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Date:

December 7, 1999

Legend:

A =

B =

C =

X =

Y =

Z =

D1 =

D2 =

D3 =

D4 =

D5 =

State =

This responds to your letter dated June 11, 1999, submitted on behalf of Z, requesting rulings as to Z's acquisition of the stock of two S corporations and contemplated Qualified Subchapter S Subsidiary (QSUB) elections for the acquired companies.

FACTS

X was incorporated under the laws of State on D1 and is a solvent S corporation. X elected S corporation status effective D4. Y was incorporated under the laws of State

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on D2 and is a solvent S corporation. Y elected S corporation status effective D5. Z was incorporated under the laws of State on D3 and is a solvent S corporation. Z was formed to acquire the stock of X and Y pursuant to a plan of liquidation. A, B, and C own all of the shares of X, Y, and Z.

A, B, and C propose to transfer all of their shares in X and Y to Z. Effective the same day as the above transfer of shares, it is anticipated that Z will make QSUB elections for X and Y.

Z has made the following representations:

- (a) To the best of Z's knowledge and belief, the transfer of X common stock in exchange for voting and non-voting common stock of Z and the transfer of Y common stock in exchange for voting and non-voting stock of Z qualify under § 351 of the Internal Revenue Code.
- (b) At the time of the proposed QSUB elections, Z will own 100% of both X and Y.
- (c) No shares of X or Y stock will have been redeemed during the 3 years preceding the adoption of the plan of complete liquidation of X and Y.
- (d) Neither X nor Y will have acquired assets in any nontaxable transaction at any time, except for acquisitions occurring more than 3 years prior to the date of adoption of the plan of liquidation.
- (e) No assets of X or Y have been, or will be, disposed of by X, Y or Z except for dispositions in the ordinary course of business and dispositions occurring more than 3 years prior to adoption of the plan of liquidation.
- (f) The liquidation of X and Y will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation (Recipient) of any of the businesses or assets of X or Y, if persons holding, directly or indirectly, more than 20 percent in value of the X and Y stock also hold, directly or indirectly, more than 20 percent in value of the stock in Recipient. For purposes of this representation, ownership will be determined by application of the constructive ownership rules of § 318(a) as modified by § 304(c)(3).
- (g) Prior to the adoption of the plan of liquidation, no assets of X will have been distributed in kind, transferred, or sold to Z, except for (i) transactions occurring in the normal course of business; and (ii) transactions occurring more than three years prior to adoption of the plan of liquidation.
- (h) Prior to the adoption of the plan of liquidation, no assets of Y will have been

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distributed in kind, transferred, or sold to Z, except for (i) transactions occurring in the normal course of business; and (ii) transactions occurring more than three years prior to adoption of the plan of liquidation.

- (i) The fair market value of the assets of X and Y will exceed their liabilities both at the date of the adoption of the plan of complete liquidation and immediately prior to the time the first liquidating distribution is made.
- (j) There is no intercorporate debt existing between Z and either X or Y and none has been canceled, forgiven, or discounted.
- (k) Z is not and will not be an organization that is exempt from federal income tax under § 501 or any other provision of the Code.
- (l) There is no plan or intention by the shareholders of X, each of whom own 1 percent or more of the X stock, to sell, exchange or otherwise dispose of a number of shares of Z stock received in the transaction that would reduce the shareholders' ownership of Z stock to a number of shares having a value, as of the date of the transaction, of less than 50 percent of the value of all the formerly outstanding stock of X as of the same date. For purposes of this representation, shares of X stock exchanged for cash or other property, surrendered by dissenters or exchanged for cash in lieu of fractional shares of Z stock will be treated as outstanding X stock on the date of the transaction. Moreover, shares of Y stock and shares of Z stock held by X shareholders and otherwise sold, redeemed, or disposed of prior or subsequent to the transaction will be considered in making this representation.
- (m) The fair market value of the Z stock received by the shareholders of X in exchange for their X stock will be approximately equal to the fair market value of the X stock surrendered in the exchange.
- (n) Z will acquire at least 90% of the fair market value of the net assets and at least 70% of the fair market value of the gross assets held by X immediately prior to the transaction. For purposes of this representation, amounts used by X to pay its reorganization expenses, and any redemptions and distributions (excluding regular, normal dividends) made by X immediately preceding the transfer will be included as assets of X held immediately before the transaction.
- (o) After the transaction, the shareholders of X will be in control of Z within the meaning of § 368(a)(2)(H).
- (p) Z has no plan or intention to reacquire any of its stock issued in the proposed transactions.

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- (q) Z has no plan or intention to sell or otherwise dispose of any of the assets of X acquired in the proposed transactions except for dispositions made in the ordinary course of business.
- (r) The liabilities of X that will be assumed by Z in the proposed transactions and the liabilities to which the transferred assets of X are subject, were incurred in the ordinary course of their business.
- (s) Following the proposed transactions, Z will continue the historic business of X or use a significant portion of X's historic business assets in a business.
- (t) At the time of the proposed transactions, Z will not have outstanding any warrants, options, convertible securities, or any other type of right pursuant to which any person could acquire stock in Z that, if exercised or converted, could affect the acquisition of "control" of Z by the former shareholders of X within the meaning of § 368(a)(2)(H).
- (u) Z and X will pay their respective expenses, if any, incurred in connection with the transactions.
- (v) X is not under the jurisdiction of a court in a Title 11 or similar case within the meaning of § 368(a)(3)(A).
- (w) The fair market value of the assets of X transferred to Z will equal or exceed the sum of the liabilities assumed by Z, plus the amount of liabilities if any, to which the transferred assets are subject.
- (x) The total adjusted basis of the assets of X to be transferred to Z will equal or exceed the sum of the liabilities, if any, to which the transferred assets are subject.
- (y) There is no plan or intention by the shareholders of Y, each of whom own 1 percent or more of the Y stock, to sell, exchange or otherwise dispose of a number of shares of Z stock received in the transaction that would reduce the shareholders' ownership of Z stock to a number of shares having a value, as of the date of the transaction, of less than 50 percent of the value of all the formerly outstanding stock of Y as of the same date. For purposes of this representation, shares of Y stock exchanged for cash or other property, surrendered by dissenters or exchanged for cash in lieu of fractional shares of Z stock will be treated as outstanding Y stock on the date of the transaction. Moreover, shares of Y stock and shares of Z stock held by Y shareholders and otherwise sold, redeemed, or disposed of prior or subsequent to the transaction will be considered in making this representation.
- (z) The fair market value of the Z stock received by the shareholders of Y in exchange

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for their Y stock will be approximately equal to the fair market value of the Y stock surrendered in the exchange.

- (aa) Z will acquire at least 90% of the fair market value of the net assets and at least 70% of the fair market value of the gross assets held by Y immediately prior to the transaction. For purposes of this representation, amounts used by Y to pay its reorganization expenses, and any redemptions and distributions (excluding regular, normal dividends) made by Y immediately preceding the transfer will be included as assets of Y held immediately before the transaction.
- (bb) After the transaction, the shareholders of Y will be in control of Z within the meaning of § 368(a)(2)(H).
- (cc) Z has no plan or intention to sell or otherwise dispose of any of the assets of Y acquired in the proposed transactions, except for dispositions made in the ordinary course of business.
- (dd) The liabilities of Y assumed by Z in the proposed transactions and the liabilities to which the transferred assets of Y are subject, were incurred in the ordinary course of their business.
- (ee) Following the proposed transactions, Z will continue the historic business of Y or use a significant portion of Y's historic business assets in a business.
- (ff) Z and Y will pay their respective expenses, if any, incurred in connection with the transactions.
- (gg) At the time of the proposed transactions, Z will not have outstanding any warrants, options, convertible securities, or any other type of right pursuant to which any person could acquire stock in Z that, if exercised or converted, could affect the acquisition of "control" of Z by the former shareholders of Y within the meaning of § 368(a)(2)(H).
- (hh) The fair market value of the assets of Y transferred to Z will equal or exceed the sum of the liabilities assumed by Z, plus the amount of liabilities if any, to which the transferred assets are subject.
- (ii) The total adjusted basis of the assets of Y to be transferred to Z will equal or exceed the sum of the liabilities, if any, to which the transferred assets are subject.
- (jj) Y is not under the jurisdiction of a court in a Title 11 or similar case within the meaning of § 368(a)(3)(A).

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- (kk) No two parties to the transaction are investment companies within the meaning of § 368(a)(2)(F)(iii) and (iv).

LAW AND ANALYSIS

Section 381(a) provides that in the case of the acquisition of assets of a corporation by another corporation in a distribution to such other corporation to which § 332 applies, or in a transfer to which § 361 applies, but only if the transfer is in connection with a reorganization described in subparagraphs (A), (C), (D), (F), or (G) of § 368(a)(1), the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in § 381(c) of the distributor or transferor corporation, subject to the conditions and limitations specified in § 381(b) and (c).

Section 381(c) delineates the items referred to in § 381(a). These items include the subchapter C earnings and profits of the distributor or transferor corporation as described in § 381(a). §§ 381(c)(2), 1.381(c)(2)-1.

