

Part I

Section 368. - Definitions Relating to Corporate Reorganizations

26 CFR 1.368-1: Purpose and scope of exception of reorganization exchanges.

Rev. Rul. 2003-48

ISSUE

What are the tax consequences when, as described in the facts below, a mutual savings bank converts to a stock savings bank?

FACTS

State Y Mutual Bank is a State Y mutual savings bank engaged in banking and banking related activities. State Y Mutual Bank is regulated by State Y, and State Y Mutual Bank's deposits are insured by the FDIC. A membership interest in State Y Mutual Bank arises from the ownership of a bank deposit account in State Y Mutual Bank and is inextricably tied to the bank deposit account from the time of deposit. A membership interest in State Y Mutual Bank entitles the member to vote for the board of directors and to receive assets and other consideration in the event of the liquidation, dissolution, or winding up of State Y Mutual Bank. The rights inherent in each membership interest are created by operation of State Y law solely as a result of the member's ownership of a bank deposit account in State Y Mutual Bank and cannot be transferred separately from that bank deposit account. Further, if a bank deposit

account is surrendered by the member, the membership interest ceases to exist, having no continuing value.

Mutual Holding Company is a State Y mutual bank holding company. A membership interest in Mutual Holding Company arises from the ownership of a bank deposit account in a bank that is a direct or indirect, wholly owned subsidiary of Mutual Holding Company. Such a membership interest is inextricably tied to the bank deposit account from the time of deposit. A membership interest in Mutual Holding Company entitles the member to vote for the board of directors of Mutual Holding Company and to receive assets or other consideration in the event of the liquidation, dissolution, or winding up of Mutual Holding Company. The rights inherent in each membership interest are created by operation of State Y law solely as a result of the member's bank deposit account and cannot be transferred separately from that bank deposit account. Further, if a bank deposit account is surrendered by the member, the membership interest ceases to exist, having no continuing value.

Stock Holding Company is a State Y stock company the articles of incorporation and by-laws of which authorize the issuance of capital stock. Stock Holding Company has one class of voting stock outstanding.

Transitory is a transitory State Y stock savings bank.

Each transaction described below is undertaken for a valid business purpose.

Situation 1. Pursuant to State Y law and pursuant to an integrated business plan to convert State Y Mutual Bank from a State Y-chartered mutual savings bank to a State Y-chartered stock savings bank and create a holding company structure, the following events occur. State Y Mutual Bank incorporates Mutual Holding Company for the sole purpose of engaging in the following transactions. Mutual Holding Company initially is organized in stock form. Although Mutual Holding Company is temporarily organized as a stock corporation solely due to regulatory requirements, the parties intend at the time Mutual Holding Company is organized that Mutual Holding Company will operate and

function in mutual form. In turn, Mutual Holding Company incorporates two wholly owned subsidiaries, Stock Holding Company and Transitory. Thereafter, the following events occur substantially contemporaneously: State Y Mutual Bank exchanges its State Y mutual bank charter for a State Y stock savings bank charter (which permits the bank to issue equity interests in the form of stock) and changes its name to Stock Bank; Mutual Holding Company cancels its outstanding stock and exchanges its charter for a State Y mutual holding company charter; and Transitory merges with and into Stock Bank with Stock Bank surviving as a wholly owned subsidiary of Mutual Holding Company and State Y Mutual Bank's members receiving Mutual Holding Company membership interests in place of their former State Y Mutual Bank membership interests. Mutual Holding Company then transfers all of its Stock Bank stock to Stock Holding Company in exchange for voting stock of Stock Holding Company. Pursuant to the same plan, Stock Holding Company issues more than 20 percent but less than 50 percent of its common stock to the public in a qualified underwriting transaction as defined in § 1.351-1(a)(3) (the "Stock Offering").

Under State Y law, Stock Bank's corporate existence as a stock savings bank is a continuation of State Y Mutual Bank's corporate existence as a mutual savings bank.

Situation 2. The facts are the same as in Situation 1, except that Stock Holding Company issues no more than 20 percent of its common stock in the Stock Offering.

LAW

Section 351(a) provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation.

Section 1.351-1(a)(3) of the Income Tax Regulations provides that, for purposes of § 351, if a person acquires stock of a corporation from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires stock from the

underwriter is treated as transferring cash directly to the corporation in exchange for stock of the corporation and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory.

Section 354(a) provides that, in general, no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Section 368(a)(1)(A) states that the term "reorganization" means a statutory merger or consolidation. Section 368(a)(2)(E) provides that a transaction otherwise qualifying under § 368(a)(1)(A) will not be disqualified by reason of the fact that stock of a corporation (the "controlling corporation") that before the merger was in control of the merged corporation is used in the transaction, if (1) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction), and (2) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation that constitutes control of such corporation (the control-for-voting-stock requirement).

