Internal Revenue Service

Department of the Treasury

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Refer Reply To:
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Date:
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UST =

State A =

Business A =

Country A =

Exchange 1 =

FA =

Country B =

Exchange 2 =

Area aa =

Sub1 =

ww =

xx =

yy =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Dear Messrs. :

This is in reply to your letter dated November 8, 2000, in which you request a ruling under section 1.367(a)-3(c)(9) of the Income Tax Regulations, that, based on the representations in the letter, the exchange of shares by U.S. persons described below will qualify for an exception to the general rule of section 367(a)(1) of the Internal Revenue Code. Additional information was provided in a letter dated January 26, 2001 and in a letter dated February 14, 2001.

The rulings contained in this letter are based upon information and representations submitted by the taxpayers and accompanied by penalty of perjury statements executed by the appropriate parties. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification upon examination.

FACTS

UST is a domestic corporation organized under the laws of State A. UST is the common parent corporation of an affiliated group of companies that files a consolidated federal income tax return. The consolidated group is engaged in Business A in Country A. UST has two classes of shares outstanding, each of which is publicly traded on Exchange 1. UST has several different stock options plans.

FA is a Country B entity classified as a foreign corporation for U.S. federal income tax purposes. FA has one class of stock, and its shares are publicly traded on Exchange 2. FA is engaged in Business A through subsidiaries in Area aa, Country A, and other countries. FA has owned directly and indirectly through its wholly owned domestic subsidiary (Sub1) a significant stake in UST for the last ww years. Currently,

FA owns, together with Sub1, approximately a xx% economic interest and approximately a yy% voting interest in UST. FA maintains two separate stock options plans.

On Date 1, FA publicly announced an offer for a statutory share exchange (the Exchange) in which UST shareholders would exchange their UST stock for FA stock. FA and UST represent that the Exchange will qualify as a reorganization under section 368(a)(1)(B). On Date 2, FA and UST publicly announced that they had agreed to the Exchange.

LAW AND ANALYSIS

The exchange of stock in a domestic corporation (the U.S. target company) for stock in a foreign corporation by U.S. persons is subject to section 367(a), 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. Section 1.367(a)-3(c) provides that the transfer of domestic 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 the requirements of section 1.367(a)-3(c)(1) are satisfied.

Section 1.367(a)-3(c)(1) requires the U.S. target company to satisfy the reporting requirements in section 1.367(a)-3(c)(6). UST, the U.S. target company, represents that it will satisfy the reporting requirements of section 1.367(a)-3(c)(6). Additionally, a transfer by a U.S. transferor that is a five-percent shareholder of the transferee foreign corporation immediately after the transfer will only qualify for the exception in section 1.367(a)-3(c) if the transferor enters into a five-year gain recognition agreement as provided in section 1.367(a)-8. The other section 1.367(a)-3(c)(1) requirements are as follows:

a) U.S. persons transferring U.S. target stock must receive in the transaction, in the aggregate, 50 percent or less of both the total voting power and total value of the stock of the transferee foreign corporation (taking into account the attribution rules of section 318, as modified by the rules of section 958(b)). For purposes of this test, options and interests similar to options are treated as exercised and thus counted as stock for purposes of determining whether the 50-percent threshold is exceeded if a principal purpose of the issuance or acquisition of the options or similar interests was the avoidance of the general rule under section 367(a)(1). FA and UST represent that U.S. transferors of UST stock will receive, in the aggregate, actually or constructively, 50 percent or less of both the total voting power and total value of the stock in FA in the Exchange, and that the 50-percent threshold will not be exceeded even if all the stock options, convertible notes, and exchangeable shares in UST, were treated as exercised and

exchanged for FA stock in the 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, must own, in the aggregate, no more than 50 percent of each of the total voting power and the total value of the stock of the transferee foreign corporation, immediately after the transfer of the U.S. target stock (taking into account the attribution rules of section 318, as modified by the rules of section 958(b)). FA and UST represent that U.S. persons who are officers, directors, or 5-percent shareholders of UST will own, in the aggregate, actually or constructively, no more than 50 percent of each of the total voting power and total value of the stock of FA immediately after the Exchange.

c) The active trade or business test of section 1.367(a)-3(c)(3) must be satisfied. The three requirements of the active trade or business test are as follows:

1. The transferee foreign corporation (or any qualified subsidiary or qualified partnership as defined in sections 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 sections 1.367(a)-2T(b)(2) and (3), for the entire 36-month period immediately before the exchange of U.S. target stock. FA and UST represent that a qualified subsidiary (as defined in section 1.367(a)-3(c)(5)(vii)) of FA will have been engaged in Business A outside the United States for the entire 36-month period preceding the Exchange.

2. At the time of the exchange, neither the transferors nor the transferee foreign corporation (and, if applicable, any qualified subsidiary or qualified partnership engaged in the active trade or business) will have the intention to substantially dispose of or discontinue the active trade or business outside the United States. FA and UST represent that neither the shareholders of UST nor FA (including its qualified subsidiaries) will have an intention to substantially dispose of or discontinue Business A.

3. The substantiality test in section 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 section 1.367(a)-3(c)(3)(iii)(A). FA and UST submitted information and representations showing that FA's value was greater than UST's value (including the value of UST's options) for a significant amount of the time prior to the announcement date. From Date 3 through Date 4, UST's market capitalization has been larger than FA's market capitalization, and FA and UST represent that there is a significant likelihood that this will be the case on the date of the Exchange.

Under section 1.367(a)-3(c)(9), the Service may issue a private letter ruling permitting a taxpayer to qualify for an exception to section 367(a)(1) if the taxpayer is unable to satisfy all 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 section 1.367(a)-3(c)(1). Taxpayers in this case request a ruling under section 1.367(a)-3(c)(9) that there is substantial compliance with the active trade or business test notwithstanding that FA may not be equal or greater in value compared to UST on the date of the Exchange.

For purposes of the substantiality test, the value of the transferee foreign corporation must be reduced by the amount of certain prohibited assets acquired outside the ordinary course of business by the transferee foreign corporation or any of its qualified subsidiaries within the 36-month period preceding the exchange, as provided in section 1.367(a)-3(c)(3)(iii)(B) (commonly referred to as the "stuffing rule"). FA represents that the fair market value of FA (including the value of stock of any qualified subsidiary of FA and the value of an interest in any qualified partnership) will not include the fair market value of any asset acquired by FA, a qualified subsidiary, or a qualified partnership, outside the ordinary course of business within the 36 months preceding the Exchange for the principal purpose of satisfying the substantiality test of section 1.367(a)-3(c)(3)(iii). FA also represents that the fair market value of FA (including the value of stock in any qualified subsidiary or an interest in any qualified partnership) 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 Exchange only to the extent such assets were acquired in a transaction (or series of transactions) which was not undertaken for a purpose of satisfying the substantiality test of section 1.367(a)-3(c)(3)(iii).

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). Section 1.367(a)-3(c)(1) and section 1.367(a)-3(c)(9).

(2) Any U.S. person transferring UST shares who is a five-percent transferee shareholder, as defined in section 1.367(a)-3(c)(5)(ii), will qualify for the exception to section 367(a) only upon entering into a five-year gain recognition agreement pursuant to section 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 or implied as to whether the Exchange qualifies as a reorganization within the meaning

of section 368(a)(1)(B). In addition, no opinion is expressed as to the reporting requirements of U.S. persons exchanging their UST stock for FA stock under section 6038B and the regulations thereunder.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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

In accordance with the Power of Attorney Forms on file with this office, copies of this letter are being sent to the taxpayers' representatives.

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