Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200628008**
Release Date: 7/14/2006
Index Number: 7701.00-00

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B03
PLR-148137-05
Date: March 28, 2006

Legend

X =

Acquirer =

Target A =

Target B =

State 1 =

State 2 =

Shareholder =

d1 =

$a =

$b =

$c =

Dear :

This letter responds to your letter dated September 19, 2005, and subsequent correspondence, written on behalf of X, requesting a ruling on the proper tax treatment of cash mergers of S corporations into a disregarded entity which is wholly owned by X.

Facts

According to the information submitted, X is a limited liability company taxed as a partnership for federal tax purposes which is incorporated in State 1. Acquirer is a limited liability company wholly owned by X and is classified as an entity that is disregarded as separate from its owner under § 301.7701-3(b)(1)(ii) of the Income Tax Regulations.

X intended to acquire Target A and Target B, both S corporations incorporated under the laws of State 2. On or about d1, Target A and Target B were merged into Acquirer. Shareholder, who was the sole owner of Target A and Target B, received cash in the amount of $a (including liabilities assumed by Acquirer) and a working capital adjustment expected to be no greater than $c for Target A. Shareholder received consideration in the amount of $b (including liabilities assumed by Acquirer) plus potential earn-out consideration and a working capital adjustment expected to be no greater than $c for Target B.

The information submitted represents that the mergers of Target A and Target B into Acquirer will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation of any of the businesses or assets of Target A or Target B. Furthermore, no part of the consideration received by Shareholder is being received by Shareholder is his capacity as a creditor, employee, or any non-shareholder capacity of Target A or Target B.

As a result of the mergers, Target A and Target B will cease to be going concerns. In addition, the fair market values of each of Target A and Target B's assets exceed its liabilities on the date of the adoption of the merger agreement and at the time of the merger. The mergers are also isolated transactions and are not related to any past or future transaction. Target A and Target B have always been S corporations and do not have any potential liability for any tax under § 1374.

Law and Analysis

Section 331(a) of the Internal Revenue Code provides that amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

In Rev. Rul. 69-6, 1969-1 C.B. 104, a state chartered savings and loan association ("State S&L") proposed to merge into a federally chartered non-stock membership savings and loan (Federal S&L"), with the owners of the State S&L receiving mostly cash equivalent consideration from the merger. The Internal Revenue Service ruled that, since the merger of the State S&L into the Federal S&L was a taxable transaction, the merger would be treated as (a) a sale of the State S&L's assets to the Federal S&L, with gain being recognized by the State S&L equal to the difference between the amount of consideration received and the basis of the property transferred to the Federal S&L, followed by (b) a liquidating distribution to the State S&L shareholders pursuant to § 331(a) of the Internal Revenue Code with gain or loss being recognized by the State S&L shareholders equal to the difference between the amount the shareholders received in the distribution and their basis in the State S&L stock.

Section 1362(a)(1) provides that, except as provided in § 1362(g), a small business corporation may elect to be an S corporation.

Section 1362(d) provides that an election under § 1362(a) may be terminated (1) by revocation, (2) by the corporation ceasing to be a small business corporation, and (3) where passive investment income exceeds 25 % of gross receipts for 3 consecutive taxable years and corporation has accumulated earnings and profits. If a corporation's election to be an S corporation terminates under § 1362(d)(2), § 1362(d)(2)(B) provides that the termination is effective on and after the date of cessation.

In Revenue Ruling 64-94, 1964-1 C.B. 317, the Internal Revenue Service held that the merger of an electing small business corporation into another corporation, pursuant to a statutory merger within the meaning of § 368(a)(1)(A) does not terminate its S election. That ruling held that where the event that causes the corporation to be disqualified as a small business corporation also terminates its taxable year, the corporation remains a small business corporation throughout the entire taxable year so terminated.

Section 1366(a)(1) provides that in determining the tax of a shareholder for the shareholder's taxable year in which the S corporation taxable year ends, there shall be taken into account the shareholder's pro-rata share of the corporation's (A) items of income (including tax exempt income), loss, deductions, or credit the separate treatment of which could affect the liability for tax of any shareholder and (B) nonseperately computed income or loss. Section 1366(a)(2) defines "nonseperately computed income or loss" as gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items in § 1366(a)(1)(A).

Section 1366(b) states that the character of any item included in a shareholder's pro rata share under § 1366(a)(1) shall be determined as if such item were realized by the corporation, or incurred in the same manner as incurred by the corporation.

Section 1366(d)(1) provides that the aggregate amount of losses and deductions taken into account by a shareholder under § 1366(a) for any taxable year shall not exceed the sum of (A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of § 1367(a) for the taxable year), and (B) the shareholder's adjusted basis of any indebtness of the S corporation to the shareholder (determined without regard to any adjustment under § 1367(b)(2) for the taxable year).

Section 1367(a)(1) provides that the basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period: (A) the items of income described in § 1366(a)(1)(A), (B) any nonseperately computed income determined under § 1366(a)(1)(B), and (C) the excess of the deductions for depletion over the basis of the property subject to depletion.

Section 1367(a)(2) provides that the basis of each shareholder's stock in the S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period: (A) distributions by the corporation which were not includable in the income of the shareholder by reason of § 1368, (B) the items of loss and deduction described in § 1366(a)(1)(A), (C) any nonseperately computed loss determined under § 1366(a)(1)(B), (D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to the capital account, and (E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under § 613A(c)(11)(B).

Section 1371(a) provides that, except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.

Section 301.7701-1(a)(1) provides that the classification of various organizations for federal tax purposes and whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Section 301.7701-2(a) provides that 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; 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(b)(1) provides that except as provided in § 301.7701-3(b)(3), unless the entity elects otherwise, a domestic eligible entity is- (i) A partnership if it has two or more members; or (ii) Disregarded as an entity separate from its owner if it has a single owner.

Conclusion

Based solely on the facts submitted and representations made, we conclude the following:

1. The mergers of Target A and Target B into Acquirer for cash will be treated for federal income tax purposes as a deemed sale of assets by Target A and Target B to X, followed by the distribution of cash by Target A and Target B to Shareholder in complete liquidation of Target A and Target B.

2. X will have an aggregate basis in the assets deemed acquired equal to the sum of (i) the amount of cash consideration paid by X to Shareholder and (ii) the liabilities of Target A and Target B assumed by Acquirer in the merger.

3. Target A and Target B will recognize gain or loss in an amount equal to the difference between the consideration received from Acquirer and the adjusted basis of the assets transferred to Acquirer, and that the gain or loss will pass through to Shareholder under § 1366(a) as limited by § 1366(d).

4. Gain or loss will be recognized by Target A and Target B on the distribution of property to Shareholder in complete liquidation under § 336. The proceeds of the sale of the assets by Target A and Target B will be treated as distributed by Target A and Target B in complete liquidation of Target A and Target B and will be treated as full payment in exchange for shares of Target A and Target B under § 331. Under § 1001, gain or loss will be recognized by Shareholder measured by the difference between (i) the amount of cash received and (ii) Shareholder's adjusted basis in Target A and Target B stock surrendered (after taking into account any adjustments to Shareholder's basis resulting from the gain or loss recognized by Target A and Target B upon the deemed sale of assets).

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. In particular, no opinion is expressed or implied concerning whether Targets A or B were S corporations or whether § 1374 applies as a result of the taxable sale of their assets to X.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representatives.

This ruling is directed only to the taxpayer who requested it. According to 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

/s/

Jeanne Sullivan
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes