

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
December 4, 2000

Parent =

Sub 1 =

Sub 2 =

Foundation =

New Sub 1 =

State X =

State Y =

Litigants =

Business A =

Date 1 =

a =

b =

c =

d =

e =

f =
g =
h =
i =

This letter responds to your letter dated May 17, 2000, requesting rulings as to the federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated August 2, August 23, October 13, October 25, October 31, November 16, November 22, and December 1, 2000. The information submitted for consideration is summarized below.

Parent (a licensed Business A company) is a State X nonprofit non-stock health services corporation that is subject to income tax under the Internal Revenue Code. Parent is authorized to issue various forms of Business A products. Parent is the common parent of an affiliated group that files a consolidated return and includes Sub 1 and Sub 2. Business A assets cannot be lawfully held by an unlicensed Business A company.

Sub 1 (an unlicensed Business A company) is a State X general business corporation. Sub 1 has two classes of stock outstanding – class A common stock (“Class A Stock”) and class B common stock (“Class B Stock”). Class A Stock is publicly traded on a recognized national stock exchange. Each share of Class A Stock is entitled to h vote per share, and each share of Class B Stock is entitled to i votes per share. Parent owns all of the outstanding Class B Stock, representing approximately a percent of the value and b percent of the vote of all outstanding Sub 1 shares (a and b are each more than 80 percent). The outstanding Class A Stock represents approximately c percent of the value and d percent of the vote of all outstanding Sub 1 shares and is held predominantly by the public (“Sub 1 Public Shareholders”).

Sub 2 (a licensed Business A company) is a State X general business corporation. Sub 2 has a single class of common stock outstanding all of which is owned by Sub 1. Sub 2 is authorized to issue various forms of Business A products. Sub 2 has been owned by Sub 1 since Year 1 and has been included in the Parent consolidated federal income tax return as a Business A company subject to Subchapter L. The taxpayer has represented that Sub 2 is not, has never been and will not be, an organization subject to section 833 of the Code.

Foundation is a newly-created nonprofit public benefit corporation established by State X pursuant to the settlement agreement between the Litigants, Parent and Sub 1 (“Settlement Agreement”). Foundation is a section 501(c)(4) organization. Foundation owns all of the outstanding stock of New Sub 1 (an unlicensed Business A company), a newly-created State Y corporation with no business operations and formed to effect the

proposed transaction described below.

For what are represented to be valid business reasons and pursuant to the Settlement Agreement, Parent wishes to convert to a State X for-profit stock corporation as part of a larger integrated transaction (“Reorganization”) as follows:

- (i) Parent will transfer certain assets (excluding patents, patent applications, copyrights, franchises, trademarks, trade names or stock of another corporation being transferred), liabilities, contracts, and agreements relating to Business A to Sub 2 with an aggregate value equal to the sum of (i) 100 percent of the estimated Business A liabilities, and (ii) an amount, if any, necessary for Sub 2 to meet reserve requirements (“Transfer and Assumption Transaction”).
- (ii) Parent will amend its Articles of Incorporation to convert from a State X nonprofit non-stock health services corporation to a State X for-profit stock corporation (“New Parent”) (“Charter Conversion Transaction”). As a result, Parent will cease to exist as a licensed Business A Company. In the Charter Conversion Transaction, New Parent (an unlicensed Business A company) will issue one share of stock to Foundation (“Prime New Sub 1 Share”), which then will be the sole shareholder of New Parent.
- (iii) New Parent will be reincorporated under the corporate laws of the State Y by means of a merger of New Parent with and into New Sub 1 in accordance with State X and State Y corporate law, with New Sub 1 surviving (as a wholly-owned subsidiary of Foundation) (“Reincorporation Merger Transaction”). In the Reincorporation Merger Transaction, the Prime New Sub 1 Share owned by Foundation will remain issued and outstanding, and the share of New Parent stock owned by Foundation will be canceled. New Parent’s directors and officers will resign, and New Sub 1’s directors and officers will continue.
- (iv) Sub 1 will merge upstream into New Sub 1 in accordance with State X and State Y corporate law, with New Sub 1 surviving in a transaction intended to qualify as both a merger under section 368(a)(1)(A) of the Code and a complete liquidation under sections 332(a) and 337 of the Code (“Sub 1/New Sub 1 Merger Transaction”). Each outstanding share of Sub 1 Class A stock, other than shares for which dissenter’s rights have been perfected, will be converted into one share of New Sub 1 stock. All outstanding Sub 1 Class B stock, and any Sub 1 stock held as treasury shares, will be canceled. The Prime New Sub 1 Share held by Foundation will be converted into the right to receive a number of shares of New Sub 1 stock equal to the number of Sub 1 Class B shares outstanding prior to the merger. As a result, New Sub 1 will not issue to any party either fractional shares of New Sub 1 stock, or cash in lieu of

fractional shares of New Sub 1 stock. Outstanding options for Sub 1 Class A stock will be converted into options for an equal number of shares of New Sub 1 stock. After the Sub 1/New Sub 1 Merger Transaction, the Sub 1 Public Shareholders will own approximately c percent of the outstanding shares of New Sub 1 common stock, and Foundation will own approximately a percent (more than 80 percent) of the outstanding shares of New Sub 1 common stock. Unlike the Sub 1 Class B Stock, which has i votes per share, each share of the New Sub 1 common stock will have h vote per share. Therefore, the Sub 1 Public Shareholders will have approximately c percent of the voting power of New Sub 1 and Foundation will have approximately a percent of the voting power of New Sub 1. The Foundation has authorized and directed New Sub 1 to issue all but e percent of the shares of New Sub 1 stock issuable in exchange for the one outstanding share of New Sub 1 stock held by Foundation directly to the trustee of a voting trust ("Voting Trust").

- (v) Pursuant to the Settlement Agreement, all but e percent of the shares of New Sub 1 owned by Foundation will be transferred to the Voting Trust, and all of the shares of New Sub 1 held by Foundation and the Voting Trust will be liquidated with the proceeds applied to the purposes stated in Foundation's charter documents. After the Reorganization, New Sub 1 will have certain options and rights of first refusal to repurchase its shares from Foundation in one or more transactions that may require the prior approval of the State X agency which regulates Business A companies. The Board of Directors of Foundation independently will decide whether to accept or reject any offer to acquire the stock of New Sub 1. No member of the Board of Directors of Foundation will be an officer, agent, employee, director, or independent contractor of New Sub 1, or any governmental authority.
- (vi) On the Closing Date, Parent will pay to Foundation the amount of \$f cash in partial satisfaction of claims by various parties that Parent has a public purpose obligation, which amount is to be used by Foundation to carry out its stated purpose. After consummation of the Reorganization, New Sub 1 will pay to Foundation \$g cash in partial satisfaction of any obligation Parent may have incurred under the State X statutes resulting from the conversion of Parent from a nonprofit non-stock health services corporation to a for-profit stock corporation, as described above under the Charter Conversion Transaction.

The taxpayer has made the following representations regarding the Transfer and Assumption Transaction:

- (a) No stock or securities will be issued for services rendered to or for the benefit of the transferee in connection with the proposed transaction, and

no stock or securities will be issued for indebtedness of the transferee that is not evidenced by a security or for interest on indebtedness of the transferee which accrued on or after the beginning of the holding period of the transferor for the debt. See section 351(d) of the Code.

- (b) The proceeds received in collection of the income items will be included as ordinary income in computing the taxable income of the transferee(s). (Rev. Rul. 80-198, 1980-2 C.B. 113).
- (c) The transfer is not the result of the solicitation by a promoter, broker, or investment house.
- (d) The transferor will not retain any rights in the property transferred to the transferee.
- (e) The value of the stock deemed received in exchange for accounts receivable will be equal to the net value of the accounts transferred, i.e., the face amount of the accounts receivable previously included in income less the amount of the reserve for bad debts. See Rev. Rul. 78-280, 1978-2 C.B. 139.
- (f) With respect to the larger transaction, shareholders of the acquired corporation (Sub 1) will receive, in exchange for their stock of the acquired corporation, stock of the acquiring corporation (New Sub 1) equal, in the aggregate, to a number of shares having a value, as of the date of the exchange, of at least 50 percent of the value of all of the formerly outstanding stock of the acquired corporation as of the same date.
- (g) There is no plan or intention on the part of the shareholders of the acquired corporation (Sub 1) to sell or otherwise dispose of a number of shares of stock of the acquiring corporation (New Sub 1) to be received in the transaction that would reduce such shareholders' ownership to a number of shares having, in the aggregate, a value of less than 50 percent of the total fair market value of the acquired corporation's stock outstanding as of the effective date of the proposed transaction.
- (h) There have not been any significant changes in the stock ownership of the acquired corporation (Sub 1) in the last five years that would cause the continuity of interest requirement not to be satisfied.
- (i) The adjusted basis and the fair market value of the assets to be transferred by the transferor to the transferee will, in each instance, be equal to or exceed the sum of the liabilities to be assumed by the transferee plus any liabilities to which the transferred assets are subject. See section 357(c) of the Code.

- (j) The liabilities of the transferor to be assumed by the transferee were incurred in the ordinary course of business and are associated with the assets to be transferred. See section 357(b) of the Code.
- (k) As a result of the transaction, there is no indebtedness between the transferee and the transferor and there will be no indebtedness created in favor of the transferor.
- (l) The transfers and exchanges will occur under a plan agreed upon before the transaction in which the rights of the parties are defined. See section 1.351-1(a)(1) of the Income Tax Regulations.
- (m) All exchanges will occur on approximately the same date.
- (n) There is no plan or intention on the part of the transferee to redeem or otherwise reacquire any stock or indebtedness deemed to be issued in the proposed transaction.
- (o) Taking into account any issuance of additional shares of transferee stock; any issuance of stock for services; the exercise of any transferee stock rights, warrants, or subscriptions; a public offering of transferee stock; and the sale, exchange, transfer by gift, or other disposition of any of the stock of the transferee to be received in the exchange, the transferor will be in "control" of the transferee within the meaning of section 368(c) of the Code. See Rev. Rul. 59-259, 1959-2 C.B. 115, and section 1.351-1(a)(1) of the Regulations.
- (p) The transferor will be deemed to receive stock, securities or other property approximately equal to the fair market value of the property transferred to the transferee or for services rendered or to be rendered for the benefit of the transferee.
- (q) The transferee will remain in existence and retain and use the property transferred to it in a trade or business.
- (r) There is no plan or intention by the transferee to dispose of the transferred property other than in the normal course of business operations.
- (s) Each of the parties to the transaction will pay its or his/her own expenses, if any, incurred in connection with the proposed transaction, except Sub 2 is not paying any expenses.

- (t) The transferee will not be an investment company within the meaning of section 351(e)(1) of the Code and section 1.351-1(c)(1)(ii) of the Regulations.
- (u) The transferor is not under the jurisdiction of a court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) and the stock or securities received in the exchange will not be used to satisfy the indebtedness of such debtor. See section 351(e) of the Code.
- (v) The transferee will not be a "personal service corporation" within the meaning of section 269A of the Code.

The taxpayer has made the following representations regarding the Charter Conversion Transaction:

- (aa) For purposes of State X corporate law, Parent and New Parent will be the same legal entity both before and after the Charter Conversion Transaction.
- (bb) The Charter Conversion Transaction will occur under a plan of reorganization agreed upon before the transaction.
- (cc) Each party to the Charter Conversion Transaction will pay its own expenses, if any, incurred in connection with the Charter Conversion Transaction.
- (dd) After the effective time of the Charter Conversion Transaction, New Parent and its affiliated subsidiaries will continue to conduct the business operations that Parent and its affiliated subsidiaries conducted immediately prior to the effective time of the Charter Conversion Transaction.
- (ee) The Charter Conversion Transaction is not part of a plan to periodically increase the proportionate interest of any shareholder in the assets or earnings and profits of Parent.
- (ff) Parent is not under the jurisdiction of a court in a Title 11 or similar case within the meaning of section 368(a)(3)(A) of the Code.
- (gg) Upon completion of the Reorganization, none of Foundation, Parent, New Parent, or New Sub 1 will have entered into negotiations to sell or otherwise transfer the New Sub 1 stock issued to Foundation.
- (hh) Foundation has no current plan or intention to sell the New Sub 1 stock to New Sub 1, or any corporation related to New Sub 1.