Section 368(a)(1)(B) provides that the term reorganization means the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

For purposes of §§ 368(a)(1)(B) and 368(a)(2)(E), control is defined in § 368(c).

Section 368(c) defines the term "control" to mean the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 368(a)(1)(E) provides that the term reorganization includes a recapitalization. In Helvering v. Southwest Consol. Corp., 315 U.S. 194, 202 (1942), the Supreme Court defined a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation."

Section 368(a)(1)(F) provides that the term reorganization means a mere change in identity, form, or place of organization of one corporation, however effected.

Section 368(a)(2)(C) states, in relevant part, that a transaction otherwise qualifying under § 368(a)(1)(A) or 368(a)(1)(B) will not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock.

Section 1.368-2(k)(1) of the Income Tax Regulations restates the general rule of § 368(a)(2)(C) but permits the assets or stock acquired in certain types of reorganizations, including reorganizations under § 368(a)(1)(A) or (B), to be successively transferred to one or more corporations controlled (as defined in § 368(c)) in each transfer by the transferor corporation without disqualifying the reorganization. Additionally, § 1.368-2(k)(2) provides that a transaction qualifying under §§ 368(a)(1)(A) and 368(a)(2)(E) is not disqualified by reason of the fact that part or all of the stock of the surviving corporation is transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation.

Generally, to qualify as a reorganization under § 368(a)(1), a transaction must satisfy the continuity of business enterprise (COBE) requirement. Section 1.368-1(d)(1) provides that COBE requires the issuing corporation (generally the acquiring corporation) in a potential reorganization to either continue the target corporation's

historic business or use a significant portion of the target's historic business assets in a business. Pursuant to § 1.368-1(d)(4)(i), the issuing corporation is treated as holding all of the businesses and assets of all members of its qualified group. Section 1.368-1(d)(4)(ii) defines a qualified group as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of § 368(c) in at least one other corporation, and stock meeting the requirements of § 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations. Continuity of business enterprise is not required for a recapitalization to qualify as a reorganization under § 368(a)(1)(E). See Rev. Rul. 82-34, 1982-1 C.B. 59.

Generally, to qualify as a reorganization under § 368(a)(1), a transaction must satisfy the continuity of interest requirement. Section 1.368-1(e)(1)(i) provides that continuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved. Continuity of interest is not a requirement for reorganizations under § 368(a)(1)(E). See Rev. Rul. 77-415, 1977-2 C.B. 311.

In Paulsen v. Commissioner, 469 U.S. 131 (1985), a state-chartered stock savings and loan association merged into a federally-chartered non-stock mutual savings and loan association. The stockholders exchanged all of their stock in the state-chartered stock savings and loan association for passbook savings accounts and certificates of deposit in the federally-chartered non-stock mutual savings and loan association. The Supreme Court determined that the passbooks and certificates of deposit in the federally-chartered non-stock mutual savings and loan association had a predominantly cash-equivalent component and an insubstantial equity component. Because the passbooks and certificates of deposit essentially represented cash with an

insubstantial equity component, the Court held that the transaction did not satisfy the continuity of interest requirement and, therefore, did not qualify as a tax-free reorganization.

In Rev. Rul. 69-3, 1969-1 C.B. 103, X, a mutual savings and loan association, merged into Y, another mutual savings and loan association. In the merger, Y issued to each share account holder of X a share account equal to the dollar amount evidenced by such holder's passbook. Because the share account holders of X received proprietary interests in Y that were equivalent to their equity interests in X before the exchange, the exchange was solely an equity-for-equity exchange that satisfied the continuity of interest requirement. Accordingly, the Service ruled that the transaction qualified as a tax-free reorganization under § 368(a)(1)(A).

ANALYSIS

Situation 1. Because Stock Bank is a continuation of State Y Mutual Bank under State Y law, the conversion from State Y Mutual Bank to Stock Bank qualifies as a reorganization under § 368(a)(1)(E) as well as a reorganization under § 368(a)(1)(F). Because Stock Bank is a continuation of State Y Mutual Bank, tax attributes of State Y Mutual Bank (such as a bad debt reserve maintained under § 585 and a suspended reserve described in § 593(g)(2)(A)(ii)) continue as tax attributes of Stock Bank. Finally, neither the subsequent transfer of Stock Bank stock to Stock Holding Company nor the Stock Offering prevents the conversion from qualifying as a reorganization under § 368(a)(1)(E) as well as a reorganization under § 368(a)(1)(F). See § 1.368-1(e)(1); Rev. Rul. 96-29, 1996-1 C.B. 50; Rev. Rul. 77-415, 1977-2 C.B. 311.

Because the status of Mutual Holding Company as a stock holding company is transitory, the conversion of Mutual Holding Company from a stock holding company to a mutual holding company is disregarded.

