Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date: OCT 21 1998

199903048

UST =

FA =

State A =

Date B =

Date C =

S1 =

Date D =

S2 =

Date E =

S3 =

business F =

Country G =

Date H =

Date I =

yy =

zz =

Date J =

Date L =

Partnership M =

Trust N =

tt =

Individual O =

Trust P =

Trust Q =

Trust R =

Dear

This is in reply to your letter dated July 8, 1998, requesting rulings under Treas. Reg. §1.367(a)-3(c), and whether, based on your representations, the exchange of shares by U.S. persons will qualify for an exception to the general rule of section 367(a) of the Internal Revenue Code of 1986, as amended (the Code). Additional information was provided in letters dated August 27, 1998, September 9 and 25, 1998, and October 16, 1998.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

UST is a domestic corporation incorporated under the laws of State A. UST owns directly or indirectly 100 percent of the stock of various subsidiaries. UST was incorporated on Date B. Its major direct or indirect subsidiaries were incorporated on Date C (S1), Date D (S2), and Date E (S3). At all times since their incorporation, UST, S1, S2, and S3 have been engaged in business F directly or through wholly-owned subsidiaries. UST is publicly traded on a U.S. stock exchange.

FA is a corporation organized under the laws of Country G. At all times since Date H, FA has been engaged in business F directly and through its subsidiaries. FA is publicly traded on several Country G stock exchanges, as well as on a U.S. stock exchange.

UST and FA have agreed to combine their businesses to expand the markets served by each. Under the terms of the agreement, signed on Date I, a newly formed, first-tier U.S. subsidiary of FA will merge into UST in a reverse triangular merger that the taxpayers have represented will qualify under section 368(a)(2)(E) of the Code. Shareholders of UST will exchange their UST stock for stock of FA. Under the exchange formula in the agreement, each UST shareholder will receive yy FA share upon exchanging one UST share. Based on this exchange ratio and the number of shares outstanding, the shareholders of UST will receive FA stock representing approximately zz percent of the total value of FA stock immediately after the exchange (zz percent is less than 50 percent of the total value of FA stock).

The taxpayers represent (based on calculations on Date L) that immediately after the merger, a related group comprised of Partnership M and Trust N will own approximately tt percent (greater than 5 percent) of FA common shares. Since Date L, Partnership M has dissolved and its assets have been distributed to its partners (all U.S. persons), which are: Individual O, Trust P, Trust Q, and Trust R. Trust N is a grantor trust, with Individual O as its grantor. Thus, immediately after the merger, Individual O, Trust P, Trust Q, and/or Trust R might be 5-percent transferee shareholders as defined in §1.367(a)-3(c)(5)(ii).

The exchange of UST stock by U.S. persons is subject to section 367(a) of the Code, which provides that the transfer of appreciated property (including stock) by a U.S. person to a foreign corporation in a transaction that would otherwise qualify as a nonrecognition exchange is treated as a taxable transfer, unless an exception applies. In the case of a section 367(a) transaction in which a U.S. person transfers domestic stock to a foreign corporation, the U.S. transferor will qualify for nonrecognition treatment if the requirements of Treas. Reg. §1.367(a)-3(c)(1) are satisfied.

Among the Treas. Reg. §1.367(a)-3(c)(1) requirements is the requirement that the U.S. target company satisfy the reporting requirements of Treas. Reg. §1.367(a)-

3(c)(6), and the requirement that each U.S. transferor who is a 5-percent shareholder of the transferee foreign corporation immediately after the exchange of target stock enter into a 5-year gain recognition agreement as provided in §1.367(a)-8. The taxpayers represent that UST, as the U.S. target company, will satisfy the reporting requirements of §1.367(a)-3(c)(6). The remaining §1.367(a)-3(c)(1) requirements are as follows:

a. U.S. persons transferring U.S. target stock must receive, in the aggregate, 50 percent or less of both the total voting power and total value of the stock in the transferee foreign corporation. The taxpayers represent that U.S. transferors of UST stock will, in the aggregate, receive 50 percent or less of both the total voting power and total value of the stock in FA in the UST exchange.

b. U.S. persons who are officers or directors of the U.S. target corporation, or who are 5-percent shareholders of the U.S. target corporation, will own, in the aggregate, 50 percent or less of each of the total voting power and the total value of the stock of the transferee foreign corporation, immediately after the exchange of the U.S. target stock. The taxpayers represent that U.S. persons who are officers, directors, or 5-percent target shareholders of UST will own, in the aggregate, 50 percent or less of each of the total voting power and total value of the stock of JV immediately after the UST exchange.

c. The active trade or business test of Treas. Reg. §1.367(a)-3(c)(3) must be satisfied. The three elements of the active trade or business test are described below:

(i) The transferee foreign corporation (or any qualified subsidiary or qualified partnership as defined under §1.367(a)-3(c)(5)(vii) and (viii)) must have been engaged in the active conduct of a trade or business outside the United States, within the meaning of §§1.367(a)-2T(b)(2) and (3), for the entire 36-month period immediately preceding the exchange of U.S. target stock. The taxpayer represents that FA (including its qualified subsidiaries) will have been engaged in an active trade or business outside the United States for the entire 36-month period preceding the UST exchange.

