Internal Revenue Service

Number: **200107018**
Release Date: 2/16/2001
Index Number: 1361.05-00

Department of the Treasury

Washington, DC 20224

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Refer Reply To:
CC:PSI:Br.1-PLR-113499-00
Date:
November 16, 2000

Legend:

A	=
X	=
Y	=
Z	=
LLC1	=
F1	=
F2	=
p%	=
q%	=
r%	=
s%	=
State1	=
State2	=
State3	=
State4	=
Country	=
Year	=

D1 =

D2 =

This letter responds to your June 29, 2000 request for a private letter ruling and subsequent correspondence, submitted on behalf of Y, requesting rulings on the transactions described below.

FACTS

According to the information submitted, A is the sole shareholder of X, a State1 corporation incorporated in Year, and Y, a State2 corporation incorporated on D1. X and Y elected subchapter S status for Federal tax purposes on D2 and D1 respectively. A is the sole owner of LLC1, a State3 limited liability company that is disregarded as an entity separate from its owner under section 301.7701-3 of the Procedure and Administration Regulations. Y owns all of the stock of Z, a State2 corporation incorporated on D1 that Y has elected to treat as a qualified subchapter S subsidiary under 1361(b)(3)(B) effective D1. Z owns p% of F1, a limited liability company formed in Country. F1 owns p% of F2, another limited liability company formed in Country. The remaining q% of both F1 and F2 is owned by LLC1.

In order to relocate some assets in State1 to State4, X will sell some of its assets to a related entity or distribute those assets to A who will then contribute the assets to a newly formed corporation (which will elect to be taxed as a S corporation). In connection with and prior to the transfer of X assets, in order to avoid State1 franchise taxes and to provide greater flexibility in the current operating structure, the following will occur:

First, Y will organize a State2 limited liability company ("LLC2") and contribute a r% interest in Z. Z will then convert to a limited partnership ("LP1") owned s% by Y as limited partner and r% by LLC2 as general partner.

Second, Y and LLC1 will form a new State2 limited partnership ("LP2") also owned s% by Y as limited partner and r% by LLC2 as general partner. LP1 will transfer its p% interest in F1 to LP2. F1 will then distribute its p% ownership interest in F2 to LP2.

Third, X will merge into Y in a statutory merger, with Y surviving. Taxpayer has represented that this merger will qualify as a statutory merger under section 368(a)(1)(A) of the Code. Y will then contribute all of the assets it received from X to LP1. No election will be made to treat LP1, LP2, or LLC2 as an association under section 301.7701-3(c).

LAW AND ANALYSIS

Ruling 1:

Section 1361(b)(3)(B) of the Code and section 1.1361-2(a) of the Income Tax Regulations provide that the term qualified subchapter S subsidiary (QSUB) means any domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2) and the regulations thereunder), if (1) 100% of the stock of such corporation is held by an S corporation; and (2) the S corporation properly elects to treat the subsidiary as a QSUB. Section 1.1361-2(b) provides that for purposes of satisfying the 100% stock ownership requirement in sections 1361(b)(3)(B)(i) and 1.1361-2(a), stock of a corporation is treated as held by an S corporation if the S corporation is the owner of that stock for Federal income tax purposes. See section 1.1361-2(d) (Examples 2 and 3).

Section 301.7701-3(b)(1)(ii) provides that a domestic eligible entity (a business organization not classified as a corporation under section 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) with a single owner is disregarded as an entity separate from its owner for federal tax purposes unless the entity elects to be treated as a corporation. If the entity is disregarded, its activities are treated in the same manner as those of a division of its owner, and its assets will be treated as those of the owner.

In this case, for Federal income tax purposes, Y will be the owner of any stock in Z that is transferred to LLC2. Accordingly, we conclude that Y's contribution of a r% interest in Z to LLC2 will not cause the termination of Z's QSUB election.

Rulings 2 and 3:

Section 1.1361-5(b)(1) provides that, in general, if a QSUB election terminates under section 1.1361-5(a), the former QSUB is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. Section 1.1361-5(b)(1) also provides that the tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

Section 1.1361-5(b)(3) (Example 2) illustrates the application of step transaction principles to the merger of a QSUB (lower-tier corporation) into a disregarded entity. In that example, the merger of the lower-tier corporation into the limited liability company causes a termination of the lower-tier corporation's QSUB election. The new corporation that is formed as a result of the termination is immediately merged into the limited liability company. Because at the end of the series of transactions, the assets continue to be held by the S corporation for Federal tax purposes, under step transaction principles, the formation of the new corporation and the transfer of assets pursuant to the merger are disregarded.

The conversion under State2 law of Z into LP1, which will be disregarded as an entity separate from Y, will cause a termination of Z's QSUB election without taxable gain or loss being recognized. Because LLC1 is disregarded as an entity separate from its owner, Y, LP1 will be treated as an eligible entity having a single owner and will be disregarded as an entity separate from Y. Because at the end of the series of transactions, the assets continue to be held by Y for Federal tax purposes, under step transaction principles, the formation of a new corporation and the transfer of assets from Z to Y will be disregarded.

Because LLC1 is disregarded as an entity separate from its owner, Y, LP2 will also be treated as an eligible entity having a single owner and will be disregarded as an entity separate from Y.

Ruling 4:

Rev. Rul. 72-526, 1973-2 C.B. 404 provides for the treatment of employer identification numbers ("EIN") for corporations involved in statutory mergers. The Service ruled that if a corporation ("Target") merges into another corporation in a statutory merger, then the EIN previously assigned to Target must be discontinued. The surviving corporation should continue to use its previously assigned EIN. Assuming the merger of X into Y in the present case qualifies under section 368(a)(1)(A), X should discontinue use of its EIN while Y continues to use its EIN.

Ruling 5:

Provided that the statutory merger of X into Y qualifies as a reorganization under section 368(a)(1)(A), the merger (1) will not terminate the election of Y as an S corporation within the meaning of section 1361(a)(1), and (2) will not terminate the election of X as an S corporation within the meaning of section 1361(a)(1) for its final taxable year ending on the effective date of the merger (Rev. Rul. 69-566, 1969-2 C.B. 165; Rev. Rul. 64-94, 1964-1 C.B. 317).

Ruling 6:

As provided by sections 381(c)(2), 1.381(c)(2)-11, and 1.1368-2(d)(2), Y will succeed to and take into account the subchapter C earnings and profits (or deficit in earnings and profits) and the Accumulated Adjustments Account of X as of the date of the merger.

Ruling 7:

Provided that the statutory merger of X into Y qualifies as a reorganization under section 368(a)(1)(A), Y will be subject to the tax on net built-in gains imposed by section 1374 of the Code, as amended by the Tax Reform Act of 1986, for assets held by X as of the beginning of the first taxable year for which X was an S corporation. Y will not recognize any built-in gains tax under section 1374 as a result of the merger. Instead, the section 1374 tax will be imposed on any net unrealized built-in gain attributable to the assets of X acquired in the merger for any taxable year during the applicable recognition period. Section 1.1374-8. X's built-in gain recognition period and remaining built-in gain of X with respect to its assets immediately prior to the merger will remain the same in Y as they were in X immediately prior to the merger. In addition, for purposes of determining the tax imposed under section 1374, a separate determination is made with respect to the assets Y acquired from X from other assets, if any, that Y held immediately before the merger that are subject to the tax under section 1374. Section 1.1374-8.

Except as specifically ruled on above, we express no opinion about the Federal tax consequences of any aspect of the above described transaction. More specifically, no opinion is expressed about the tax characterization of the disposition of X assets prior to its merger. In addition, no opinion is expressed as to whether X and Y met or continue to meet the requirements of section 1361(b) of the Code, or whether either their S elections was terminated under section 1362(d) as a result of events not specifically addressed and ruled on by this letter ruling. Furthermore, no opinion is expressed about whether the merger of X into Y qualifies as a statutory merger under the laws of Delaware, within the meaning of section 368(a)(1)(A).

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 the taxpayer and to the taxpayer's second authorized representative.

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

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

cc: