Internal Revenue Service

Department of the Treasury

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UST =

FA =

Fbus1 =

Fbus2 =

Fbus3 =

FH1 =

FH2 =

FH3 =

US =

Individual #1 =

Individual #2 =

Country X =

Country Y =

Country Z =

Year 1 =

business aa =

business bb =

Date 2 =

business cc =

business dd =

Year 3 =

Date 4 =

$5x =

$100 =

Dear

This is in reply to your letter dated August 17, 1999, requesting rulings under Treas. Reg. §1.367(a)-3(c)(9), that, 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)(1) of the Internal Revenue Code of 1986, as amended (the Code). Additional information was provided in letters dated November 15, 1999, December 20, 1999, January 7, 2000, and January 20, 2000.

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 the rulings, it is subject to verification on examination.

UST is a domestic corporation incorporated in Delaware in Year 1. UST is the common parent of an affiliated group of corporations which files a consolidated federal income tax return. UST is engaged in businesses aa, bb, and cc. UST owns a Canadian subsidiary engaged in the related business bb.

UST has issued and outstanding shares of common stock which are widely held and publicly traded on a U.S. stock exchange. UST has compensatory stock options held by officers, employees and directors of UST to acquire additional shares of UST common stock. UST also has notes outstanding which are convertible into UST common stock. Certain outstanding shares of the Canadian subsidiary are also exchangeable for UST common stock.

Fbus1, Fbus2, and Fbus3 (hereinafter called the Companies) are Country X limited liability companies principally engaged, directly or through qualified subsidiaries, in business dd. Business dd has been conducted by one or more of the Companies or their qualified subsidiaries since Year 3. The Companies are part of an affiliated group of Country X corporations privately owned, directly or indirectly, by Individual #1 and Individual #2 and members of their family (herein after referred to as the Family), all of whom are citizens of Country Y. Specifically, Fbus2 is wholly owned by FH1, a Country X corporation wholly owned by the Family. Fbus3 is wholly owned by FH2, a Country X limited liability company wholly owned by the Family. Fbus1 is owned 76 percent (in common stock) by FH1 and 24 percent (in preferred stock) by FH3, a Country X subsidiary indirectly owned by US, a domestic corporation. FH3 also holds options to acquire stock of Fbus1. Country X and Country Y are countries that have a comprehensive income tax treaty with the United States.

On Date 4, UST entered into an Agreement and Plan of Reorganization with FH1 and the Companies (referred to as the Merger Agreement). The Merger Agreement (which was amended on October 6, 1999) provides for the following transactions to occur before the acquisition of UST stock in the section 367(a) exchange:

1. FH1 will contribute all of the common stock of Fbus1 (representing 76% equity) and all of its stock in Fbus2 to FA, a recently formed Country Z subsidiary of FH1;

2. FH2 will contribute all of the stock of Fbus3 to FA; and

3. FH1 and FH2 will contribute all of the stock of FA to a newly formed Country X corporation, Holdco, in exchange for all of the stock of Holdco.

Pursuant to a separate agreement between FH3 and FH1 (and affiliates), FH3 will surrender its options to purchase Fbus1 stock in exchange for a debenture of FA, and FH3 will exchange its preferred stock in Fbus1 (representing 24% equity) for a debenture in Holdco which will be convertible into stock of FA or Holdco. As a result of these steps, FH1 and FH2 will own all of Holdco, which will own all of FA, which will in turn own all of the stock of the Companies. FH3 will own a straight debenture in FA and a convertible debenture in Holdco.

Pursuant to the Merger Agreement, FA has organized a wholly-owned domestic sub (Merger Sub). UST will merge into Merger Sub under Delaware law, with the shareholders of UST receiving FA stock and/or cash. Taxpayer represents that the acquisition of UST stock by FA will constitute a forward triangular merger described in section 368(a)(1)(A) and (a)(2)(D) of the Code. On the same day as the merger, FA will make an initial public offering (IPO) of approximately 30 percent of its stock and list the stock on certain exchanges in Country X and in the United States.

Pursuant to the forward triangular merger, each UST shareholder will receive cash and/or FA stock with a total value of $5x per share of UST stock surrendered. In the aggregate, UST shareholders will receive 40% to 49% of the merger consideration in cash and 51% to 60% in FA stock. Each shareholder will be able to elect FA stock, cash, or some combination of the two (adjustments will be made to what shareholders receive if the aggregate range of cash and stock that the shareholders receive is not met). In applying the percentages above, dissenters will be assumed to receive all cash in the amount of $5x per share of UST stock in the merger.

Under the Merger Agreement, UST's compensatory stock options and convertible notes (currently convertible into UST stock) will be convertible into FA stock. The shares of the Canadian subsidiary, currently exchangeable into UST stock, will become exchangeable for FA stock and/or cash in the merger (subject to the same shareholder elections and aggregate stock/cash limitations as apply to UST stock).

The exchange of UST common stock for FA shares 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 only 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 enter into a 5-year gain recognition agreement as provided in §1.367(a)-8. The taxpayer represents 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 (taking into account the attribution rules of section 318 of the Code, as modified by the rules of section 958(b) of the Code). The taxpayer represents 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 merger. The taxpayer also represents that the 50-percent threshold will be satisfied even if all the stock options, convertible notes, and exchangeable shares in the Canadian subsidiary were subject to §1.367(a)-3(c)(4)(ii) and treated as exercised and exchanged for FA stock in the merger.

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, 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 (taking into account the attribution rules of section 318, as modified by the rules of section 958(b)). The taxpayer represents that U.S. persons who are officers, directors, or 5-percent target shareholders of UST will own, in the aggregate, actually or constructively, 50-percent or less of each of the total voting power and total value of the stock of FA immediately after the UST exchange. The taxpayer also represents, to the best of its knowledge, that no officers, directors, or 5-percent target shareholders of UST intend to purchase FA shares in the IPO so as to own, in the aggregate, more than 50-percent of the total voting power or total value of FA after the merger.

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 discussed below:

The first element of the active trade or business test provides that 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. Treas. Reg. §1.367(a)-2T(b)(3) refers to §1.954-2(d)(1) (which has been withdrawn and superceded with §1.954-2(c)) in determining whether an enterprise that produces rental income is engaged in the active conduct of a trade or business.

The Taxpayer represents that, as qualified subsidiaries of FA, one or more of the

Companies or their respective qualified subsidiaries will have been engaged in business dd for the entire 36-month period preceding the merger. Since the Companies' business dd produces rental income, it is subject to the requirements of §1.954-2(c) to determine whether it is an active trade or business. The taxpayers believe that the rental income of business dd qualifies as an active trade or business under §1.954-2(c) of one or more of the Companies or their qualified subsidiaries, because the rental income is derived from property which is leased as a result of marketing functions by each such company, through its own officers or employees located in a foreign country, and, each such entity, maintains and operates an organization in such country which is regularly engaged in the business of marketing and servicing the leased property, and which is substantial in relation to the amount of rents derived from the leasing of such property (see §1.954-2(c)(1)(iv)). An organization in a foreign country is substantial in relation to the amount of rents based on all of the facts and circumstances. Based on the description of business dd as represented to by the taxpayers, it is determined that business dd entails significant marketing and servicing of leased property and is in the nature of an active trade or business as contemplated by §1.367(a)-3(c).

The second element of the active trade or business test provides that 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 FA's qualified subsidiaries) have an intention to substantially dispose of or discontinue such active trade or business.

The third element of the active trade or business test is the substantiality test as defined in Treas. Reg. §1.367(a)-3(c)(3)(iii). 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 UST stock transfer (see §1.367(a)-3(c)(3)(iii)(A)).

The substantiality test contemplates the valuation of corporations according to their market capitalization. In this case, however, the acquiring corporation, FA, is a privately held corporation. The parties intend to value FA stock according to the value the underwriters ascribe to the stock for purposes of the IPO. The price of FA stock offered in the IPO will be determined by underwriters two to four business days before the IPO and merger. The Merger Agreement provides as a condition that the merger will not occur unless the underwriter values FA as being larger than UST. It is anticipated that FA stock will be fully subscribed to by investors at the time of the IPO. It is also anticipated that, pursuant to industry practice, the underwriters will have a firm commitment to purchase all the shares offered in the IPO, and that the underwriters will not offer the stock in the IPO unless arrangements have been made to resell all of the IPO shares at the IPO price.

Thus, at the beginning of the day in which the merger and IPO occur, the value of FA will exceed the value of UST. The taxpayer is concerned, however, that if the price of FA declines in market trading during the day, the value of FA might not exceed the value of UST at the close of the day. If UST is valued by the consideration received by UST shareholders (i.e. cash and FA stock), the presence of the cash component might cause the value of UST to be greater than FA if the value of FA stock declines enough. Thus, there is uncertainty as to whether the substantiality test will be satisfied on the closing date of the merger.

The taxpayer proposes, and we hold, that, for purposes of valuing FA and UST under the substantiality test, the value of FA stock will be determined by the underwriters two to four business days before the date of the IPO and merger, and the merger will satisfy the substantiality test if the aggregate value of FA stock in the hands of the original FA shareholders (determined before the merger and IPO) is equal to or greater than the sum of cash and FA stock issued to UST shareholders pursuant to the merger.

For purposes of the substantiality test, the value of FA (as determined by the IPO price of its stock) would have to be discounted or reduced by the amount of certain prohibited assets acquired outside the ordinary course of business by FA or any of its qualified subsidiaries within the 36-month period preceding the exchange, as provided in §1.367(a)-3(c)(3)(iii)(B) (commonly referred to as the “stuffing rule”). The taxpayers represent that, for purposes of the “stuffing rule” in §1.367(a)-3(c)(3)(iii)(B), 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-month period preceding the merger 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 (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 UST stock 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 taxpayer requests 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’s value might be less than UST’s value during the closing date of the merger, and notwithstanding that the “stuffing rule”, as described in §1.367(a)-3(c)(3)(iii)(B), may not be met due to the acquisition by FA’s qualified subsidiaries 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 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)(1)(A) of the Code, by virtue of section 368(a)(2)(D) of the Code.

Also, no opinion is expressed as to whether the exchangeable shares should be classified as stock of the Canadian corporation or stock of UST.

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,
Philip L. Tretiak
Senior Technical Reviewer, Branch 4
Office of Associate Chief
Counsel (International)

cc: