Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:
March 27, 2002

Legend

X =

Y =

Z =

State =

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Dear

This responds to a letter dated March 26, 2002, together with prior correspondence, requesting rulings under § 1361 of the Internal Revenue Code.

FACTS

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

First, the X shareholders will form Y, a State general partnership. All of the interests in Y will have identical rights to distribution and liquidation proceeds. Y will file an election under § 301.7701-3 of the Procedure and Administration Regulations to be classified as an association taxable as a corporation and will make an S corporation election. Second, the X shareholders will contribute all outstanding X stock to Y. Y immediately will elect to treat X as a qualified subchapter S subsidiary (QSub) under § 1361(b)(3). Third, Y will form Z, a State limited liability company. Z will be

disregarded as an entity separate from its owner under § 301.7701-3. Y will then transfer 1% of X's stock to Z. Fourth, X will convert pursuant to State law from a corporation to a limited partnership. After the conversion, Z will hold a 1% general partner interest, and Y will hold a 99% limited partner interest.

X represents that Y 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 Y.

Y's partnership agreement states that interests in the partnership will be divided into two types of interest. The first type is designated Voting Partnership Units that have full voting rights. The second type is designated Non-Voting Partnership Units. These units may only vote on certain partnership actions enumerated in the partnership agreement.

Y's partnership agreement states that a partner cannot sell, assign, transfer, mortgage, alienate, hypothecate or in any way encumber or dispose of the Partner's units except as provided in the partnership agreement.

Y's partnership agreement states that a partner who desires to dispose of any or all of the Partner's units to a third party, must give written notice to Y setting forth the terms of the offer. Y will have the exclusive option to purchase the units under the same terms, within 30 days. If Y does not purchase the units, Y's option expires and the partner must offer the remaining partners a 30 day option to purchase a proportionate share of the units under the same terms. If the remaining partners do not purchase the units, the partner may sell the units to the third party who will be subject to the terms of the partnership agreement.

Y's partnership agreement states that upon the divorce of a partner whereby the partner is required by judicial decree to transfer all or part of the partner's units to his or her spouse, that partner shall have a 15 day option to purchase all of the units so awarded for a price determined under the partnership agreement. If the partner does not purchase the units, the spouse must offer Y a 30 day option to purchase the units under the same terms. If Y does not purchase the units, Y's option expires and the spouse may hold the units subject to the terms of the partnership agreement.

Y's partnership agreement states that upon the death of a partner's spouse having an interest, community or separate, in the partner's units, the partner shall have a 60 day option to purchase all of the units that are not left to the partner for a price determined under the partnership agreement. If the partner does not purchase the units, the legal representative of the spouse's estate must offer Y a 60 day option to purchase the units under the same terms. If Y does not purchase the units, Y's option expires and the legal representative of the spouse's estate may hold the units subject to the terms of the partnership agreement.

Y's partnership agreement states that upon the death of a partner, Y shall purchase the outstanding partnership units owned by the deceased partner's estate and the deceased partner's spouse for a price determined under the partnership agreement, within 6 months of the partner's death.

Y's partnership agreement states that no partner has the right to withdraw from the partnership until the partnership terminates and its affairs are wound up. Upon wrongful withdrawal, Y will have a one year unilateral option to purchase the withdrawn partner's units for the price determined under the partnership agreement.

Y's partnership agreement states that the purchase price shall be $a for each partnership unit for purposes of the death, divorce and wrongful withdrawal provisions described above. This figure may be redetermined annually by mutual agreement of the selling party and the purchaser. X represents that $a is not significantly in excess of or significantly below the fair market value of each partnership unit.

Y's partnership agreement states that Y shall terminate and wind up upon the vote of two-thirds of the partners, an occurrence of an event that makes it illegal for all or substantially all of the business of the partnership to continue, or a judicial decree. Upon the occurrence of any of those events, Y's assets shall be liquidated and the proceeds shall be distributed in the following order: 1) to satisfy Y's debts to non-partners, 2) to the expenses of liquidation, 3) to the setting up of any reserves for contingencies that the managing board may consider necessary and 4) to the partners, first to satisfy Y's debts to the partners, then among the partners in the same proportion as the partners' partnership units.

Y's partnership agreement states that the managing board may accumulate net profits for use in Y's business or declare and pay out "dividends" from the net profits. "Dividends" will be paid pro-rata based on the partners partnership units. Additionally, Y shall have the first lien on all "dividends" declared on its units for any indebtedness of the respective partner.

Y's partnership agreement provides for an election to be classified as an association taxable as a corporation and for an S corporation election. The agreement restricts transfers of partnership units to any party that is not an eligible S corporation shareholder.

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

LAW

Section 1361(a)(1) defines an "S corporation" as 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 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, a trust described in subsection (c)(2), or an organization described in subsection (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)(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 section 585, (B) an insurance company subject to tax under subchapter L, (C) a corporation to which an election under section 936 applies, or (D) a DISC or former DISC. According to the representations made, Y is not an ineligible corporation as defined in § 1361(b)(2).

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 1361(c)(4) provides that for purposes of subsection (b)(1)(D), a corporation shall not be treated as having more than 1 class of stock solely because there are differences in voting rights among the shares of common stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical right to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock than may vote only on certain issues, irrevocable proxy agreement, or groups of shares that differ with respect to rights to elect members of the board of directors.

Section 1.1361-1(l)(2) provides that the determination of whether all outstanding shares of stock confer identical right to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law and binding agreements relating to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(iii)(A) provides that buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption

agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless -- (1) a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (1), and (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock. Agreements that provide for the purchase or redemption of stock at fair market value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights.

Section 1.1361-1(l)(2)(iii)(B) provides that bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under section 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 section 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 section 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 Y will be eligible to be treated as an S corporation, and Y's partnership agreement will not create a second class of stock.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

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 X is a valid S corporation prior to these transactions. Furthermore, no opinion is expressed on the

effect that any modifications in Y'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 X.

Sincerely,
Matthew Lay
Senior Technician Reviewer
Associate Chief Counsel
(Passthroughs and Special Industries)

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