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Person To Contact:

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Date:

October 14, 2004

Legend

Oldco =

Newco =

ManageCo =

State =

a% =

b% =

Dear

This responds to a letter dated May 6, 2004, requesting rulings under § 368 and § 1361 of the Internal Revenue Code.

FACTS

The information submitted states that Oldco is a State corporation that elected to be treated as an S corporation for federal tax purposes. For business reasons, Oldco wants to restructure by undertaking the following transactions.

Step (I) The shareholders of Oldco will form Newco as a State general partnership.

- Step (II) Newco will file an election to be classified as an association taxable as a corporation for Federal income tax purposes.
- Step (III) Newco will file an election to be taxed as an S corporation (within the meaning of § 1361(a)).
- Step (IV) The shareholders of Oldco will contribute all the stock of Oldco to Newco in exchange for all the partnership interest in Newco. (These partnership interests are hereinafter termed stock as a result of Newco's Step (II) election to be treated as a corporation for Federal tax purposes.)
- Step (V) Newco will immediately make an election to have Oldco treated as a Qualified Subchapter S Subsidiary (QSub) within the meaning of § 1361(b)(3)(B).
- Step (VI) Newco will form another company, ManageCo, as a single member State A limited liability company, that is disregarded as an entity separate from Newco in accordance with § 301.7701-3(b)(1) of the Procedure and Administration Regulations.
- Step (VII) Newco will contribute to ManageCo a% of its stock in Oldco.
- Step (VIII) Oldco will convert from a corporation to a limited partnership under State law. Pursuant to this State conversion, ManageCo will become the general partner of Oldco (holding a a% partnership interest) and Newco will hold the limited partnership interest in Oldco (the b% partnership interest).
- Step (IX) Oldco will immediately elect to be treated for Federal tax purposes as an association taxable as a corporation.

Oldco makes the following representations:

- (a) For valid business purposes, Oldco, an S corporation incorporated under the laws of State, is undertaking Steps (I) through (IX), above, in order to achieve a state law change (the "State Change") so that it becomes a successor entity, Newco, that will constitute a limited partnership under State A law, but, that, in accordance with § 301.7701-3, will elect to be treated as a corporation for Federal tax purposes.
- (b) All Federal tax elections (for instance, elections in Steps (II), (III), (V), and (IX) above) will be effective as of the time of the State Change so that:

- (i) Newco will never exist as a partnership for Federal tax purposes; and
 - (ii) the pretransaction assets of Oldco will never be considered as being owned by more than one entity for Federal tax purposes.
- (c) Immediately following the State Change, Newco will have exactly the same assets and liabilities as those held by Oldco prior to the transaction. The only exception to the prior sentence is the possibility that a small amount of Oldco cash will not be transferred because it will be used to pay expenses of the transaction. This Oldco cash not received by Newco will constitute less than 1% (one percent) of Oldco's pretransaction net assets.
 - (d) The Oldco shareholders are receiving nothing in the transaction except a stock interest in Newco.
 - (e) For each Oldco shareholder, the fair market value of the stock interest in Newco received by the shareholder (see Step (IV) above) will be approximately equal to the fair market value of the Oldco stock surrendered by the shareholder in the transaction.
 - (f) Immediately following the State Change, the Oldco shareholders will own the entire stock interest in Newco, and they will own their Newco stock interest solely by reason of their ownership of Oldco stock immediately prior to the transaction.
 - (g) Any expenses properly allocable to the Oldco shareholders will be paid by them, and will not be paid by Oldco, Newco, or ManageCo.
 - (h) Newco has no plan or intention to redeem or otherwise acquire any of the Newco stock interests (Newco partnership interests) issued to the Oldco shareholders in the transaction.
 - (i) Oldco is not under the jurisdiction of a court in a Title 11 or similar case within the meaning of § 368(a)(3)(A).
 - (j) Following the completion of Step (IV), Steps (V) through (IX) will be undertaken as expeditiously as business conditions permit.
 - (k) Newco will have fewer than 75 owners, none of which would be ineligible to hold stock in an S corporation, and State law does not require different rights to distributions or liquidation proceeds among the owners of Newco.

We have been asked to rule that Newco will be eligible to be treated as an S corporation, that Newco's partnership agreement will not create a second class of stock,

and whether Newco can elect to treat Oldco as a QSub. We have also been asked to rule that the transaction qualifies as a reorganization under § 368(a)(1)(F).

LAW

Section 368(a)(1)(F) provides that the term "reorganization" means, among other things, a mere change in identity, form, or place of organization of one corporation, however effected.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect.

Section 1361(b)(1) defines the term "small business corporation" to mean a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate and other than a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(b)(2) identifies an ineligible corporation as any corporation which is (A) a financial institution which uses the reserve method of accounting for bad debts described in § 585, (B) an insurance company subject to tax under subchapter L, (C) a corporation to which an election under § 936 applies, or (D) a DISC or former DISC.

Section 1361(b)(3)(B) defines a QSub as a domestic corporation which is not an ineligible corporation, if 100 percent of the stock of the corporation is owned by the S corporation, and the S corporation elects to treat the corporation as a QSub.

Section 1361(b)(3)(A) provides that generally a QSub shall not be treated as a separate corporation, and that all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and such items of the S corporation.

Section 1.1361-3(a)(2) of the Income Tax Regulations provides that an S corporation may elect to treat an eligible subsidiary as a QSub by filing a completed form to be prescribed by the Service. The Service prescribes that QSub status may be elected through a Form 8869. Section 1.1361-3(a)(4) provides guidance on when a QSub election will be effective.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7) or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in § 301.7701-3. An eligible entity with at least two members can elect to be classified as either an association (and

thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(b)(1)(ii) provides that in the absence of an election to be classified as an association, a domestic eligible entity with a single member will be disregarded as an entity separate from its owner if it has a single owner.

CONCLUSIONS

Based solely on the facts and representations submitted, we conclude that Newco will be eligible to be treated as an S corporation, Newco's partnership agreement will not create a second class of stock, and Newco is eligible to treat Oldco as a QSub. Furthermore, provided that each of the three following conditions is met: Condition (A), at the time of the State Change all necessary elections are made by Oldco, Newco, and ManageCo so that immediately following the State Change these three state law entities will be considered a single entity that is treated as an S corporation for Federal tax purposes; Condition (B), throughout the transaction once Oldco is acquired by Newco in Step (IV), above, there is no time when the various state entities constitute more than a single entity for Federal tax purposes; Condition (C), at the time of the State Change, there is no intent by Oldco, Newco, ManageCo, or the persons owning these three entities to change their Federal tax status so that these three state law entities would cease to be treated for Federal tax purposes as a single entity taxable as an S corporation, we rule as follows:

- (1) Steps (I) through (IX) will constitute a corporate reorganization under § 368(a)(1)(E) and (F).
- (2) No gain or loss will be recognized by Oldco upon the exchange of its of assets and liabilities for Newco stock pursuant to Steps (IV) and (V) (§§ 361(a) and 357(a)).
- (3) Newco will not recognize any gain or loss on the receipt of the assets and liabilities of Oldco in exchange for Newco stock under Steps (IV) and (V) (§ 1032(a)).
- (4) The basis of the Oldco assets in the hands of Newco will be the same as the basis of those assets in the hands of Oldco immediately prior to Steps (IV) and (V) (§362(b)).
- (5) Newco's holding period for the Oldco assets it holds as a result of the transaction will include the period during which such assets were held by Oldco (§ 1223(2)).

(6) The Oldco shareholders will not recognize any gain or loss on the exchange of their Oldco stock for partnership interests in Newco (treated as Newco stock), pursuant to Step (IV) (§ 354(a)).

(7) The basis of the Newco stock received by each Oldco shareholder will be the same as such shareholder's basis in the Oldco stock surrendered in the exchange (§ 358(a)(1)).

(8) Each Oldco shareholder's holding period in the Newco stock received, will include the period during which the shareholder held the Oldco stock exchanged therefor, provided the Oldco stock surrendered was held by such shareholder as a capital asset on the date of the exchange (§ 1223(1)).

(9) The reorganization under § 368(a)(1)(E) and (F) does not result in a closing of the tax year and Oldco's taxable year continues in the name of Newco. (§ 381(b) and § 1.381(b)-(1)(a)(2)).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. In particular, no opinion is expressed or implied as to whether Oldco is a valid S corporation prior to the proposed transactions. Furthermore, no opinion is expressed on the effect that any modifications in Newco's partnership agreement would have under § 1361(b).

This ruling is directed only to the taxpayer(s) requesting 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 office, a copy of this letter is being sent to Oldco's authorized representative.

Sincerely,

Carolyn Hinchman Gray
Senior Counsel, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purpose s