Section 1.381(a)-(1)(a) of the Income Tax Regulations provides that a corporation which acquires the assets of another corporation in certain liquidations and reorganizations shall succeed to, and take into account, as of the close of the date of distribution or transfer, the items described in § 381(c) of the distributor or transferor corporation. These items are taken into account by the acquiring corporation subject to the conditions and limitations specified in §§ 381, 382(b), and 383 and the regulations thereunder.

Section 1361(b)(3)(A) provides that a corporation which is a qualified subchapter S subsidiary (QSUB) shall not be treated as a separate corporation and all of its assets, liabilities, and items of income, deduction, and credit shall be treated as the assets, liabilities, and such items (as the case may be) 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. The statutory provision does not, however, provide guidance on the manner in which the QSUB election is made or the effective date of the election. The legislative history to the act provides "if an election is made to treat an existing corporation (whether or not its stock was acquired from another person or previously held by the corporation) as a qualified subchapter S subsidiary, the subsidiary will be deemed to have liquidated under §§ 332 and 337 immediately before the election is effective." H.R. Rep. No. 586, 104th Cong. 2d Sess. 89 (1996), 1996-3 C.B. 331, 427.

On January 13, 1997, the Service published Notice 97-4, 1997-1 C.B. 351, providing a temporary procedure for making a QSUB election. Under Notice 97-4, a taxpayer makes a QSUB election with respect to a subsidiary by filing Form 966, subject to certain

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modifications, with the appropriate service center. The election may be effective on the date Form 966 is filed or up to 75 days prior to the filing of the form, provided that date is not before the parent's first taxable year beginning after December 31, 1996, and that the subsidiary otherwise qualifies as a QSUB for the entire period for which the retroactive election is in effect.

Section 1223(2) provides that the holding period for property however acquired includes the period for which such property was held by any other person, if such property has for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

Section 1374 provides that for any taxable year beginning in the recognition period an S corporation has a net recognized built-in gain, there is a tax imposed on the income of such corporation for such taxable year.

Section 1.1374-8(b) provides that a separate determination of tax is made with respect to the assets the S corporation acquires in one § 1374(d)(8) transaction from the assets the S corporation acquires in another § 1374(d)(8) transaction and from the assets the corporation held when it became an S corporation.

CONCLUSION

Based solely on the facts submitted and the representations made, we rule as follows:

- 1) Neither Z, X, nor the shareholders of X will recognize gain or loss as a result of the transactions in which the shareholders of X will transfer all of their shares in X to Z in exchange for Z stock, followed by the QSUB election for X.
- 2) Neither Z, Y, nor the shareholders of Y will recognize gain or loss as a result of the transactions in which the shareholders of Y will transfer all of their shares in Y to Z in exchange for Z stock, followed by the QSUB election for Y.
- 3) The basis of the assets of X in the hands of Z shall be the same as the basis of the assets in the hands of X.
- 4) The basis of the assets of Y in the hands of Z shall be the same as the basis of the assets in the hands of Y.
- 5) The holding period of the assets of X in the hands of Z includes the period which the assets were held by X. Section 1223(2).

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- 6) The holding period of the assets of Y in the hands of Z includes the period which the assets were held by Y. Section 1223(2).
- 7) Pursuant to § 381(a) and § 1.381(a)-(1), Z will succeed to and take into account those attributes of X and Y described in § 381(c), subject to the provisions and limitations specified in §§ 381, 382, 383, and 384, if applicable, and the regulations thereunder.
- 8) As provided by §§ 381(c)(2) and 1.381(c)(2)-1, Z will succeed to and take into account the subchapter C earnings and profits (or deficit in earnings and profits) of X and Y as of the dates of the respective QSUB elections.
- 9) Z is subject to the built-in gains tax of § 1374 with respect to the assets it is deemed to receive from X pursuant to the QSUB election for X. See § 1.1374-8(b) (relating to the separate determination of tax for the assets of X). For federal tax purposes, including the built-in gains tax of § 1374, X shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of X shall be treated as assets, liabilities, and such items (as the case may be) of Z (§ 1361(b)(3)(A)).
- 10) Neither X or Y shall be considered a “C” corporation for any period of time as a result of the transfer of its stock from its current shareholders to Z.

Except as specifically set forth above, no opinion is expressed as to the federal tax consequences of the transaction described above under any other provision of the Internal Revenue Code. Specifically, no opinion is expressed on whether the transaction is characterized as a § 368(a)(1)(D) reorganization or a § 332 liquidation.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Daniel J. Coburn
Assistant to the Branch Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2

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