Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:2-PLR-117503-98
Date:
February 9, 1999

X =

Y =

Z =

A =

Date 1 =

Date 2 =

Dear :

This responds to a letter dated September 9, 1998, submitted on behalf of X by its authorized representative, requesting a ruling under § 1361(b)(1)(D) of the Internal Revenue Code.

A, vice president of X, represents that X filed an election to be treated as an S corporation and that X for periods ending on or before the consummation of the transaction described below had filed its federal income tax returns as an S corporation. Y is a C corporation. Z is a wholly owned subsidiary of Y.

On Date 1, X and the shareholders of X entered into a merger agreement with Y. On Date 2, pursuant to the terms of the merger agreement, Z merged into X, with X being the surviving corporation.

In the transaction, the shareholders of X sold their X stock to Y for cash. A represents that, for federal income tax purposes, the merger constituted a "reverse subsidiary cash merger." The merger agreement provides that the consideration

paid for the X stock will consist of a fixed component and a contingent component that is based on X's performance. The shareholders of X will each receive their pro-rata share of the fixed consideration and the contingent consideration based on their stock ownership of X.

Y desires to make an election under § 338(h)(10). The merger agreement provides that, if an election under § 338(h)(10) is made, the shareholders of X will each receive a payment to compensate them for any increased liability for federal and state income taxes or a reduction in selling price that results from the § 338(h)(10) election. The amount of these payments, per share of X stock, will vary among the shareholders.

A represents that X and X's shareholders are not related to Y or Z and that the merger agreement between X, X's shareholders and Y results from arm's length negotiations between X, X's shareholders and Y. A further represents that the merger agreement is not designed or intended to circumvent or otherwise violate the one class of stock requirement of § 1361(b)(1)(D).

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for that year.

Section 1361(b)(1) defines the term "small business corporation" as a domestic corporation that is not an ineligible corporation and that, among other things, does not have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that, except as provided in § 1.1361-1(l)(4)(relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to liquidation and distribution proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements (collectively, the governing provisions).

Section 338(a) permits certain qualified stock purchases to be treated as asset acquisitions if certain requirements are met. Section 1.338(h)(10)-1(a) provides that if a § 338(h)(10) election is made, the sale of target stock in the qualified stock

purchase generally is ignored and target generally is deemed to sell all of its assets and distribute the proceeds in complete liquidation.

Based on the representation that the shareholders of X sold their stock in X to Y for fair market value pursuant to an agreement negotiated at arm's length with Y, we conclude that solely for purposes of determining whether X has only one class of stock within the meaning of § 1361(b)(1)(D), the transaction will be treated as a sale of stock by the shareholders of X to Y, and not as a liquidating distribution of assets by X to its shareholders, even though Y and X propose to make a § 338(h)(10) election. Accordingly, X will not be treated as having a second class of stock by reason of the unequal payments to the shareholders of X by Y and the § 338(h)(10) election.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the above-described facts under any other provision of the Code. Specifically, no opinion is expressed or implied concerning whether X's S corporation election was a valid election under § 1362, the validity of the § 338(h)(10) election by X and Y, or the appropriate tax consequences of this transaction to either X, the shareholders of X, or Y.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

J. THOMAS HINES
Senior Technician Reviewer,
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy of this letter

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