Based solely on the information submitted and the representations set forth above, we hold as follows:

- (1) For federal income tax purposes, Steps (i) through (iv) above will be characterized as follows: (i) Charter Conversion Transaction; (ii) Reincorporation Merger Transaction; (iii) Sub 1/New Sub 1 Merger Transaction; and (iv) Transfer and Assumption Transaction as if directly between New Sub 1 and Sub 2.

Based solely on the information submitted and the representations set forth above, we hold as follows with respect to the Charter Conversion Transaction:

- (2) The conversion of Parent from a non-stock nonprofit corporation to a for-profit stock corporation will constitute a reorganization within the meaning of section 368(a)(1)(E) of the Code.
- (3) Parent will be a “party to the reorganization” within the meaning of section 368(b) of the Code.
- (4) No gain or loss will be recognized by Parent (or New Parent) (section 1032; Rev. Rul. 94-45, 1994-2 C.B. 39).
- (5) No gain or loss will be recognized by Foundation on its receipt of New Parent shares in connection with the Charter Conversion Transaction (section 354 of the Code).

Based solely on the information submitted and the representations set forth above, we hold as follows with respect to the Transfer and Assumption Transaction:

- (6) New Sub 1’s transfer of the Business A to Sub 2 in a exchange for a constructive issuance of stock of Sub 2 and Sub 2’s actual assumption of certain liabilities in the Transfer and Assumption Transaction will qualify as a tax-free transfer under section 351 of the Code. Accordingly, New Sub 1 will not recognize gain or loss on the transfer (*Lessinger v. Commissioner*, 872 F.2d 519 (2nd Cir. 1989); Rev. Rul. 94-45, 1994-2 C.B. 39).
- (7) No gain or loss will be recognized by Sub 2 on its receipt of Business A in constructive exchange for additional shares of Sub 2 stock (section 1032(a); Rev. Rul. 94-45, 1994-2 C.B. 39).
- (8) The basis of the Sub 2 stock deemed to be received by New Sub 1 will equal the basis of all the assets transferred to Sub 2 decreased by the amount of liabilities assumed by Sub 2, and increased by the amount of

gain (if any) recognized by New Sub 1 (sections 358(a)(1), 358(a)(1)(A)(ii) and 358(d)).

- (9) The holding period of the Sub 2 shares deemed to be received by New Sub 1 will include the period during which the assets exchanged therefor were held by New Sub 1, provided the assets so exchanged were capital assets or property described in section 1231 of the Code (section 1223(1)).
- (10) The basis of the Business A in the hands of Sub 2 following the transfers will equal the basis of Business A in the hands of New Sub 1 immediately prior to the asset transfers, increased by the amount of gain (if any) recognized by New Sub 1 on the exchange (section 362(a)).
- (11) The holding period of Business A in the hands of Sub 2 will, in each instance, be the same as the holding period of Business A in the hands of New Sub 1 (section 1223(2)).

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.

In particular, no ruling was requested and no opinion is expressed as to the tax consequences of (1) the Reincorporation Merger Transaction described in Step (iii); (2) the Sub 1/New Sub 1 Merger Transaction described in Step (iv); (3) the disposition of Foundation's interest in New Sub 1 as described in Step (v); and (4) Parent's payments of \$f and \$g to Foundation described in Step (vi).

This ruling letter 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. A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

The rulings contained in this letter are predicated on upon the facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for a ruling. Verification of the factual information, representations, and other data may be required as part of the audit process.

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

Sincerely yours,
Associate Chief Counsel (Corporate)

By Mark S. Jennings
Chief, Branch 1