Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200326024**
Release Date: 6/27/2003
Index Number: 1361.01-04, 1361.05-00

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2-PLR-144764-02
Date:
March 14, 2003

Legend

X =

A =

n% =

State =

Dear :

This responds to a letter dated June 6, 2002, together with subsequent correspondence, requesting rulings as to the federal income tax consequences of a proposed transaction.

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 one shareholder, A. For business reasons, X wants to restructure by undertaking the following transaction.

First, A will organize Y, a new limited liability partnership, and LLC, a new limited liability company under the laws of State. A will be the sole owner of LLC, which will be disregarded as an entity separate from its owner under § 301.7701-3 of the Procedure and Administration Regulations. A will contribute n% of the interest in Y to LLC. Y will file an election under § 301.7701-3 to be classified as an association taxable as a corporation and will make an S corporation election. Both elections will be effective on

the date of Y's formation. Second, A will contribute all outstanding X stock to Y. Y will elect to treat X as a qualified subchapter S subsidiary (QSub) under § 1361(b)(3), effective on the date of the contribution. Third, Y will form Z, a State limited liability company. Y will be the sole owner of Z, which will be disregarded as an entity separate from its owner under § 301.7701-3. Y will then transfer n% of the X 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 n% general partner interest, and Y will hold the remaining limited partner interest. The steps, collectively, are referred to as the "Proposed Transaction."

Y's partnership agreement will provide that distributions will be made in proportion to the number of partnership units owned by the partner to the total number of outstanding partnership units.

Y's partnership agreement will provide that a partner will not have a right to withdraw as defined in the partnership agreement, and that Y may recover damages from a partner who wrongfully withdraws. Additionally, Y's partnership agreement will provide that upon an event of withdrawal with respect to any partner, that partner will automatically become a "special partner." Under the partnership agreement, a special partner will have the same rights to distributions and obligations for capital contributions as the rights and obligations previously held. However, a special partner will only be entitled to vote on certain matters.

Y's partnership agreement will provide that a partner will be prohibited from encumbering or transferring all or any portion of the partner's interest in Y except as provided in the agreement or by written consent of all other partners.

Y's partnership agreement will provide that no partner may make any "voluntary lifetime transfer" other than a transfer pursuant to a bona fide offer. The partner receiving the offer must notify the partnership and each of the other partners of all material information, including the terms and conditions of the offer. This will be treated as an offer to sell the interest to the partnership or its partners at the Agreement Price and Agreement Terms (as defined below). The partnership will have 30 days to purchase any or all of the offered interest. Upon expiration each partner will have 30 days to purchase a either a proportionate share or a share agreed upon by the other partners of the offered interest.

Y's partnership agreement will provide that a partner must notify the partnership and each partner if the partner has information that would reasonably lead the partner to reasonably expect an involuntary lifetime transfer will occur. The notice must state all material information, including the expected terms and conditions of the transfer. This notice will be treated as an offer to sell the interest to the partnership or its partners at the Agreement Price and Agreement Terms (as defined below). The partnership will have 30 days to purchase any or all of the offered interest. Upon expiration each partner will have 30 days to purchase a either a proportionate share or a share agreed upon by the other partners of the offered interest.

Y's partnership agreement will provide that upon death of a partner, that partner's personal representative will be treated as offering to sell the interest to the partnership or its partners at the Agreement Price and Agreement Terms (as defined below). The partnership will have 30 days to purchase any or all of the offered interest. Upon expiration each partner will have 30 days to purchase a either a proportionate share or a share agreed upon by the other partners of the offered interest.

Y's partnership agreement will provide that the Agreement Price shall be fair market value as determined by a certified public accountant regularly employed by the partnership, or if there one is not regularly employed, then by one chosen by the partnership for this purpose. The expense of the valuation shall be borne by the partnership. If the transfer is pursuant to a bona fide offer, the Agreement Price shall be the lesser of the appraisal or the price set forth in the offer. The Agreement Terms in Y's partnership agreement will provide the time, date and manner of payment.

Y's partnership agreement will provide that upon termination of Y, Y's assets will be sold to the extent necessary to pay Y's debts and liabilities. All remaining cash and other property shall be distributed among the partners in accordance with their pro rata share of outstanding partnership units.

X represents that Y will have fewer than 75 owners, none of which would be ineligible to hold stock in an S corporation; that State law does not require different rights to distributions or liquidation proceeds among the owners of Y; that Y's operating agreement will ensure identical rights to distributions and liquidation proceeds; and that the Proposed Transaction will constitute a reorganization under § 368(a)(1)(F).

Law and Analysis

Section 1361(a)(1) of the Internal Revenue Code defines an "S corporation" as a small business corporation for which an election under section 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 will not be an ineligible corporation as defined in § 1361(b)(2).

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(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(c)(4) provides that for purposes of § 1361(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 1363(d)(1) provides if an S corporation was a C corporation for the last taxable year before the first taxable year for which the election under § 1362(a) was effective, and the corporation inventoried goods under the LIFO method for such taxable year, the LIFO recapture amount shall be included in the gross income of the corporation for such last taxable year (and appropriate adjustments to the basis of inventory shall be made to take into account the amount included in gross income under § 1363(d)).

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 § 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 §§ 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, that Y's partnership agreement will not create a second class of stock, and that Y will be eligible to make a QSub election for X. We further conclude that, as provided in § 381 and § 1.381(a)-1, Y will succeed to and take into account those attributes of X described in § 381(c), subject to the provisions and limitations specified in §§ 381, 382, 383 and 384, if applicable, and the regulations thereunder. Moreover, X will not be treated as a C corporation at any time during the proposed transaction. Accordingly, § 1363(d) will not require X to include in its gross income any LIFO recapture amounts for the inventory deemed transferred to Y.

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 the Proposed Transaction, the effect that any modifications in Y's partnership agreement would have under section 1361(b), or whether the Proposed Transaction qualifies as a reorganization under § 368(a)(1)(F).

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's authorized representative.

Sincerely,

Matthew Lay
Senior Technician Reviewer, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

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