Internal Revenue Service

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Person To Contact:
, ID No.

Telephone Number:

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CC:INTL:B04
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Date:
May 31, 2019

LEGEND:

USP =

UST =

DRE1 =

FA =

Merger Sub 1 =

Merger Sub 2 =

Industry A =

Business A =

Business B =

b-percent =

c-percent =

Amount D =

Amount E =

Date E =

Date F =

Amount F =

g =

h =

i =

Amount J =

k =

L-percent =

Dear :

This is in reply to your letter dated April 19, 2019, requesting a ruling under § 1.367(a)-3(c)(9) of the Income Tax Regulations that the indirect transfer of shares in a domestic corporation by U.S. persons described below will qualify for an exception to the general rule of § 367(a)(1) of the Internal Revenue Code (the "Code"). Supplemental information was provided in letters dated May 8, May 16, May 22, and May 29, 2019.

The rulings contained in this letter are predicated upon facts and representations submitted by the taxpayers and accompanied by penalty of perjury statements executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the factual information, representations, and other data may be required as part of the audit process.

FACTS

USP is a domestic corporation and the common parent of an affiliated group of corporations that files a consolidated federal income tax return (USP Consolidated Group). The USP Consolidated Group is engaged in Business A and Business B.

UST is a domestic corporation that is a member of the USP Consolidated Group. USP owns all of UST's stock by vote and more than b-percent of UST's stock by value; the UST stock is owned by USP through DRE1, an entity wholly-owned by USP and disregarded as separate from USP for federal income tax purposes. Management employees of UST own the remaining c-percent of UST stock. UST is engaged in Business A.

UST has three classes of stock outstanding: Class A shares, Class B shares, and Class C shares. USP owns all of the outstanding Class A and Class B shares; both classes of stock have voting rights. USP and UST management own all of the currently outstanding Class C shares; the C class shares do not have voting rights. Additionally, UST has both unvested restricted stock awards (RSAs) and stock-settled appreciation rights (SSARs) outstanding.

FA is a foreign corporation that is engaged in Business A. FA has one class of stock, and its shares are publicly traded. As of Date F, FA has g shares of common stock outstanding. FA serves clients around the globe and has a significant global presence in Industry A.

FA operates an Employee Stock Purchase Plan (ESPP) that allows FA employees to purchase FA stock in annual intervals at less than fair market value. All FA stock purchased through the ESPP is treated as stock outstanding, and thus, such stock is included in the valuation of FA. FA employees paid Amount F for FA stock under the ESPP within the last 36 months.

On Date E, USP and FA entered into a merger agreement (Merger Agreement) pursuant to which the UST shareholders will exchange their UST stock for FA common stock and newly-issued FA preferred stock pursuant to a series of transactions described below (Merger).

Typically, USP invests seed capital on behalf of its subsidiaries. USP did not pursue this structure with UST; instead, UST invested Amount D itself. During Merger negotiations, FA informed the UST shareholders that FA did not want to issue shares to account for some of the investments made by UST because FA considered those investments undesirable. Accordingly, in order to effectuate the Merger, UST sold Amount D of the investments to USP and distributed the proceeds of the sale to the UST shareholders in a transaction characterized as a non-ordinary course distribution (NOCD) under § 1.7874-10. The Amount D NOCD accounts for the majority of the NOCDs issued by UST. The total amount of NOCDs is Amount E, which also includes dividends and employee share repurchases.

Pursuant to the Merger Agreement, UST shareholders will exchange their UST stock for a mixture of FA common stock and newly-issued FA preferred stock, and the unvested RSAs will be exchanged for FA restricted shares. Under the Merger Agreement, cash will be issued in lieu of fractional shares for any UST shareholders that would otherwise be entitled to a fractional share of FA common stock or FA preferred stock by virtue of the Merger. Under the Merger Agreement, the SSARs will vest upon closing of the Merger and will be exchanged for a nominal amount of cash.