Because the former owners of the bank are in control (within the meaning of § 368(c)) of Mutual Holding Company, their transfer of their equity interests in the bank

to Mutual Holding Company, in exchange for membership interests in Mutual Holding Company, qualifies as a transfer described in § 351. Furthermore, that transaction qualifies as a transfer described in § 351, even though Mutual Holding Company transfers all of its Stock Bank stock to Stock Holding Company. See Rev. Rul. 77-449, 1977-2 C.B. 110; Rev. Rul. 83-34, 1983-1 C.B. 79. However, the same transaction (in which Transitory merges into Stock Bank) does not qualify as a reorganization either under §§ 368(a)(1)(A) and 368(a)(2)(E) or under § 368(a)(1)(B) because at the end of the planned series of transactions Stock Holding Company is not a controlled corporation.

Finally, Mutual Holding Company's contribution of the stock of Stock Bank to Stock Holding Company in exchange for Stock Holding Company's voting stock constitutes a transfer described in § 351. The subsequent Stock Offering by Stock Holding Company does not prevent the transaction from qualifying as a transfer described in § 351 because the persons to whom the stock is issued pursuant to the Stock Offering, together with Mutual Holding Company, are transferors to Stock Holding Company under § 351. See § 1.351-1(a)(3).

Situation 2. For the reasons described in the analysis of Situation 1, the conversion from State Y Mutual Bank to Stock Bank qualifies as a reorganization under § 368(a)(1)(E) as well as a reorganization under § 368(a)(1)(F). Because Stock Bank is a continuation of State Y Mutual Bank, tax attributes of State Y Mutual Bank (such as a bad debt reserve maintained under § 585 and a suspended reserve described in § 593(g)(2)(A)(ii)) continue as tax attributes of Stock Bank.

Because the status of Mutual Holding Company as a stock holding company is transitory, the conversion of Mutual Holding Company from a stock holding company to a mutual holding company is disregarded.

For the reasons described in Situation 1, the exchange by the former bank owners of their equity interests in the bank for membership interests in Mutual Holding

Company qualifies as a transfer described in § 351.

In addition, each of the membership interests in State Y Mutual Bank and Mutual Holding Company constitutes a proprietary interest in the entities that is treated as voting stock for Federal income tax purposes. See Rev. Rul. 69-3, 1969-1 C.B. 103. Because Mutual Holding Company acquires, in exchange solely for membership interests in Mutual Holding Company, the actual stock of Stock Bank, and, immediately after that acquisition Mutual Holding Company controls Stock Bank, that acquisition qualifies as a reorganization under § 368(a)(1)(B), provided that the continuity of business enterprise and continuity of interest requirements are satisfied. Because Stock Bank continues to provide the same services as State Y Mutual Bank after the transactions described herein, the continuity of business enterprise requirement is satisfied. See § 1.368-1(d)(1). In addition, the acquisition satisfies the continuity of interest requirement because, in the overall transaction, the State Y Mutual Bank members receive Mutual Holding Company membership interests in place of their former Mutual Bank membership interests. See Rev. Rul. 69-3; cf. Paulsen v. Commissioner, 469 U.S. 131 (1985). Thus, the acquisition qualifies as a reorganization within the meaning of § 368(a)(1)(B). Moreover, neither the subsequent transfer by Mutual Holding Company of Stock Bank stock to Stock Holding Company nor the Stock Offering prevents the acquisition from qualifying as a reorganization under § 368(a)(1)(B). See § 368(a)(2)(C); § 1.368-1(d)(4)(i); § 1.368-2(k).

For purposes of § 354, the former State Y Mutual Bank's members' exchange of their ownership interests for Mutual Holding Company's membership interests is pursuant to that reorganization.

In addition, the merger of Transitory into Stock Bank qualifies as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(E) because the owners of the bank exchanged, for membership interests in Mutual Holding Company, an amount of stock in the bank that constitutes control of Stock Bank. Neither the subsequent transfer by Mutual Holding

Company of the Stock Bank stock to Stock Holding Company nor the Stock Offering (of no more than 20 percent of the stock of Stock Holding Company) prevents the merger from so qualifying. See § 1.368-2(k).

Furthermore, for the reasons described in Situation 1, Mutual Holding Company's contribution of the stock of Stock Bank to Stock Holding Company in exchange for Stock Holding Company's voting stock constitutes a transfer described in § 351.

The analyses in Situations 1 and 2, in general, would also apply if State Y Mutual Bank and Stock Bank were incorporated in different jurisdictions. However, in that case, the conversion would not qualify as a reorganization under § 368(a)(1)(E), but would qualify as a reorganization under § 368(a)(1)(F). In a reorganization under § 368(a)(1)(F), Stock Bank takes into account the items of State Y Mutual Bank as provided in § 381.

HOLDING

This revenue ruling describes the tax consequences that occur when, as described in the facts set forth in this ruling, a mutual savings bank converts to a stock savings bank.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Jeffrey B. Fienberg and Emidio J. Forlini, Jr., of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact either Mr. Fienberg or Mr. Forlini at (202) 622-7930 (not a toll-free call).