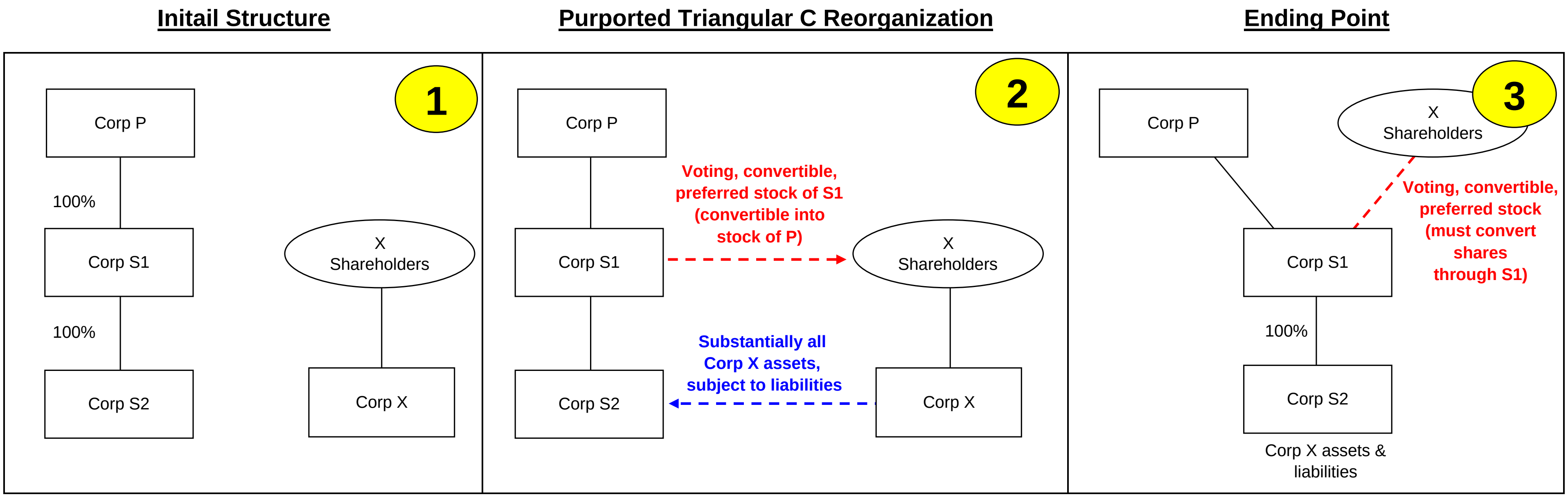
Revenue Ruling 69-265, Situation 2

Stock Convertible Into Parent Shares Okay for Triangular C Reorganization



Corporation S2 was the wholly-owned subsidiary of corporation S1 which in turn was the wholly-owned subsidiary of corporation P. Pursuant to a plan of reorganization that was intended to meet the definition of a reorganization in section 368(a)(1)(C), S2 proposed to acquire substantially all the assets, subject to the liabilities, of corporation X, an unrelated company, in exchange for voting convertible preferred stock of S1. The voting preferred stock of S1 was convertible into common stock of P at the election of the shareholders at any time after five years from the date of the reorganization. After the transaction S1 was still in control of S2 as defined in section 368(c). Section 368(a)(1)(C) provides that a reorganization includes the acquisition by one corporation of substantially all the assets of another corporation in exchange solely for all or a part of its voting stock or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation. The question, therefore, was whether the right to convert the stock issued in the transaction is a right that should be considered property other than voting stock (i.e., "boot"). If the right in these circumstances is boot, then the foregoing requirement of section 368(a)(1)(C) will not be satisfied.

The agreement provided that not later than the first date for conversion of the S1 stock into stock of P, P would transfer to S1 as a contribution to its capital the total number of shares of P common stock necessary for the conversion of all of the S1 convertible preferred stock involved in the transaction. The shareholders of S1 could then present their stock to S1 which would distribute the P stock to each shareholder entitled thereto. Prior to the time that the shareholders of S1 present the convertible preferred stock to S1 for conversion, they do not have a preferred right to the P stock held by S1. In the event all the outstanding shares of convertible preferred stock of S1 are not exchanged, S1 would retain the balance of the P stock. In this situation, the stock of P constitutes property of S1 which like the other assets of S1 is subject to creditors' claims. In this context the right to convert S1 stock into stock of P is in effect a right to have the S1 stock redeemed for specified property of S1. Therefore, the distribution of the stock of P by S1 to the holders of the convertible preferred stock of S1 is a distribution by S1 in redemption of its stock subject to the provisions of section 302. Accordingly, in this situation, the acquisition of the assets of X by S2 is solely in exchange for the stock of S1 and is, therefore, a reorganization within the meaning of section 368(a)(1)(C).