

MEMO# 2301

November 1, 1990

IRS PRIVATE LETTER RULING APPLYING IRS NOTICE 88-19 (TAXING BUILT-IN GAINS OF NONRIC MERGED INTO RIC)

- 1 - November 1, 1990 TO: TAX MEMBERS NO. 47-90 ACCOUNTING/TREASURERS MEMBERS NO. 22-90 RE: IRS PRIVATE LETTER RULING APPLYING IRS NOTICE 88-19 (TAXING BUILT-IN GAINS OF NONRIC MERGED INTO RIC)

As you may know, the so-called General Utilities rule, that generally permitted liquidating corporations to distribute appreciated property to shareholders without incurring a corporate level tax, was repealed by the Tax Reform Act of 1986. In addition, the Treasury Department was given regulatory authority under Code section 337(d) to ensure that the corporate-level tax on distributions of appreciated property could not be avoided through the transfer of such property to pass-through entities such as regulated investment companies ("RICs"). In 1988, the IRS issued Notice 88-19, which describes in general terms the regulations the IRS plans to issue under section 337(d). (See Institute Memorandum to Tax Members No. 9-88, dated February 12, 1988.) Pursuant to Notice 88-19, if a Subchapter C corporation (or "NONRIC") either becomes a RIC by qualification under Subchapter M or transfers its assets to a RIC in a carryover basis transaction, the NONRIC can either recognize currently any net built-in gain on its assets or defer recognition of those gains under rules similar to those in section 1374 for Subchapter S corporations. If deferral is chosen, tax liability on the net built-in gains arises only to the extent and at the time that the RIC disposes of the assets which contained the built-in gains. Furthermore, if the RIC holds the assets with built-in gains for 10 years or more, no corporate-level tax would be imposed on the built-in gains, so long as those gains are distributed to shareholders. The attached private letter ruling addresses for the first time how Notice 88-19 and rules similar to those in section 1374 will apply to the merger of a NONRIC into a RIC. The facts involved are as follows. NONRIC will dispose of any assets other than cash and marketable securities prior to the merger of NONRIC into RIC. Pursuant to the plan of reorganization, RIC and NONRIC - 2 - will enter into an escrow agreement whereby the shareholders of 11/ Hereafter, the term "built-in gain" refers to any gain attributable to any asset of the NONRIC in an amount not greater than the unrealized gain on the date that asset was transferred by NONRIC to RIC. - 3 - NONRIC will keep in escrow for up to 10 years RIC shares with a value of 125 percent of the estimated remaining built-in gain tax liability. The escrow agent will liquidate a portion of the assets pro rata from the escrow account of each exchanging shareholder to the extent necessary to pay any built-in gain tax owed by the RIC on the sale of assets previously held by NONRIC. The ruling sets forth a statement that will constitute a valid and effective election to be subject to rules similar to the rules of section 1374. In addition, the ruling includes the following holdings: 1) NONRIC will not be subject to tax on the unrecognized gain which

exists in the assets of NONRIC that are transferred to RIC at the time of the merger. 2) RIC will pay tax on the RIC's net recognized built-in gain on the disposition of the NONRIC's assets within 10 years from the date of the merger. 1/1 3) RIC's recognized built-in gains will be included in RIC's gross income. Whether the gains are "good income" for purposes of the RIC qualification tests will depend upon the nature of the assets sold. 4) When computing the tax on investment company taxable income and reporting investment company taxable income for a taxable year, RIC will exclude any net built-in gain recognized for the taxable year. However, the RIC will be required to distribute 90 percent of the net recognized built-in gain (less the tax imposed with respect to this gain) to maintain its RIC status under Subchapter M. 5) When computing the tax on its undistributed net capital gain and when reporting its net capital gain for a taxable year, RIC will exclude any net built-in gain recognized for the taxable year. Thus, any net built-in gain recognized by a RIC on NONRIC's assets will not qualify for capital gain dividend treatment. 6) The RIC's required distribution for section 4982 - 4 - excise tax purposes will not include any net built-in gain recognized by RIC. - 5 - 7) Neither the indemnification by the NONRIC shareholders of RIC for its built-in gain tax liability nor any payment pursuant to such indemnification will cause the dividends paid by RIC to be preferential dividends under section 562. 8) The indemnification by the NONRIC shareholders of RIC for its built-in gain tax liability will not constitute gross income of the RIC. The letter ruling concludes by noting that it is directed only to the taxpayer who requested it and may not be used or cited as precedent by others. We will keep you informed of developments. Keith D. Lawson
Associate General Counsel Attachment