Pursuant to the Merger Agreement, the Merger will be effectuated through a two-step forward triangular merger under § 368(a)(1)(A) and (a)(2)(D). Specifically, FA will form two domestic corporations, Merger Sub 1 and Merger Sub 2, which will be combined with UST as follows:

(i) Step 1. Merger Sub 1 will merge with and into UST, with UST surviving as a wholly-owned subsidiary of FA. Merger Sub 1 shares will be converted into UST shares. In exchange for their UST shares, UST shareholders will receive: (a) h FA common shares for each UST common share outstanding; (b) i newly-issued FA preferred shares for each UST common share outstanding (value of Amount J); and (c) k FA restricted shares for each UST unvested RSA.

(ii) Step 2. Immediately following Step 1, and as part of a single, integrated transaction, UST will merge with and into Merger Sub 2, with Merger Sub 2 surviving as a wholly-owned subsidiary of FA.

Thus, under the terms of the Merger Agreement, FA will acquire UST in exchange for consideration provided to the UST shareholders consisting of FA common stock; perpetual, non-cumulative FA preferred stock; FA restricted shares; cash for the SSARs; and cash for the fractional shares. The value of the preferred stock is fixed and, therefore, will not vary due to fluctuations in the value of FA common stock. Accordingly, the Merger consideration will be fixed to the extent of Amount J. The shares held by USP will be subject to an agreement not to sell those shares for a period of two years following the Merger.

On Date E, UST's fair market value, adjusted to take into account the Amount E of NOCDs, was equal to approximately L-percent of the aggregate of UST's adjusted fair market value and the fair market value of FA, reduced by Amount F, the amount paid by FA employees for FA stock under the ESPP.

Since Date E, however, the value of FA's common stock has fluctuated. Thus, UST's fair market value has also fluctuated, as part of UST's fair market value is tied to the Merger consideration. Specifically, the fair market value of UST fluctuates to the extent of the Merger consideration consisting of FA common stock. The remaining Merger consideration, totaling Amount J, consists of FA preferred stock and is not subject to fluctuation. After adjusting to account for the NOCDs, UST's approximate fair market value has approached that of FA. Accordingly, it is possible that FA's fair market value may not be at least equal to UST's adjusted fair market value on the closing date.

The taxpayer, therefore, requests a private letter ruling under § 1.367(a)-3(c)(9)(i) providing that the taxpayer is in substantial compliance with the active trade or business test and thus qualifies for an exception to the general rule of § 367(a)(1).

REPRESENTATIONS

The taxpayer has made the following representations:

(a) The Merger will qualify as a two-step forward triangular merger under § 368(a)(1)(A) and (2)(D) and will, therefore, qualify as a reorganization within the meaning of § 368(a) of the Code.

(b) UST will satisfy the reporting requirements of § 1.367(a)-3(c)(6).

(c) The requirements set forth in § 1.367(a)-3(c)(1)(i), (ii), and (iii)(B) will be met immediately following the Merger.

(d) FA and USP will satisfy the requirements set forth in § 1.367(a)-3(c)(3)(i)(A) and (B).

(e) FA has not acquired any assets in the 36-month period preceding the exchange in violation of the anti-stuffing provision of § 1.367(a)-3(c)(3)(iii)(B).

(f) The fair market value of FA exceeded UST's adjusted fair market value on Date E. Specifically, on Date E, UST's adjusted fair market value was equal to approximately L-percent of the aggregate of UST's adjusted fair market value and the fair market value of FA. Since that date, the market price of FA's common stock has occasionally declined, which caused UST's adjusted fair market value to approach FA's fair market value.

LAW AND ANALYSIS

When a U.S. person transfers appreciated property to a foreign corporation in a transaction that would otherwise qualify as a nonrecognition exchange, the transfer will generally be treated as a taxable exchange under § 367(a)(1). If the appreciated property consists of stock, § 1.367(a)-3 applies. Under that section, a transfer of appreciated stock of a domestic corporation by a U.S. person to a foreign corporation constitutes a taxable exchange unless the requirements of § 1.367(a)-3(c)(1) are met.

Certain reorganizations under § 368(a)(1)(A) and (a)(2)(D) trigger the application of § 367(a)(1). Specifically, when a U.S. person exchanges appreciated stock in a domestic target corporation for stock in a foreign corporation that controls the acquiring corporation, § 1.367(a)-3(d)(1) provides that the U.S. person will be treated as having made an indirect transfer of stock in a domestic corporation to a foreign corporation and the indirect stock transfer rules of § 1.367(a)-3(d) will apply. Accordingly, unless the requirements of § 1.367(a)-3(c)(1) are satisfied, the indirect transfer of appreciated stock constitutes a taxable exchange under § 367(a)(1) to the extent the exchange would otherwise have qualified for nonrecognition treatment under § 354 or § 356.

The requirements of § 1.367(a)-3(c)(1) are as follows:

(i) The U.S. target company must comply with the reporting requirements of § 1.367(a)-3(c)(6).

(ii) U.S. persons transferring U.S. target stock must receive, in the aggregate, 50% or less of both the total voting power and total value of the stock in the transferee foreign corporation.

(iii) U.S. persons who are officers or directors of the U.S. target corporation, or who are 5% shareholders of the U.S. target corporation, will own, in the aggregate, 50% or less

of each of the total voting power and the total value of the stock of the transferee foreign corporation immediately after exchange of the U.S. target stock.

(iv) U.S. persons transferring the U.S. target stock cannot be five-percent transferee shareholders. If a U.S. person is a five-percent transferee shareholder, the U.S. person may still qualify for the exception. To do so, the U.S. person must enter into a gain recognition agreement that conforms to the requirements set forth in § 1.367(a)-8.

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

(a) 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)-2(d)(2), (3), and (4), for the entire 36-month period immediately preceding the transfer.

(b) At the time of the transfer, neither the transferors nor the transferee foreign corporation (or any qualified subsidiary or qualified partnership engaged in the active trade or business) has an intention to substantially dispose of or discontinue such trade or business.

(c) The substantiality test of § 1.367(a)-3(c)(3)(iii) must be satisfied.

Under the substantiality test, the fair market value of the transferee foreign corporation must equal or exceed the fair market value of the U.S. target company at the time of the exchange of U.S. target company stock (see § 1.367(a)-3(c)(3)(iii)(A)). For this purpose, § 1.367(a)-3(c)(3)(iii)(B) provides an anti-stuffing rule that requires the fair market value of the transferee foreign corporation to be reduced by the value of certain assets. The value of the transferee foreign corporation is further reduced by the value of any assets that it received within the 36-month period preceding the exchange if those assets were owned by the U.S. target company or an affiliate (see § 1.367(a)-3(c)(3)(iii)(B)(3)).

The substantiality test also includes an NOCD rule aimed at preventing a U.S. target company from reducing its value for purposes of satisfying the substantiality test. Specifically, § 1.367(a)-3(c)(3)(iii)(C) provides that the fair market value of the U.S. target includes the aggregate amount of NOCDs made by the U.S. target company within the 36-month period preceding the exchange.

After these adjustments, if the fair market value of the transferee foreign corporation continues to equal or exceed the fair market value of the U.S. target company, then the substantiality test of § 1.367(a)-3(c)(3)(iii) will be satisfied.

Under § 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 § 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 § 1.367(a)-3(c)(1).

CONCLUSION

Based solely on the information submitted and on the representations set forth above, we hold as follows:

(1) Subject to ruling (2), below, the indirect transfer of UST shares by U.S. persons in exchange for shares of FA will qualify for an exception to the general rule of § 367(a)(1). § 1.367(a)-3(c)(1) and 1.367(a)-3(c)(9)(i).

(2) USP will qualify for this exception only upon entering into a gain recognition agreement. § 1.367(a)-3(c)(1)(iii)(B). This gain recognition agreement must conform to the requirements set forth in § 1.367(a)-8.

No opinion is expressed as to the tax treatment of the transactions under other provisions of the Code and regulations, and no opinion is expressed about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions that are not specifically covered by this ruling. In particular, no opinion is expressed or implied as to whether the Merger qualifies as a reorganization within the meaning of §§ 368(a)(1)(A) and (a)(2)(D). Nor is an opinion expressed as to the reporting requirements of U.S. persons exchanging stock under § 6038B and the regulations thereunder.

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

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling. This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Charles P. Besecky
Branch Chief, Branch 4
(International)