(ii) At the time of the exchange, neither the transferors nor the transferee foreign corporation (or any qualified subsidiary or qualified partnership engaged in the active trade or business) will have the intention to substantially dispose of or discontinue such trade or business. The taxpayer represents that neither the shareholders of UST nor FA (including its qualified subsidiaries) have an intention to substantially dispose of or discontinue such active trade or business.

(iii) The substantiality test as defined in Treas. Reg. §1.367(a)-3(c)(3)(iii) must be satisfied.

Under the substantiality test, the transferee foreign corporation must be equal or greater in value than the U.S. target corporation at the time of the U.S. target stock exchange (see §1.367(a)-3(c)(3)(iii)(A)). The taxpayers represent, taking into account the rules of §1.367(a)-3(c), that at the time of the transfer, it is expected that the fair market value of FA will be at least equal to the fair market value of UST. From Date I through Date J, which is in close proximity to the closing date, the fair market value of the stock of UST never exceeded the fair market value of the stock of FA, according to the information supplied by the taxpayers. The period between Date I and Date J is more than 100 days. However, because the stock values of UST and FA are relatively close and their values might fluctuate in the stock market, it is difficult to predict their precise values and represent that FA will be equal or greater in value than UST at the time of closing.

For purposes of the substantiality test, the value of the transferee foreign corporation will include assets acquired outside the ordinary course of business by the transferee foreign corporation within the 36-month period preceding the exchange if certain requirements are met (see §1.367(a)-3(c)(3)(iii)(B)). The taxpayers represent, for purposes of the substantiality test of §1.367(a)-3(c)(3)(iii)(B), amounts received from the exercise of stock options were outside the ordinary course of business. The fair market value of FA will not include the fair market value of any asset acquired outside the ordinary course of business within the 36-month period preceding the UST exchange for the principal purpose of satisfying the substantiality test of §1.367(a)-3(c)(3)(iii). Also, for purposes of this fair market value representation, the taxpayers represent that the fair market value of FA will include assets producing, or held for the production of, passive income as defined in section 1297(b) (formerly section 1296 (b)) which assets were acquired outside the ordinary course of business within the 36-month period preceding the UST exchange only to the extent such assets were acquired in a transaction (or series of related transactions) which was not undertaken for a purpose of satisfying the substantiality test of §1.367(a)-3(c)(3)(iii).

The taxpayers request a ruling under §1.367(a)-3(c)(9) that there will be substantial compliance with the active trade or business test, notwithstanding that FA may not be equal or greater in value than UST at the time of closing, and notwithstanding that the substantiality test as described in §1.367(a)-3(c)(3)(iii)(B) may not be met due to the acquisition by FA or any qualified subsidiary of FA of certain passive assets not undertaken for a purpose of satisfying the substantiality test.

Under Treas. Reg. §1.367(a)-3(c)(9), the Service may, in limited circumstances, issue a private letter ruling to permit the taxpayer to qualify for an exception to section

367(a)(1) if the taxpayer is unable to satisfy all of the requirements of the active trade or business test but is in substantial compliance with such test and meets all of the other requirements of §1.367(a)-3(c)(1).

Based solely on the information submitted and on the representations set forth above, it is held as follows:

(1) The transfer of the UST shares by U.S. persons in exchange for shares of FA will qualify for an exception to section 367(a)(1) (§1.367(a)-3(c)(1) and §1.367(a)-3(c)(9)).

(2) Any U.S. person transferring UST shares who is a 5-percent transferee shareholder (as defined in §1.367(a)-3(c)(5)(ii)) will qualify for the exception to section 367(a) only upon entering into a 5-year gain recognition agreement pursuant to §1.367(a)-8.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion was requested and none is expressed as to whether the UST stock exchange qualifies as a reorganization within the meaning of section 368(a)(2)(E) of the Code. In addition, no opinion is expressed as to the reporting requirements of U.S. persons exchanging UST stock under section 6038B and the regulations thereunder.

A copy of this letter must be attached to any income tax return to which it is relevant.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Charles P. Besecky

Charles P. Besecky
Chief, Branch 4, Office of Associate
Chief Counsel (International)