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Date:
October 22, 2009

Legend

X =

Y =

Z =

State =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

Dear :

This responds to your letter dated June 5, 2009, and subsequent correspondence, submitted on behalf of X, requesting rulings under §§ 1361 and 368 of the Internal Revenue Code.

Facts

X, a corporation organized under the laws of State, made an election to be treated as an S corporation effective Date 1. Y, a corporation organized under the laws of State, is wholly owned by X. Y was formed in Year 1 and made a Qualified Subchapter S Subsidiary (QSub) Election effective Date 2. In Year 2, X acquired all of the issued and outstanding capital stock of Z and made a QSub Election for Z effective Date 2.

X and Y wish to combine their assets and operations into one corporation to take advantage of planned efficiencies and to reduce expenses and redundancies. Certain legal agreements of Y prohibit Y merging upstream into X, but do not prohibit X from merging downstream into Y. To combine their respective asset and operations, X proposes to merge downstream with and into Y, with Y surviving the merger (the "Merger"). The outstanding shares of X will be exchanged solely for common stock of Y, such that after the Merger, the existing shareholders of X will have an identical ownership interest in Y.

Representations

1. Pursuant to the merger, by operation of State law, the following will occur simultaneously at the effective time of the transaction: (i) all of the assets held by X immediately before the merger and all of the liabilities of X immediately before the merger will become the assets and liabilities of Y, and (ii) X will cease its separate legal existence for all purposes.
2. The fair market value of the shares of Y that the shareholders will receive in the merger will be equal to the fair market value of the X shares that will be converted into the Y shares in connection with the merger.
3. The shareholders will receive no consideration other than the shares of Y in exchange for their X shares.
4. Immediately after X's merger with and into Y, the shareholders will own all of the outstanding shares of Y, and will own such shares solely by reason of their ownership of X shares immediately prior to the merger.
5. Immediately after X's merger into Y, Y will possess all of the assets and liabilities possessed by X immediately prior to the merger, including assets and liabilities that Y held as a QSub immediately prior to the merger. No assets will be distributed in the course of the merger and there will be no dissenting shareholders.
6. The liabilities of X assumed by Y plus the liabilities, if any, to which the transferred assets are subject, were incurred by X in the ordinary course of its business and are associated with the assets transferred.
7. Y has no plan or intention to reacquire any of its stock issued in the merger.
8. Y has no plan or intention to issue additional shares of Y stock following the merger.

9. At the time of the merger, neither X nor Y will have any outstanding warrants, options, convertible securities, or any other type of right pursuant to which any person could acquire an ownership interest in X or Y.
10. Following the merger, Y will continue to conduct the same businesses that X conducted prior to the merger.
11. In connection with the merger, no shareholder will incur any expense.
12. X, Y, and Z are not presently under the jurisdiction of any court in a Title 11 case or similar case within the meaning of § 368(a)(3)(A).

Law and Analysis

Section 1361(a) 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 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, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1362(d)(2) provides that an election under § 1362(a) is terminated whenever at any time on or after the first day of the first taxable year for which the corporation is an S corporation, the corporation ceases to be a small business corporation.

Rev. Rul. 64-250, 1964-2 C.B. 333, holds that a reorganization under § 368(a)(1)(F) did not cause a termination of an election under former § 1372, the predecessor to § 1362. In that revenue ruling, an electing small business corporation within the meaning of former § 1371(b) was reincorporated in another state through the corporation's shareholders organizing a new corporation in the other state and merging the existing corporation into the new corporation. The revenue ruling states that the surviving corporation also met the requirements for qualification as a small business corporation.

Section 1361(b)(3)(B) defines the term “qualified subchapter S subsidiary” as a domestic corporation which is not an ineligible corporation if (1) 100 percent of the stock of the corporation is owned by the S corporation, and (2) the S corporation elects to treat the corporation as a QSub.

Section 1.1361-5(a)(1)(iii) provides that the termination of a QSub election is effective at the close of the day on which an event occurs that renders the subsidiary ineligible for QSub status under § 1361(b)(3)(B).

Section 1.1361-5(b)(1)(i) provides that if a QSub election terminates under paragraph (a) of this section, 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. 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. For purposes of determining the application of § 351 with respect to this transaction, instruments, obligations, or other arrangements that are not treated as stock of the QSub under § 1.1361-2(b) are disregarded in determining control for purposes of § 368(c) even if they are equity under general principles of tax law.

Section 1.1361-5(b)(3), Example 8, provides X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X merges into Y under state law, causing the QSub election for Y to terminate, and Y survives the merger. The formation of the new corporation, Y, and the merger of X into Y can qualify as a reorganization described in § 368(a)(1)(F) if the transaction otherwise satisfies the requirements of that section.

Section 1.1361-5(b)(3), Example 9, provides X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. Z, an unrelated C corporation, acquires 100 percent of the stock of Y. The deemed formation of Y by X (as a consequence of the termination of Y's QSub election) is disregarded for Federal income tax purposes. The transaction is treated as a transfer of the assets of Y to Z, followed by Z's transfer of these assets to the capital of Y in exchange for Y stock. Furthermore, if Z is an S corporation and makes a QSub election for Y effective as of the acquisition, Z's transfer of the assets of Y in exchange for Y stock, followed by the immediate liquidation of Y as a consequence of the QSub election are disregarded for Federal income tax purposes.

Rev. Rul. 2004-85, 2004-2 C.B. 189, holds that an election to treat a wholly owned subsidiary of an S corporation as a QSub, as described in § 1361(b)(3)(B), does not terminate solely because the S corporation engages in a transaction that qualifies as a reorganization under § 368(a)(1)(F).

Rulings

We rule as follows:

1. The merger will constitute as a reorganization under § 368(a)(1)(F).
2. X and Y will each be a “party to a reorganization” under § 368(b).

3. No gain or loss will be recognized by X upon the transfer of its assets to Y in the merger in exchange for the Y stock and the assumption of liabilities (§ 361(a) and § 357(a)).
4. No gain or loss will be recognized by Y upon the receipt of X's assets in exchange for Y stock (§1032(a)).
5. The basis of the assets of X in the hands of Y will be the same as the basis of such assets in the hands of X immediately prior to the merger (§ 362(b)).
6. The holding period of X assets held by Y will include the period during which such assets were held by X (§1223(2)).
7. No gain or loss will be recognized by X shareholders upon their exchange of X shares for Y shares pursuant to the merger (§ 354(a)(1)).
8. The basis of the Y shares received by X shareholders will be equal to the basis of the X shares surrendered in exchange therefore (§ 358(a)(1)).
9. The holding period of the Y shares received by X shareholders will include the period during which X shareholders held the X shares exchanged therefor, provided that the X shares are held as a capital asset on the date of the exchange (§ 1223(1)).
10. The reorganization under § 368(a)(1)(F) will not adversely affect X's status as an S corporation. Accordingly, X's S Corporation election will continue with respect to Y after the merger. See Rev. Rul. 64-250.
11. Z's status as a QSub will not terminate as a result of the Reorganization. See Rev. Rul. 2004-85.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed as to whether the original elections made by X to be an S corporation, or Y and Z to be QSubs, were valid elections under § 1362.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter ruling will be sent to the taxpayer's representative.

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.

Sincerely,

Melissa C. Liquerman
Branch Chief, Branch 2
(Passthroughs & Special Industries)

Enclosures (2)
Copy of Letter
Copy of Letter for § 6110 purposes