

ALABAMA DEPARTMENT OF REVENUE
REVENUE RULING 2008-001

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TO: Parent Corporation

**FROM: Commissioner of Revenue
Alabama Department of Revenue**

DATE: March 18, 2008

RE: Alabama tax treatment of business entity conversion of a Delaware corporation to a single member Delaware limited liability company located and doing business in Alabama and Georgia.

PROPOSED TRANSACTION- SUMMARY

S1, (the “Subsidiary”), is a Delaware corporation that is a wholly-owned subsidiary of P1 (the “Parent”). Pursuant to a plan of conversion to be executed in accordance with Delaware Law section 18-214 of the Delaware Limited Liability Company Act (the “conversion statute”), the Subsidiary will be converted from a Delaware Corporation into a Delaware Limited Liability Company. The Requestor has represented that, post-conversion, the Subsidiary will become a single member limited liability company wholly owned by the Parent.

FACTS AS REPRESENTED BY REQUESTOR

The facts as represented by the Requestor are as follows:

- 1) The Parent manufactures and sells paper, pulp, paperboard, and other wood products. It also manufactures and distributes school and office supplies, paper and other industrial supplies. The Parent also serves as a holding company for various U.S. and foreign corporations involved in the paper business. The Subsidiary owns and operates a paper mill in XXXXX County, Alabama and owns timber land in Alabama and Georgia.
- 2) The Board of Directors of both the Parent and the Subsidiary and the stockholders of the Subsidiary will adopt resolutions approving the Plan of Conversion. All assets of the Subsidiary will be deemed transferred to the Parent on the “effective date” of the conversion, which is defined in the Plan of Conversion and incorporated herein.

- 3) On the date of the deemed distribution of the assets of the Subsidiary to the Parent, the Subsidiary will cease to be a going concern for tax purposes. It will, however, continue as a legal entity for state law purposes as well as for some tax purposes such as sales and use taxes, various payroll taxes and property taxes.
- 4) All stock of the Subsidiary will be deemed redeemed and cancelled and the Subsidiary dissolved on the “effective date” of the Plan of Conversion. For tax purposes as a disregarded entity, the Subsidiary will retain no assets as a corporation but will retain all assets as a limited liability company. The Subsidiary’s legal charter as a corporation will cease to exist, but will continue as a limited liability company.
- 5) On the date the Plan of Conversion is adopted, the capital stock of the Subsidiary will consist of one thousand (1,000) shares of \$.01 par value common stock of which one thousand (1,000) shares will be outstanding. There is no other capital stock of the Subsidiary.
- 6) On the date the Plan of Conversion will be adopted, the Parent will own, and currently owns, all of the stock above described. At all times, Parent has owned all of the stock of the Subsidiary. No stock of the Subsidiary was acquired by the Parent by exercise of an option. The stock of the Subsidiary was acquired by the Parent at the time of the Subsidiary’s incorporation under section 351 of the Internal Revenue Code (“IRC”). In 1988, the Parent and an unrelated corporation owned Corporation 1 with each owning 50% of the stock of Corporation 1. Certain assets of Corporation 1 were transferred to the Subsidiary in exchange for one thousand (1,000) shares of stock. Stock acquired by Corporation 1 was transferred to the Parent in exchange for stock in Corporation 1 owned by the Parent. The transfer of assets and stock took place on the same day that the Subsidiary was created. In 1993, the stock of the Subsidiary was transferred by the Parent to another subsidiary, Corporation 2. On November 1, 1996, Corporation 2 transferred the stock of the Subsidiary back to the Parent, which has owned it since that time. There is no plan or intent to sell or otherwise dispose of any Subsidiary stock prior to the Plan of Conversion or for the Subsidiary to issue any additional shares of Subsidiary stock. For purposes of section 332(b)(1) of the IRC, the Parent on the date of adoption of the Plan of Conversion, will be the owner of 100% of the single outstanding class of Subsidiary stock. The acquisition of Subsidiary stock did not constitute a “qualified stock purchase” within the meaning of section 338(d)(3) of the IRC. The Parent never made a “qualified stock purchase” of any Subsidiary target affiliate (as defined in section 338(h)(4) of the IRC). The Parent never acquired any asset of the Subsidiary or a Subsidiary target affiliate (as defined in section 338(h)(6) of the IRC) during the consistency period. Holding Company 1 was established in August 2001 when the merger between Predecessor Corporation 1 and Predecessor Corporation 2 was announced. On January 29, 2002, the transaction was

approved by the shareholders of Predecessor Corporation 1 and Predecessor Corporation 2 and there was a share exchange. Holding Company 1 was renamed Holding Company 2. Predecessor Corporation 1 and Predecessor Corporation 2 shareholders received Holding Company 2 stock in exchange for their shares creating the Parent. On December 31, 2002, Predecessor Corporation 2 merged in Holding Company 2 and the majority of Predecessor Corporation 2's assets were transferred to Holding Company 2. At that time, the Predecessor Corporation 1 entity was converted into a limited liability company and renamed.

- 7) No shares of Subsidiary stock will have been redeemed during the three (3) years preceding the adoption of the Plan of Conversion.
- 8) The Subsidiary will not have acquired assets in any nontaxable transaction at any time, except for (i) acquisitions occurring more than 3 years prior to the date of adoption of the Plan of Conversion; and (ii) acquisitions to which section 1031 of the IRC is applicable.
- 9) No assets of the Subsidiary have been, or will be, disposed of by either the Subsidiary or the Parent except for: (i) dispositions in the ordinary course of business; (ii) the sale of a building to XXXXX County, Alabama; and (iii) a sale of timber land in Alabama and Georgia.
- 10) In the three year period preceding the conversion, no assets of the Subsidiary will have been acquired by a corporation, other than the Parent, except by sales in the normal course of business. Moreover, no assets of the Subsidiary will have been distributed in kind, transferred, or sold to the Parent, except for (i) transactions occurring in the normal course of business and (ii) transactions occurring more than three years prior to adoption of the Plan of Conversion.
- 11) The liquidation of the Subsidiary will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation of any of the business or assets of the Subsidiary, if persons holding, directly or indirectly, more than twenty percent (20%) in value of the Subsidiary stock also hold, directly or indirectly, more than twenty percent (20%) in value of the stock in such recipient.
- 12) The Subsidiary will report all earned income represented by assets that will be deemed distributed to its shareholders. This category of income includes but is not limited to items such as receivables being reported on a cash basis, unfinished construction contracts, commissions due, etc. The Subsidiary is an accrual basis taxpayer and does not anticipate any such items.
- 13) The fair market value of the assets of the Subsidiary will exceed its liabilities, both at the date of the adoption of the Plan of Conversion and immediately prior to the time the first liquidating distribution is deemed made.

- 14) The debt owed by the Subsidiary to the Parent and from the Parent to the Subsidiary is based on intercompany sales of products by the Subsidiary to the Parent, a sum which is presently in excess of one billion dollars (\$1,000,000,000.00), as well as cross charges between the entities such as shared services, employee benefits and consulting fees.
- 15) The Parent is not an organization that is exempt from federal income tax under section 501 of the IRC or any provision of the Alabama Code.
- 16) The Subsidiary has no minority shareholders.
- 17) The Parent represents that the issues addressed herein are not reported or disclosed in any return of the Parent (or in a return for any year of a related taxpayer within the meaning of Section 267 of the Internal Revenue Code, or a member of an affiliated group of which the Parent is also a member within the meaning of Section 1504) for federal income tax purposes or purposes of Alabama income tax purposes other than a subsidiary of Parent that is not included in the Alabama consolidated group.
- 18) The Parent represents that the identical or similar issues addressed herein have not been submitted to the Internal Revenue Service or the Alabama Department of Revenue by them or its predecessors.

REQUESTOR'S STATED BUSINESS REASONS

The requestor's stated business reasons for the transaction are to simplify accounting, simplify its organizational structure and to provide greater transparency to the business organization of the Parent and the Subsidiary.

RULINGS REQUESTED

- 1) Whether the Parent will recognize gain or loss for Alabama income tax purposes on the conversion of the Subsidiary under section 40-18-8(h) of the Alabama Code.
- 2) Whether the Parent's basis in the assets deemed acquired from the Subsidiary on the date of conversion for Alabama income tax purposes will be the same basis as the Subsidiary's basis under Alabama Department of Revenue, Admin. Reg. 810-3-6.08.
- 3) Whether the Subsidiary will recognize gain or loss for Alabama income tax purposes on the conversion of the Subsidiary under section 40-18-8(i).

- 4) Whether the Parent will succeed to the net operating loss carryovers of the Subsidiary for Alabama income tax purposes under Alabama Department of Revenue, Admin. Reg. 810-3-35.1-.01(9).
- 5) Whether the Parent will succeed to the other tax attributes of the Subsidiary under section 381(c) of the Code and, if so, whether such treatment will be followed for Alabama income tax purposes.
- 6) Whether the Parent will be entitled to deduct, for Alabama income tax purposes, the interest portion of the rents paid with respect to the IDB Leases under section 40-18-35(a)(4)b of the Code of Alabama of 1975. (WITHDRAWN BY REQUESTOR)
- 7) Whether the Parent will be entitled to exclude from income, for Alabama income tax purposes, interest on the IDB Bonds under section 40-18-35(a)(9) of the Code of Alabama of 1975. (WITHDRAWN BY REQUESTOR)

LAW AND ANALYSIS

Code of Ala. 1975, § 40-18-33, provides:

In the case of a corporation subject to the tax imposed by Section 40-18-31, the term “taxable income” means **federal taxable income** without the benefit of federal net operating losses plus the additions prescribed and less the deductions and adjustments allowed by this chapter and as allocated and apportioned to Alabama. (**Emphasis added**).

Based on the information submitted and associated representations made by the requestor, the first three (Ruling Requests # 1, 2 and 3) of the above-listed rulings are answered by resort to application of **Code of Ala. 1975**, § 40-18-33. This provision uses “federal taxable income”, with the specific adjustments noted therein, as the starting point for determining Alabama corporate income tax. Insofar as “federal taxable income” subsumes within its calculus the specific questions raised by the requestor with respect to the Parent’s and Subsidiary’s recognition of gain, loss, and basis arising out of the proposed conversion, the State of Alabama, Department of Revenue will determine “federal taxable income” in accordance with the respective federal statutes and regulations.

With respect to whether the Parent will succeed to the net operating loss carryovers of the Subsidiary (Ruling Request # 4), **Code of Ala. 1975**, § 40-18-33, specifically excludes federal net operating losses from the definition of “federal taxable income.” However, in computing Alabama taxable income of corporations, **Code of Ala. 1975**, § 40-18-35.01 specifically provides:

Carry forward of net operating losses.

In computing the taxable income of corporations subject to income tax as outlined in Section 40-18-35, there shall be allowed, in addition to the deductions specified therein, a deduction for the sum of the net operating losses which may be carried forward to the taxable year for which the net income of the corporation is being computed.

(1) The term "net operating loss" for the purposes of this section means the excess of the deductions (other than the deduction allowed by this subdivision) allowed by this chapter during a taxable year of the corporation over the corporation's gross income during that taxable year. For purposes of this paragraph, the corporation's gross income and allowable deductions shall be determined under the provisions of this chapter applicable to the year in which the net operating loss arises.

(2) A net operating loss shall be carried forward to the earliest subsequent taxable year in which the corporation has taxable income (determined without taking into account the deduction allowed by this subdivision). The amount of a net operating loss which may be carried to any later taxable year shall be the excess of the net operating loss over the sum of the amounts thereof deductible under this subdivision in all the taxable years preceding this taxable year.

(3) If net operating losses arising in more than one taxable year can be carried forward to a taxable year of the corporation, the net operating loss arising from the earliest of those years shall be deducted first.

(4) The net operating loss deduction allowed by this section shall be limited to sources attributable to Alabama.

(5) A net operating loss may be carried forward and deducted only during the 15 consecutive year period immediately following the taxable year in which it arose.

(6) In the case of an acquiring corporation subject to the rules of 26 U.S.C. § 381, or in the case of a new loss corporation within the meaning of 26 U.S.C. § 382, or in the case of the recognized built-in gains of a gain corporation within the meaning of 26 U.S.C. § 384, only

the net operating losses as are allowable in accordance with 26 U.S.C. §§ 381, 382, and 384 shall be allowed as a deduction under this section. This subdivision shall be applied before the limitations in the preceding subdivisions are applied.

(7) Notwithstanding the foregoing provisions of this section, for a taxpayer's taxable year beginning during calendar year 2001 no deduction for any net operating loss shall be allowed or allowable. If and only to the extent that any net operating loss deduction is disallowed by reason of this subdivision, the date on which the amount of the disallowed net operating loss deduction would otherwise expire will be extended by one year. A corporation dissolved and completely liquidated within calendar year 2001 may use its net operating loss without the restrictions provided in this subdivision.

The Department promulgated Department Reg. 810-3-35.1-.01(9) pursuant to this statute, which provides in relevant part:

In the case of an acquiring corporation subject to the rule of 26 U.S.C. § 381...only such net operating losses as are allowable in accordance with said U.S.C. § 381...shall be allowed as a deduction under this section.

The Subsidiary, post-conversion, will be classified as it is classified for federal income tax purposes under the Internal Revenue Service's ("IRS") "check-the-box" regulations. *See* regulations issued by the IRS under I.R.C. section 7701, as amended, to determine the tax classification of an LLC as a partnership, corporation or otherwise; *see also* Alabama Department of Revenue, Revenue Procedure 98-001, issued March 16, 1998. Thus, by resort to the plain language of the Alabama statutes and the accompanying Alabama regulations, the Parent, as the acquiring corporation, is entitled to a deduction for the net operating losses of the Subsidiary, subject to the conditions and limitations set forth in section 381 of the IRC and the limitations set forth in **Code of Ala. 1975**, § 40-18-35.1.

With respect to whether the Parent will succeed to the "other tax attributes" found in section 381(c) of the IRC (Ruling request #5), the Department submits that to the extent those attributes (save for net operating losses addressed specifically in **Code of Ala. 1975**, § 40-18-35.01 and accompanying regulations) are already subsumed within the Parent's calculus employed in arriving at its federal taxable income, such treatment will be followed for Alabama income tax purposes, provided it is reached in accordance with the relevant federal statutes and accompanying regulations.

DEPARTMENT DISCLOSURE

The rulings contained in this Revenue Ruling are based solely upon the facts and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. The Department of Revenue has not verified any of the facts, representations, or materials submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process, and may result in modification or revocation of the rulings set forth herein.