INTERNAL REVENUE SERVICE

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September 27, 2001

W =

X =

Y =

Z =

T =

A =

B =

State =

Date 1 =

Dear :

This is in reply to a letter dated November 6, 2000, submitted on behalf of X.

FACTS

X is a State corporation formed in Date 1. X elected to be an S corporation. The sole shareholder of X is T, a trust.

T is a grantor trust within the meaning of §§ 671 through 678 that is owned by A and B, a married couple in State, a community property state. T will distribute 2.5% of its stock in X each to A and B.

T, A, and B will form Z, a State general partnership, which will file an election to be treated as an association and an election to be taxed as an S corporation. The general partnership agreement provides for distributions of cash from operations and distributions on dissolution to the partners in the same proportion as their interests in the partnership. T, A, and B will contribute their stock in X to Z in exchange for proportionately identical ownership interests in Z, and Z will file an election to treat X as a qualified subchapter S subsidiary (QSub) effective as of the date of contribution.

Thereafter, Z will contribute 1% of its stock in X to W, a newly-formed State limited liability company in exchange for 100% of the ownership interest in W, and X will convert into a limited partnership, Y, under State law. Neither W nor Y will make an election under § 301.7701-3(c) of the Procedure and Administration Regulations.

X represents that the series of transactions through which X is converted to Z, a corporation that owns all of the assets of X through its ownership of Y, a state law limited partnership that is disregarded for federal tax purposes, qualifies as a reorganization under § 368(a)(1)(F).

X asks for rulings that Z is an eligible entity that may elect to be taxed as an association and an S corporation, that X's status as a QSub will not be affected by the formation of W, and that the conversion of X from a QSub to a limited partnership that is disregarded has no federal income tax consequences.

LAW AND ANALYSIS

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

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) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not- (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, 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 1 class of stock.

Section 1361(b)(3)(A) provides that a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation and 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 1361(b)(3)(B) provides that a qualified subchapter S subsidiary is any domestic corporation which is not an ineligible corporation (as defined in § 1361(b)(2)) if (i) 100% 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 1361(b)(3)(C) provides that, when a QSub election terminates, such corporation shall be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such termination from the S corporation in exchange for its stock.

Section 1.1361-2(b)(1) provides that, for purposes of satisfying the 100% stock ownership requirement of § 1361(b)(3)(B)(i), 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.

Section 1.1361-5(b)(1) of the Income Tax Regulations provides that the tax treatment of a QSub termination or of a larger transaction that includes the termination 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 into a disregarded entity. In that example, the merger of the QSub into a limited liability company that is disregarded causes a termination of the 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.

Section 301.7701-3(a) of the Procedure and Administration Regulations 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. An eligible entity with at least two members may 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) provides that, unless the entity elects otherwise, a domestic eligible entity is a partnership if it has two or more members and is disregarded as an entity separate from its owner if it has a single owner. Under § 301.7701-2(a) if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

Section 301.7701-3(c) provides the election procedures for an election to be classified as other than as provided under § 301.7701-3(b).

CONCLUSIONS

Based on the facts submitted and the representations made we conclude that Z is a domestic eligible entity that may elect to be treated as an association. Provided that Z timely elects under § 301.7701-3(c) to be classified as an association and otherwise satisfies the definition of a small business corporation in § 1361(b), Z may elect to be treated as an S corporation under § 1362.

Moreover, Z's transfer of 1% of the stock of X to W, a newly formed limited liability company, in exchange for 100% of the interest in W will not cause a termination of X's QSub election if no election is made under § 301.7701-3(c) to treat W as an association because Z will continue to be treated as owning 100% of X.

Finally, X's merger into Y, a state law limited partnership that is owned 1% by W, an entity wholly owned by Z, and 99% by Z will be disregarded for federal income tax purposes if no election is made under § 301.7701-3(c) to treat W as an association because, at the end of the series of transactions, the assets of X continue to be held by Z for federal tax purposes.

Except as specifically ruled on above, we express no opinion about the federal tax consequences of any aspect of the above described transactions. More specifically, we express no opinion about whether, because of facts not specifically addressed above, Z meets the requirements of § 1361(b) or X is otherwise qualified to be a QSub.

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.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,
JEANNE M. SULLIVAN
Acting Senior Technician
Reviewer, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
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cc: