Internal Revenue Service

Department of the Treasury

Index Number: 721.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Number: **200019020**
Release Date: 5/12/2000

Refer Reply To:
CC:DOM:P&SI:1-PLR-114776-99
Date:
February 10, 2000

Legend:

A =

B =

C =

D =

w =

$x =

$y =

State =

This responds to your letter dated August 27, 1999, submitted on behalf of A, in which you seek rulings relating to the transactions described below.

FACTS

A is a corporation formed under the laws of State and has w shareholders. A is a vertically integrated manufacturing company and is the common parent of an affiliated group of corporations. A's shareholders wish to hold their stock in A indirectly through a limited liability company. To this end, they plan to undertake the following series of transactions.

Two shareholders of A will transfer a total of $x to B, a newly created limited liability company formed under the laws of State, and in return each will receive one ownership unit in B. B will be treated as a partnership under §§ 301.7701-1 through 301.7701-3 of the Procedure and Administration Regulations. B will then form C, a newly formed corporation under the laws of State.

B will also form Newco, a corporation, under the laws of State. Upon formation, B will be the only shareholder of Newco. Newco will merge into A under State law. Pursuant to the merger, B's Newco stock will be converted to A stock.

Also pursuant to the merger, A's shareholders will have the option to relinquish their A stock for ownership units in B. It is anticipated that all or substantially all of A's shareholders will do so. Those who choose to participate (Participating Shareholders) in the merger will relinquish their shares in A for ownership units in B. If all of A's shareholders are Participating Shareholders, then they will have the exact same proportional ownership interest in B that they had in A. If one or more A shareholders do not participate in the merger and therefore continue to be direct shareholders in A, or one or more A shareholders exercise dissenters' rights and their interest in A is redeemed, the Participating Shareholders' percentage interest in B will increase but will still remain proportional among them. In connection with the merger, the two shareholders of A who contributed $x to B in exchange for one ownership unit apiece, will have those units redeemed for the $x originally contributed. B will not assume any liabilities of the Participating Shareholders. In addition, none of the shares of A stock transferred to B in the merger will be subject to any liabilities of the Participating Shareholders.

Prior to the merger, A will form D, a limited liability company, under the laws of State. No election will be filed under § 301.7701-3(c) for D to be treated as an association. A will contribute $y to D in exchange for all of the ownership interests in D. A will then make a pro-rata taxable dividend distribution to its shareholders of the ownership units in D.

Pursuant to the terms of B's operating agreement ("Operating Agreement"), the income, gains, losses and deductions of B will generally be allocated among the members proportionately based on the ownership units. In addition, capital accounts will be maintained in accordance with § 704(b) of the Internal Revenue Code and the regulations thereunder. The Participating Shareholders will not receive any cash or property distributions from B during the two-year period following the merger, other than operating cash flow distributions (as defined in § 1.707-4(b)(2) of the Income Tax Regulations) pursuant to the Operating Agreement.

Based upon the above facts and representations, you request a ruling that the merger of Newco with and into A will be treated as a contribution of A common stock by the Participating Shareholders to B in exchange for membership units in B. Furthermore, you request a ruling that under § 721(a) neither the Participating Shareholders nor B will recognize gain or loss as a result of the contribution of A common stock to B.

LAW AND ANALYSIS

Section 707(a)(1) provides that if a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, the transaction shall generally be considered as occurring between the partnership and one who is not a partner.

Section 707(a)(2)(B) provides that if (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers, when viewed together, are properly characterized as a sale or exchange of property, then the transfers will be viewed as a transaction between the partnership and one not a partner or two or more members of a partnership not acting in their capacities as members of the partnership.

Section 1.707-3(a)(1) provides that, except as otherwise provided, if a transfer of property by a partner to a partnership and one or more transfers of money or other consideration by the partnership to that partner are described in § 1.707-3(b)(1), the transfers are treated as a sale of property, in whole or in part, to the partnership.

Section 1.707-3(b)(1) provides that a transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances the transfer of money or other consideration would not have been made but for the transfer of property, and, in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

Section 1.707-3(c)(1) provides that if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale. Section 1.707-3(d) provides that if there is a transfer of money or other consideration to a partner by a partnership and a transfer of property to the partnership by that partner and the transfers are more than two years apart, then the transfers are presumed not to be a sale of the property to the partnership, unless the facts and circumstances clearly establish that the transfers constitute a sale.

Section 1.707-4(b)(1) provides that notwithstanding the presumption relating to transfers made within two years of each other, an operating cash flow distribution is presumed not to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale. Section 1.707-4(b)(2) defines operating cash flow distributions as one or more transfers of money by the partnership to a partner during a taxable year of the partnership to the extent that the transfers are not presumed to be guaranteed payments for capital, are not reasonable

preferred returns, are not characterized by the parties as distributions to the partner acting in a capacity other than as a partner, and to the extent they do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of the partner's percentage interest in overall partnership profits for that year or the partner's percentage interest in overall partnership profits for the life of the partnership.

Section 721(a) provides that no gain or loss shall be recognized by either a partnership or its partners on the contribution of property to a partnership in exchange for an interest in the partnership. However, § 721(b) provides that gain (but not loss) realized on such a transfer may be recognized if the partnership would be treated as an investment company within the meaning of § 351, if the partnership were incorporated.

Section 1.721-1(a) provides that § 721 shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner and that § 707 would apply instead. In all cases, the substance of the transaction will govern, rather than its form.

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.

Section 351(e)(1) provides that § 351 does not apply to a transfer of property to an investment company. Section 1.351-1(c)(1) provides that a transfer to an investment company occurs when (i) the transfer results, directly or indirectly, in diversification of the transferors' interests, and (ii) the transferee is a regulated investment company (RIC), real estate investment trust (REIT), or a corporation more than 80 percent of the value of whose assets are held for investment and are readily marketable stock and securities, or interests in RICs or REITs.

Section 1.351-1(c)(5) provides that if there is only one transferor (or two or more transferors of identical assets) to a newly organized corporation, the transfer will generally be treated as not resulting in diversification. However, if a transfer is part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment, the original transfer will be treated as resulting in diversification.

Section 731(a) provides in the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

Generally, the substance of a transaction will be respected for tax purposes, even where the transaction is cast in the form of a series of interrelated steps, rather than being structured along the most direct route to reach the result. See Rev. Rul. 67-448, 1967-2 C.B. 144. In this case, the shortest route to the end result would have been a transfer of the A stock directly to B in exchange for membership interests in B. This result is not negated because the transaction will be cast in the form of a series of interrelated steps.

Because B will make no cash or property distributions to its partners other than operating cash flow distributions within two years from the date of the merger, the deemed contribution of the A shares to B in exchange for units in B is presumed not to result in a sale of property to the partnership under § 707. Provided that there are no additional facts that would rebut the presumptions contained in § 1.707-3(d) (regarding transfers made more than two years apart) or § 1.707-4(b)(1) (regarding operating cash flow distributions), § 721 will apply to the deemed contribution.

Because all of the Participating Shareholders will be transferring identical assets to B, shares of A stock, the transfers will not result in diversification of the Participating Shareholders' interests. Therefore, the transfers will not be considered transfers to a partnership that would be treated as an investment company (within the meaning of § 351) if the partnership were incorporated. Accordingly, § 721(b) does not apply to the deemed contribution of A stock to B by the Participating Shareholders.

Because B will not assume any liabilities of the Participating Shareholders in connection with the merger, and none of the A shares of stock transferred to B in the merger will be subject to any liabilities of the Participating Shareholders, there will be no deemed distribution to the partners in B under § 752(b) that is attributable to the merger.

CONCLUSION

Based on the facts and representations received and subject to the caveats below, we rule as follows:

For federal income tax purposes, the transitory existence of Newco will be disregarded, and the merger of Newco with and into A will be treated as a contribution by the Participating Shareholders of their interests in A to B in exchange for membership interests in B. Provided there are no additional facts sufficient to establish the existence of a disguised sale under § 707, under § 721(a) neither the Participating Shareholders nor B will recognize gain or loss as a result of the Participating Shareholders' contribution of A stock to 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 under any other section of the Code. We specifically express no opinion as to whether the transaction is part of a plan to achieve diversification without recognition of gain under § 1.351-1(c)(5).

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 representatives.

Sincerely,
Matthew Lay
Acting Assistant to the Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes