with a calendar tax year. Taxpayer was created on Date 1, Year 1, as a personal service corporation. Taxpayer performs Business A and Business B. Taxpayer is wholly owned by M number of Professionals. None of the Professionals own less than Q% nor more than N% of Taxpayer stock.

The Professionals, among their many duties for Taxpayer, perform Task C. Taxpayer bills its clients for the services performed by the Professionals, and when the invoices are paid, Taxpayer pays salaries and wages to the Professionals. Taxpayer also has other employees, such as nonshareholder clerical staff and nonshareholder Professionals.

#### Proposed Transaction

Taxpayer will elect to be an S Corporation pursuant to section 1362(a) and may have built-in gains from outstanding accounts receivable. Taxpayer requests this letter ruling to determine whether certain salary expenses and other outstanding costs relating to the production of the outstanding accounts receivable at the time of an S election will qualify as built-in losses under section 1374.

#### Representation

Taxpayer has represented that it will pay to its Professionals who are shareholders, within the first two and one-half months of the recognition period, all salary and wage expenses that are related to the production of accounts receivable that are outstanding on the effective date of the S election.

#### Law

Section 1374(d)(4) provides that any loss recognized on a disposition of an asset during the recognition period is recognized built-in loss to the extent the S corporation establishes that it held the asset on the first day of the recognition period and such loss does not exceed the excess of (i) the adjusted basis of such asset as of the beginning of such first taxable year, over (ii) the fair market value of such asset as of such time.

Section 1374(d)(5)(B) provides that any item of deduction properly taken into account during the recognition period but attributable to periods before the first day of the recognition period is recognized built-in loss for the taxable year for which it is allowable as a deduction.

Section 1374(d)(5)(C) provides that an S corporation's net unrealized built-in gain is properly adjusted for items of income and deduction that would be recognized built-in gain or loss if taken into account during the recognition period.

Section 1.1374-4(b)(2) of the Income Tax Regulations provides, in relevant part, that "any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual-method taxpayer."

Treas. Reg. § 1.1374-4(c) limits the treatment under Treas. Reg. § 1.1374-4(b)(2) of items of deduction properly taken into account during the recognition period as recognized built-in loss. The limitation of Treas. Reg. § 1.1374-4(c) applies to items of deduction constituting payments to related parties and any amount properly deducted during the recognition period under section 404(a)(5) (relating to payments for deferred compensation).

Treas. Reg. § 1.1374-4(c)(1) provides that any payment to a related party properly deducted in the recognition period under Section 267(a)(2) will be deductible as recognized built-in loss only if: (i) all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and (ii) the amount is paid: (A) within the first two and one-half months of the recognition period; or (B) to a related party owning less than five percent, by voting power and value, of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid.

Treas. Reg. § 1.1374-4(c)(2) provides that any amount properly deducted in the recognition period under section 404(a)(5) will be deductible as recognized built-in loss to the extent: (i) all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and (ii) the amount is not paid to a related party to which section 267(a)(2) applies.

## Rulings

Based solely on the information and representation submitted, we rule on the Proposed Transaction as follows:

1. Taxpayer's payments to the Professionals who hold shares in Taxpayer of salary and wages relating to the production of outstanding accounts receivable on the effective date of the S election, if paid in the first two and one-half months of the recognition period, qualify as built-in loss items under § 1374(d)(5)(B).
2. Taxpayer's payments to its nonshareholder employees of salary and wages relating to the production of outstanding accounts receivable on the effective date of the S election, if paid during the recognition period, qualify as built-in loss items under § 1374(d)(5)(B).
3. Taxpayer's payments of other unpaid payroll expenses and accounts payable related to the production of the accounts receivable outstanding on the effective date of the S election, if paid during the recognition period, qualify as built-in loss items under § 1374(d)(5)(B).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed concerning whether Taxpayer qualifies as a subchapter S corporation.

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 your authorized representative.

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.

Sincerely,

Richard Heinecke  
Assistant to the Branch Chief, Branch 6  
Office of Associate Chief Counsel  
(Corporate)

cc: