OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: REORGANIZATION & CAPITAL CONTRIBUTION

This Field Service Advice responds to your request for advice. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

P =
S1 =
S2 =
S3 =
S4 =
S5 =
a% =
b% =
c% =
d% =
e% =
X =
Y =

Z =
P2 =
P1 =
Date 1 =

Date 2 =
Date 3 =
Date 4 =
Date 5 =
$b =
$c =
$d =
$e =
$f =
$g =
$h =

FACTS:

On Date 1, P contributed to S2 S1's business and assets, subject to certain liabilities, and P's a% common stock interest in S3. S2 then merged into S3, and S3's name was changed to S4. S3's former shareholders, other than P, received cash from S4 for their shares of common stock in S3. Financing required to buy out S3's former shareholders other than P was provided by the sale of Senior Notes to a group of institutional investors. Prepayment of the Senior Notes was subject to a prepayment penalty.

By a plan of merger dated Date 2 between X and P, X merged into S4, the separate existence of X ceased, and S4 survived. Immediately prior to the merger of X into P, S5 owned c% of the preferred stock (nonvoting) of S4; additionally, S5 owned b%, Y owned d%, and Z owned e%, of the common stock of S4. Y and Z are not related to X. Our understanding is that S4 and S5 are also not related to P2 or P1.

X was formed on Date 2 to merge with S4. Immediately before the merger with S4, X was a wholly-owned subsidiary of P2, and P2 was a wholly-owned subsidiary of P1. By virtue of the merger: each share of capital stock of X issued and outstanding before the merger was converted into one share of common stock of S4; each share of capital stock of S4 was canceled and ceased to exist; and each share of the preferred stock of S4 was canceled and extinguished and converted into a right to received cash. Also, S4 changed its name after the merger.

To induce S4 and X to enter into the plan of merger, S5 and P1 agreed that P1 shall cause X to disburses $b, to be placed in escrow in the name of S4, to the holders of the S4 indebtedness. Except for cash in the amount of $c, X had no assets, liabilities, or obligations whatsoever.

On Date 2, P acquired all of S4's outstanding Senior Notes from a group of institutional lenders to facilitate the sale of S4, paying a premium of $e in order to prepay the debt.

The parties agreed to the following allocations of the aggregate purchase price of $c:

Senior Notes	$ d
Prepayment Penalty	e
Credit Agreement	f
Preferred Stock	g
Non-Competition Agreement	h
Total	$ c

The amount of the purchase price allocated to the non-competition agreement was subsequently revised.

As part of the plan of merger, X placed $b in escrow in the name of S4 for the repayment of indebtedness of S4 to P as successor to various lenders.
A Form 8-K dated Date 3 for P1 states that X paid $b to retire certain indebtedness of S4 and that the consideration paid was provided by P2 and P1 through term loan borrowing through certain banks. A form 8-K/A dated Date 3 for P1 states the purchase price for P2's acquisition of S4 was $c, which included the acquisition of all S4's outstanding common stock, as well as the retirement of S4's redeemable preferred stock and substantially all S4's long-term indebtedness. The financial statements stated the indebtedness that S4 owed to S5 contained certain restrictive covenants.

On Date 3, S4 transferred an amount representing all accrued, but unpaid, interest through Date 4 to an agent. On Date 3, the agent transferred $c from X's account to itself as an agent for the account of S4. Also on Date 3, the agent transferred funds to S5 (and itself) in repayment of indebtedness.

ISSUE 1:

Whether the provision of funds by X to pay liabilities of S4 as part of the merger of X with S4 results in gain to S4.

CONCLUSION 1:

We agree with your conclusion that the provision of funds by X to pay liabilities of S4 as part of the merger of X with S4 results in no gain to S4.

ISSUE 2:

Whether an $e prepayment penalty for paying S4's debt early is deductible by S4.

CONCLUSION 2:

We agree with your conclusion that the prepayment penalty is deductible by S4.

DISCUSSION:

Issue #1

We agree with your conclusion that, pursuant to Rev. Rul. 90-95, 1990-2 C.B. 67, the merger transaction should be treated for tax purposes as a taxable stock purchase through a reverse subsidiary cash merger. We also agree with your conclusion that P2, a shareholder that owned the stock of S4, provided funds to pay the debt of S4, and that P2's payment of these debt amounts for S4 represents capital contributions that P2 made to S4.

Rev. Rul. 90-95 indicates that X, whose sole purpose was to acquire the stock of S4, is disregarded, and P2 is viewed as purchasing the stock of S4. Since P2 is viewed as purchasing the stock of S4, S4 had no taxable sale or exchange or other recognition event. Thus, even if prior to the acquisition the liabilities of S4 exceeded the value of its assets (which the facts appear to indicate is not the case), S4 recognized no gain in the transaction.

At the time of S2's purchase of the S4 stock, S4 had outstanding indebtedness. P2 paid off this indebtedness. P's payments to pay off the debt are treated as capital contributions that P2 made to S4. Cf. Rev. Rul. 84-68, 1984-1 C.B 31. S4 recognizes no income on this capital contribution. See I.R.C. § 118.

Issue 2

We concur that, in general, with respect to the payor, prepayment penalties are deductible as interest. See Treas. Reg. § 1.163-4(c); Treas. Reg. § 1.163-7(c); Rev. Rul. 57-198, 1957-1 C.B. 94. See also TAM 9641001 (May 31, 1996).

On the payee side, the Third Circuit in Prudential Insurance Company of America v. Commissioner, 882 F.2d 832, 837 (3d Cir. 1989), rejected the position that prepayment charges are interest equivalents and concluded that the prepayment charges there in issue would generally be treated as capital gain. Regardless of the Third Circuit's holding in Prudential, in the instant case, the Service should not argue against its own revenue ruling, Rev. Rul. 57-198 (and Treas. Reg. § 1.163-4(c)).

CASE DEVELOPMENT, OTHER CONSIDERATIONS:

[redacted]

If you have any further questions, please call 622-7930.

DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL
(FIELD SERVICE)

By: _____
ARTURO ESTRADA
Acting Branch Chief
Corporate Branch