

Internal Revenue Service

Department of the Treasury

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Parent =

Target 1 =

Target 2 =

Subsidiary =

Merger Sub 1 =

Merger Sub 2 =

State X =

Business Y =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

This responds to your May 5, 1999 request for rulings as to the federal income tax consequences of a proposed transaction. The information submitted in that request and in letters dated June 28 and August 4, 1999, is substantially as set forth below.

On Date 1 (a date prior to January 1, 1987), Target 1, a State X subchapter C corporation, elected to be taxed as a subchapter S corporation. On Date 2, Target 2, a State X subchapter C corporation, elected to be taxed as a subchapter S corporation. Target 2 holds assets subject to the tax imposed on certain built-in gains under § 1374 of the Code. Neither Target 1 nor Target 2 had previously elected to be taxed as subchapter S corporations. Target 1 and Target 2 each own 50 percent of Subsidiary, a State X subchapter C corporation. Target 1, Target 2, and Subsidiary have tax years ending December 31 and use the accrual method of accounting. There is significant overlap in the shareholders of Target 1 and Target 2.

Parent was incorporated in State X by Targets 1 and 2 on Date 3, and elected to be taxed as a subchapter S corporation as of that date. Parent has formed Merger Sub 1 and Merger Sub 2 as State X subchapter C corporations in order to effectuate the transactions described below. Parent, Merger Sub 1, and Merger Sub 2 have tax years ending December 31 and use the accrual method of accounting.

Pursuant to the Merger Agreement entered into on Date 4, Merger Sub 1 will merge with Target 1, with Target 1 surviving and the shareholders of Target 1 will receive Parent stock in exchange for their Target 1 stock. Also pursuant to the Merger Agreement, Merger Sub 2 will merge with Target 2, with Target 2 surviving and the shareholders of Target 2 will receive Parent stock in exchange for their Target 2 stock. As a result, Target 1 and Target 2 will become wholly owned subsidiaries of Parent. The mergers will be effective on Date 5. After Parent acquires all of the stock of Targets 1 and 2, Targets 1 and 2 will distribute all of the stock of Subsidiary to Parent.

Also effective as of Date 5, Parent will elect to treat Target 1, Target 2, and Subsidiary as Qualified Subchapter S Subsidiaries (the "QSub Elections") as defined in § 1361(b)(3)(B).

The following representations have been made with respect to the proposed transaction:

- (a) To the best of the taxpayers' knowledge and belief, the merger of Merger Sub 1 with and into Target 1 qualifies as a reorganization under § 368(a)(1)(A), by virtue of § 368(a)(2)(E).
- (b) To the best of the taxpayers' knowledge and belief, the merger of Merger Sub 2 with and into Target 2 qualifies as a reorganization under § 368(a)(1)(A), by virtue of § 368(a)(2)(E).
- (c) On the date the Target 1 QSub Election is made, and at all times until the deemed liquidation is completed, Parent will be the owner of at least 80 percent of the outstanding stock of Target 1.
- (d) On the date the Target 2 QSub Election is made, and at all times until the deemed liquidation is completed, Parent will be the owner of at least 80 percent of the outstanding stock of Target 2.
- (e) On the date the Subsidiary QSub Election is made, and at all times until the deemed liquidation is completed, Parent will be the owner of at least 80 percent of the outstanding stock of Subsidiary.
- (f) No shares of Target 1 stock will have been redeemed during the three years preceding the adoption of the plan of liquidation.
- (g) No shares of Target 2 stock will have been redeemed during the three years preceding the adoption of the plan of liquidation.
- (h) No shares of Subsidiary stock will have been redeemed during the three years preceding the adoption of the plan of liquidation.
- (i) For federal tax purposes, Target 1 will not retain any assets following the deemed liquidation of Target 1.
- (j) For federal tax purposes, Target 2 will not retain any assets following the deemed liquidation of Target 2.
- (k) For federal tax purposes, Subsidiary will not retain any assets following the deemed liquidation of Subsidiary.
- (l) Target 1 will not have acquired assets in any nontaxable transactions at any time after the date of its acquisition by Parent, and Target 1 will not have acquired assets in any nontaxable transactions except for acquisitions occurring more

- than three years prior to the date that parent makes the QSub Election for Target 1.
- (m) Target 2 will not have acquired assets in any nontaxable transactions at any time after the date of its acquisition by Parent, and Target 2 will not have acquired assets in any nontaxable transactions except for acquisitions occurring more than three years prior to the date that parent makes the QSub Election for Target 2.
 - (n) Subsidiary will not have acquired assets in any nontaxable transactions at any time after the date of its acquisition by Parent, and Subsidiary will not have acquired assets in any nontaxable transactions except for acquisitions occurring more than three years prior to the date that parent makes the QSub Election for Subsidiary.
 - (o) No assets of Target 1 have been or will be disposed of by Target 1 or Parent except for dispositions in the ordinary course of business and dispositions occurring more than three years prior to Parent's QSub Election with respect to Target 1.
 - (p) No assets of Target 2 have been or will be disposed of by Target 2 or Parent except for dispositions in the ordinary course of business and dispositions occurring more than three years prior to Parent's QSub Election with respect to Target 2.
 - (q) No assets of Subsidiary have been or will be disposed of by Subsidiary or Parent except for dispositions in the ordinary course of business and dispositions occurring more than three years prior to Parent's QSub Election with respect to Subsidiary.
 - (r) The deemed liquidation of Target 1 will not be preceded by, nor will it be followed by, the reincorporation in, or transfer or sale to, a recipient corporation of any of the businesses or assets of Target 1, if persons holding, directly or indirectly, more than 20 percent in value of the stock of the Target 1 also hold, directly or indirectly, more than 20 percent in the value of the stock in Target 1 recipient. For purposes of this representation, ownership is determined by application of the constructive ownership rules of § 318(a), as modified by § 304(c)(3).
 - (s) The deemed liquidation of Target 2 will not be preceded by, nor will it be followed by, the reincorporation in, or transfer or sale to, a recipient corporation of any of the businesses or assets of Target 2, if persons holding, directly or indirectly, more than 20 percent in value of the stock of the Target 2 also hold, directly or indirectly, more than 20 percent in the value of the stock in Target 2 recipient.

For purposes of this representation, ownership is determined by application of the constructive ownership rules of § 318(a), as modified by § 304(c)(3).

- (t) The deemed liquidation of Subsidiary will not be preceded by, nor will it be followed by, the reincorporation in, or transfer or sale to, a recipient corporation of any of the businesses or assets of Subsidiary, if persons holding, directly or indirectly, more than 20 percent in value of the stock of the Subsidiary also hold, directly or indirectly, more than 20 percent in the value of the stock in Subsidiary recipient. For purposes of this representation, ownership is determined by application of the constructive ownership rules of § 318(a), as modified by § 304(c)(3).
- (u) Prior to making the QSub Election with respect to Target 1, no assets of Target 1 will be distributed in kind, transferred, or sold to Parent, except for (i) transactions occurring in the normal course of business and (ii) transactions occurring more than three years prior to making the QSub Election with respect to Target 1.
- (v) Prior to making the QSub Election with respect to Target 2, no assets of Target 2 will be distributed in kind, transferred, or sold to Parent, except for (i) transactions occurring in the normal course of business and (ii) transactions occurring more than three years prior to making the QSub Election with respect to Target 2.
- (w) Prior to making the QSub Election with respect to Subsidiary, no assets of Subsidiary will be distributed in kind, transferred, or sold to Parent, except for (i) transactions occurring in the normal course of business and (ii) transactions occurring more than three years prior to making the QSub Election with respect to Subsidiary.
- (x) The fair market value of the assets of Target 1 will exceed its liabilities both on the date the QSub Election is made and immediately prior to the time the deemed liquidation of Target 1 takes place.
- (y) The fair market value of the assets of Target 2 will exceed its liabilities both on the date the QSub Election is made and immediately prior to the time the deemed liquidation of Target 2 takes place.
- (z) The fair market value of the assets of Subsidiary will exceed its liabilities both on the date the QSub Election is made and immediately prior to the time the deemed liquidation of Subsidiary takes place.
- (aa) There is no intercorporate debt existing between Parent and Target 1, and none has been canceled, forgiven, or discounted.

- (bb) There is no intercorporate debt existing between Parent and Target 2, and none has been canceled, forgiven, or discounted.
- (cc) There is no intercorporate debt existing between Parent and Subsidiary, and none has been canceled, forgiven, or discounted.
- (dd) Parent is not an organization that is exempt from federal income tax under § 501 or any other provision of the Code.
- (ee) The fair market value of the Parent stock received by each Target 1 shareholder will be approximately equal to the fair market value of the Target 1 stock surrendered in the exchange.
- (ff) The fair market value of the Parent stock received by each Target 2 shareholder will be approximately equal to the fair market value of the Target 2 stock surrendered in the exchange.
- (gg) There is no plan or intention by the shareholders of Target 1 who own one percent or more of the Target 1 stock, and to the best of the knowledge of the management of Target 1, there is no plan or intention on the part of the remaining shareholders of Target 1 to sell, exchange, or otherwise dispose of a number of shares of Parent stock received in the transaction that would reduce the Target 1 shareholders' ownership of Parent 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 formerly outstanding stock of Target 1 as of the same date. For purposes of this representation, shares of Target 1 stock exchanged for cash or other property, surrendered by dissenters or exchanged for cash in lieu of fractional shares of Parent stock will be treated as outstanding Target 1 stock on the date of the transaction. Moreover, shares of Target 1 stock and shares of Parent stock held by Target 1 shareholders and otherwise sold, redeemed, or disposed of prior or subsequent to the transaction will be considered in making this representation.
- (hh) There is no plan or intention by the shareholders of Target 2 who own one percent or more of the Target 2 stock, and to the best of the knowledge of the management of Target 2, there is no plan or intention on the part of the remaining shareholders of Target 2 to sell, exchange, or otherwise dispose of a number of shares of Parent stock received in the transaction that would reduce the Target 2 shareholders' ownership of Parent 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 formerly outstanding stock of Target 2 as of the same date. For purposes of this representation, shares of Target 2 stock exchanged for cash or other property, surrendered by dissenters or exchanged for cash in lieu of fractional shares of Parent stock will be treated as outstanding Target 2 stock on

the date of the transaction. Moreover, shares of Target 2 stock and shares of Parent stock held by Target 2 shareholders and otherwise sold, redeemed, or disposed of prior or subsequent to the transaction will be considered in making this representation.

- (ii) Parent will acquire at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by Target 1 immediately prior to the transaction. For purposes of this representation, amounts paid by Target 1 to dissenters, amounts paid by Target 1 to shareholders who receive cash or other property, amounts used by Target 1 to pay its reorganization expenses, and all redemptions and distributions (except for regular, normal dividends) made by Target 1 immediately preceding the transfer will be included as assets of Target 1 held immediately prior to the transaction.
- (jj) Parent will acquire at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by Target 2 immediately prior to the transaction. For purposes of this representation, amounts paid by Target 2 to dissenters, amounts paid by Target 2 to shareholders who receive cash or other property, amounts used by Target 2 to pay its reorganization expenses, and all redemptions and distributions (except for regular, normal dividends) made by Target 2 immediately preceding the transfer will be included as assets of Target 2 held immediately prior to the transaction.
- (kk) After the transaction, the shareholders of Target 1 will be in control of Parent within the meaning of § 368(a)(2)(H) of the Code.
- (ll) After the transaction, the shareholders of Target 2 will be in control of Parent within the meaning of § 368(a)(2)(H) of the Code.
- (mm) Parent has no plan or intention to reacquire any of its stock issued in the transactions.
- (nn) Parent has no plan or intention to sell or otherwise dispose of any of the assets of Target 1 acquired in the transaction, except for dispositions made in the ordinary course of business.
- (oo) Parent has no plan or intention to sell or otherwise dispose of any of the assets of Target 2 acquired in the transaction, except for dispositions made in the ordinary course of business.

- (pp) The liabilities of Target 1 assumed by Parent plus the liabilities, if any, to which the transferred assets are subject were incurred by Target 1 in the ordinary course of its business and are associated with the assets transferred.
- (qq) The liabilities of Target 2 assumed by Parent plus the liabilities, if any, to which the transferred assets are subject were incurred by Target 2 in the ordinary course of its business and are associated with the assets transferred.
- (rr) Following the transaction, Parent will continue the historic business of Target 1 or use a significant portion of Target 1's historic business assets in a business.
- (ss) Following the transaction, Parent will continue the historic business of Target 2 or use a significant portion of Target 2's historic business assets in a business.
- (tt) At the time of the transaction, Parent will not have outstanding any warrants, options, convertible securities, or any other type of right pursuant to which any person could acquire stock in Parent that, if exercised or converted, would affect the Target 1 shareholders' acquisition or retention of control of Parent, as defined in § 368(a)(2)(H) of the Code.
- (uu) At the time of the transaction, Parent will not have outstanding any warrants, options, convertible securities, or any other type of right pursuant to which any person could acquire stock in Parent that, if exercised or converted, would affect the Target 2 shareholders' acquisition or retention of control of Parent, as defined in § 368(a)(2)(H) of the Code.
- (vv) Parent, Target 1, and the shareholders of Target 1 will pay their respective expenses, if any, incurred in connection with the transaction.
- (ww) Parent, Target 2, and the shareholders of Target 2 will pay their respective expenses, if any, incurred in connection with the transaction.
- (xx) There is no intercorporate indebtedness existing between Parent and Target 1 that was issued, acquired, or will be settled at a discount.
- (yy) There is no intercorporate indebtedness existing between Parent and Target 2 that was issued, acquired, or will be settled at a discount.
- (zz) No two parties to the transactions are investment companies as defined in § 368(a)(2)(F)(iii) and (iv) of the Code.
- (aaa) The fair market value of the assets of Target 1 transferred to Parent will equal or exceed the sum of the liabilities assumed by Parent plus the amount of liabilities, if any, to which the transferred assets are subject.

- (bbb) The fair market value of the assets of Target 2 transferred to Parent will equal or exceed the sum of the liabilities assumed by Parent plus the amount of liabilities, if any, to which the transferred assets are subject.
- (ccc) The total adjusted basis of the assets of Target 1 transferred to Parent will equal or exceed the sum of the liabilities to be assumed by Parent, plus the amount of liabilities, if any, to which the transferred assets are subject.
- (ddd) The total adjusted basis of the assets of Target 2 transferred to Parent will equal or exceed the sum of the liabilities to be assumed by Parent, plus the amount of liabilities, if any, to which the transferred assets are subject.
- (eee) Target 1 is not under the jurisdiction of a court in a Title 11 or similar case within the meaning of § 368(a)(3)(A) of the Code.
- (fff) Target 2 is not under the jurisdiction of a court in a Title 11 or similar case within the meaning of § 368(a)(3)(A) of the Code.

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

- (1) Neither Parent, Target 1 nor the Target 1 shareholders will recognize gain or loss as a result of the transaction in which Merger Sub 1 merges with and into Target 1 followed by the QSub election of Target 1.
- (2) Neither Parent, Target 2 nor the Target 2 shareholders will recognize gain or loss as a result of the transaction in which Merger Sub 2 merges with and into Target 2 followed by the QSub election of Target 2.
- (3) Upon Parent's election to treat Subsidiary as a QSub, Subsidiary will be treated as though it liquidated into Parent immediately prior to the effective date of the election in a transaction under §§ 332 and 337 of the Code. No gain or loss will be recognized by Parent or Subsidiary in connection with the Election.
- (4) Parent is subject to the built-in gains tax of § 1374 with respect to the assets it is deemed to receive from Target 2 and Subsidiary pursuant to the QSub Elections for Target 2 and Subsidiary. See § 1.1374-8(b) (relating to the separate determination of tax for the assets of Target 2 and Subsidiary). For federal tax purposes, including the built-in gains tax of § 1374, Target 2 and Subsidiary shall not be treated as separate corporations, and all assets, liabilities, and items of income, deduction, and credit of Target 2 and Subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of Parent (§ 1361(b)(3)(A)). Target 2's built-in gain recognition period and Target 2's remaining built-in gain with respect to Target 2's assets prior to the merger will

remain the same in Parent as they were in Target 2 immediately prior to the transactions described above.

- (5) Pursuant to § 381(a) and § 1.381(a)-(1), Parent will succeed to and take into account those attributes of Target 1, Target 2, and Subsidiary described in § 381(c), subject to the provisions and limitations specified in §§ 381, 382, 383, and 384, if applicable, and the regulations thereunder.
- (6) As provided by §§ 381(c)(2), 1.381(c)(2)-1, and 1.1368-2(d)(2), Parent will succeed to and take into account the subchapter C earnings and profits (or deficit in earnings and profits) and the Accumulated Adjustments Account of Target 1, Target 2, and Subsidiary as of the dates of the respective QSub elections.

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above rulings.

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

It is important to attach a copy of this letter to the federal income tax returns of the taxpayers involved for the taxable year in which the transactions covered by this ruling are consummated.

Pursuant to a power of attorney on file in this office, a copy of this letter has been sent to the taxpayer.

Sincerely yours,

Assistant Chief Counsel (Corporate)

By *Ken Cohen*

Ken Cohen

Senior Technical Reviewer, Branch 3