

**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:PSI:B05

PLR-131889-05

Date:

October 05, 2005

In Re:

**LEGEND:**

Taxpayer =

LLC =

State =

Individual A =

Individual B =

Estate =

a =

b =

c =

d =

e =

Dear :

This letter responds to a letter dated June 13, 2005, submitted on behalf of Taxpayer by its authorized representatives, requesting a ruling under section 1239 of the Internal Revenue Code.

## FACTS

Taxpayer was incorporated on a in State and elected S corporation status effective on b. Taxpayer is an oil and gas exploration and production company. Taxpayer's assets primarily consist of oil and gas reserves ("Reserves"). In addition to the Reserves, Taxpayer owns oil and gas drilling and production platforms, other assets used in Taxpayer's exploration and production activities, and other general corporate assets ("Other Assets").

Taxpayer represents that the Other Assets generally are property of a character subject to the allowance for depreciation under section 167. For the Reserves, Taxpayer has claimed depletion deductions under section 611 and intangible drilling cost deductions under section 263(c) and section 1.612-5(a) of the Income Tax Regulations.

Prior to c, Individual A and Individual B owned e percent of the stock in Taxpayer. Individual A died on c, at which time the Estate of Individual A acquired Individual A's d percent interest in Taxpayer stock. Individual B is the sole current beneficiary of the Estate with respect to the Taxpayer stock.

The Estate and Individual B plan to establish a new limited liability company, LLC, the member interests of which will be owned d percent by the Estate and d percent by Individual B. Taxpayer represents that LLC will be treated as a partnership for federal income tax purposes. LLC will be formed for the purpose of acquiring, through merger, the business and assets of Taxpayer. Taxpayer will be liquidated as part of the transaction. Taxpayer has requested a ruling that the gain from the disposition of the Reserves will not be treated as ordinary income under section 1239.

## LAW

Section 611(a) provides that, in the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations.

Section 1.611-5(a) provides that, in the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction a reasonable allowance for depreciation of improvements. Such allowance shall include exhaustion, wear and tear, and obsolescence. The deduction allowed under section 611 shall be determined under the provisions of section 167 and the regulations thereunder.

Section 1239(a) provides that in the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character that is subject to the allowance for depreciation provided in section 167.

Section 1239(b)(1) defines the term "related persons" as a person and all entities which are controlled entities with respect to such person.

Section 1239(c)(1) defines the term "controlled entity," with respect to any person, as (A) a corporation more than 50 percent of the value of the outstanding stock of which is owned (directly or indirectly) by or for such person, (B) a partnership more than 50 percent of the capital interest or profits interest in which is owned (directly or indirectly) by or for such person, and (C) any entity which is a related person to such person under section 267(b)(3), (10), (11), or (12). Section 1239(c)(2) provides that ownership shall be determined in accordance with rules similar to the rules under section 267(c) (other than section 267(c)(3)). Under section 267(c)(1), stock owned, directly or indirectly, by or for an estate is considered as being owned proportionately by or for its beneficiaries.

Section 1.1239-1(a) provides that in the case of a sale or exchange of property, directly or indirectly, between related persons after October 4, 1976, any gain recognized by the transferor shall be treated as ordinary income if the property is, in the hands of the transferee, subject to the allowance for depreciation provided in section 167. This rule also applies to property that would be subject to the allowance for depreciation provided in section 67 except that the purchaser has elected a different form of deduction, such as those allowed under sections 169, 188, and 191.

Though Individual B and Taxpayer are related persons under section 1239(b)(1), section 1239(a) applies to the sale or exchange of the Reserves only if the Reserves are subject to the allowance for depreciation provided in section 167. By claiming deductions for depletion under section 611 and for intangible drilling costs under section 263(c), Taxpayer has represented that the Reserves are mineral property and, therefore, not subject to the allowance for depreciation under section 167.

## CONCLUSION

Accordingly, based solely on the foregoing represented facts and the law, we conclude that section 1239(a) does not apply to the Reserves, which are subject to the allowance for depletion under section 611(a). However, section 1239(a) does apply to any improvements which are subject to the allowance for depreciation under sections 611(a) and 167.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

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

In accordance with the power of attorney on file with this ruling request, a copy of this letter is being sent to Taxpayer's authorized representatives.

Sincerely,

Paul F. Handleman  
Senior Technician Reviewer, Branch 5  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2):  
Copy of this letter  
Copy for section 6110

CC: