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Refer Reply To:
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Date:
March 28, 2001

X =

S-1 =

S-2 =

S-3 =

S-4 =

S-5 =

S-6 =

LP-1 =

LP-2 =

LP-3 =

LP-4 =

LP-5 =

This is in reply to a letter dated March 28, 2000, and subsequent correspondence, submitted on behalf of X, requesting rulings under §§ 409, 1361, and 4975 of the Internal Revenue Code.

The information submitted states that X is a closely-held corporation that filed an S corporation election effective January 1, 1998. X is a diversified general contractor that offers plant maintenance services and construction services to various market segments. X has made elections for most of its qualifying subsidiaries to be treated as qualified subchapter S subsidiaries (QSubs) pursuant to § 1361(b).

X maintains two employee stock ownership plans (Plans), each of which is intended to be qualified under §§ 401(a) and 4975(e)(7). The Plans hold voting common stock issued by X, which has no stock that is readily tradable on an established securities market within the meaning of § 409(l). X has only one class of stock, and each share of its common stock has the same voting and dividend rights. Each of X's subsidiaries that has employees has adopted the Plans for the benefit of its employees.

In 1999, X caused several of its QSubs to form state law limited partnerships, LP-1, LP-2, LP-3, LP-4, and LP-5 (Partnerships). Each Partnership is currently inactive and has no assets or employees. Upon the receipt of a favorable ruling, X will cause each Partnership to conduct active business operations and have employees who will be eligible to participate in the Plans. In addition, each Partnership intends to elect to be classified as an association taxable as a corporation pursuant to § 301.7701-3 of the Procedure and Administration Regulations, and X intends to elect to treat each Partnership as a qualified subchapter S subsidiary (QSub) pursuant to § 1361(b)(3).

S-1 is a wholly-owned first-tier subsidiary of X for which an election to be treated as a QSub has been made. S-2 is also a wholly-owned first-tier subsidiary of X for which an election to be treated as a QSub has been made. S-1 and S-2 formed LP-1, a Delaware limited partnership. S-1 is the sole general partner with a one percent interest in LP-1, and S-2 is the sole limited partner with a ninety-nine percent interest in LP-1.

S-1 and S-2 also formed LP-2, a Delaware limited partnership. S-1 is the sole general partner with a one percent interest in LP-2, and S-2 is the sole limited partner with a ninety-nine percent interest in LP-2.

S-3 is a wholly-owned first-tier subsidiary of X for which an election to be treated as a QSub has been made. S-4 is also a wholly-owned first-tier subsidiary of X for which an election to be treated as a QSub has been made. S-3 and S-4 formed LP-3, a Delaware limited partnership. S-3 is the sole general partner with a one percent interest in LP-3, and S-4 is the sole limited partner with a ninety-nine percent interest in LP-3.

S-5 is a wholly-owned first-tier subsidiary of X for which an election to be treated as a QSub has been made. S-6 is also a wholly-owned first-tier subsidiary of X for which an election to be treated as a QSub has been made. S-5 and S-6 formed LP-4, a Delaware limited partnership. S-5 is the sole general partner with a one percent interest in LP-4, and S-6 is the sole limited partner with a ninety-nine percent interest in LP-4.

S-5 and S-6 formed LP-5, a Delaware limited partnership. S-5 is the sole general partner with a one percent interest in LP-5, and S-6 is the sole limited partner with a ninety-nine percent interest in LP-5.

Section 301.7701-2(a) provides that for purposes of § 301.7701-2 and § 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded.

Section 301.7701-2(b)(2) provides that for federal tax purposes, the term corporation means an association (as determined under § 301.7701-3).

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 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides that for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not 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.

Section 1361(b)(2) provides that for purposes of § 1361(b)(1), the term “ineligible corporation” means any corporation which is (A) a financial institution which uses the reserve method of accounting for bad debts described in section 585, (B) an insurance company subject to tax under subchapter L, (C) a corporation to which an election under section 936 applies, or (4) a DISC or former DISC.

Section 1361(b)(3)(A) provides that except as provided in regulations prescribed by the Secretary, for purposes of title 26 (i) a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and (ii) all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S

subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation. See also § 1.1361-4(a) of the Income Tax Regulations.

Section 1361(b)(3)(B) provides that for purposes of section 1361(b)(3), the term "qualified subchapter S subsidiary" means any domestic corporation which is not an ineligible corporation (as defined in section 1361(b)(2)) if (i) 100 percent of the stock of such corporation is held by the S corporation, and (ii) the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

Section 1.1361-4(a)(4) provides that except for purposes of § 1361(b)(3)(B) and § 1.1361-2(a)(1), the stock of a QSub shall be disregarded for all federal tax purposes.

Section 4975(e)(7) provides in pertinent part that an employee stock ownership plan must be designed to invest primarily in "qualifying employer securities" which is defined in § 4975(e)(8) as any employer security within the meaning of § 409(l).

Section 409(l)(1) defines the term "employer securities" as common stock issued by the employer (or by a corporation that is a member of the same controlled group) which is readily tradable on an established securities market.

Section 409(l)(2) states that if there is no common stock which meets the requirements of § 409(l)(1), the term "employer securities" means common stock issued by the employer (or by a corporation which is a member of the same controlled group) having a combination of voting power and dividend rights equal to or in excess of (A) that class of common stock of the employer (or of any other such corporation) having the greatest voting power, and (B) that class of common stock of the employer (or of any other such corporation) having the greatest dividend rights.

Under § 1361(b)(3)(A) and § 1.1361-4, the separate existence of a QSub is disregarded for federal tax purposes such that all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation. In addition, § 1.1361-4 states that except for purposes of § 1361(b)(3)(B)(i) and § 1.1361-2(a)(1) (determining if the parent S corporation owns the requisite stock to make the QSub election), the stock of a QSub shall be disregarded for all Federal tax purposes**.** Accordingly, employees of the QSub are treated as employees of the parent S corporation for purposes of § 409(l)(2).

For purposes of § 301.7701-3, a state law partnership is an eligible entity. Consequently, a state law limited partnership may elect to be classified as a corporation for federal tax purposes. Each Partnership is an eligible entity with X as the single owner because the assets of each QSub (including the state law limited partnership interests) are treated as owned by X.

Accordingly, based on the information and representations provided, we conclude that the Partnerships may elect to be classified as associations taxable as corporations pursuant to § 301.7701-3(c), and X may elect to treat the Partnerships as QSubs under § 1361(b)(3) . Furthermore, if the Partnerships make these elections, X's stock will be "employer securities" within the meaning of §§ 4975(e)(8) and 409(l) with respect to employees of the Partnerships.

This ruling is based on the assumption that the Plans will continue to be otherwise qualified under §§ 401(a) and 4975(e)(7) at all relevant times.

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.

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

Pursuant to a power of attorney on file with this office, a copy of this letter will be sent to X.

Sincerely yours,
JEANNE M. SULLIVAN
Assistant to the Chief,
Branch 2
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for section 6110 purposes