Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:INTL:B04
PLR-148643-06
Date:
November 28, 2006

Legend

UST	=
TFC	=
State A	=
Industry X	=
American Stock Exchange 1	=
Foreign Stock Exchange 1	=
Country B	=
Foreign Sub Y	=
aa	=
bb	=
month cc	=

dd =

Year 1 =

Year 2 =

Year 3 =

ee =

Month ff =

Month gg =

Date hh =

Merger Sub 1 =

Merger Sub 2 =

Dear :

This is in reply to your letter dated October 5, 2006. In that letter, you requested a ruling under section 1.367(a)-3(c)(9) of the Income Tax Regulations that 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 letters dated November 15, 2006.

The rulings contained herein are based on information and representations submitted by the taxpayers. The information and representations are 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 this request, it is subject to verification upon examination.

Facts

UST is a domestic corporation organized under the laws of state A. It is engaged in industry X and is publicly traded on American Stock Exchange 1. TFC is a foreign corporation organized under the laws of country B. It is engaged in industry X, as well. TFC has one class of common stock, which is publicly traded on Foreign Stock

Exchange 1. American Depositary Shares (ADSs) of TFC are listed on American Stock Exchange 1. Each ADS represents one-fifth of one TFC ordinary share.

TFC has engaged in transactions over the last thirty-six months. In year 2, it acquired Foreign Sub Y, another corporation in industry X, from unrelated public shareholders. UST represents that TFC undertook this transaction to expand its business in industry X worldwide. Pursuant to the acquisition, TFC incurred a credit facility of aa. TFC issued bb ordinary shares during month cc in an effort to repay this facility.

TFC also issued dd ordinary shares upon the exercise of stock options during years 1, 2, and 3. These options had been granted to certain employees, executive officers, and directors of TFC. TFC has adopted a total of five option plans. Each plan has a unique set of terms.

Finally, TFC issued ee ordinary shares in exchange for convertible notes in months ff and gg. TFC issued these notes in year 1. Noteholders and TFC shareholders authorized an amendment to the indenture agreement in year 2 permitting early conversions of the notes. One portion was surrendered in month ff, while the remaining notes were surrendered in month gg. None of the notes remains outstanding.

On date hh, TFC and UST entered into a merger agreement. Pursuant to it, TFC will create two domestic corporations: Merger Sub 1 and Merger Sub 2. Each subsidiary will be organized under the laws of state A. The transaction will take place in two steps. First, Merger Sub 1 will merge into UST with UST as the surviving corporation. Second, UST will merge into Merger Sub 2 with Merger Sub 2 as the surviving corporation. The mergers have been structured this way to address certain corporate law issues arising under country B. UST represents that this transaction will qualify as a reorganization under section 368(a)(1)(A) and (a)(2)(D) of UST into Merger Sub 2 in exchange for TFC ADSs and a limited amount of cash.

Law and Analysis

When a U.S. person transfers appreciated property to a foreign corporation, and that transfer is in connection with an exchange described in section 354 or 356, the transfer will generally be treated as a taxable exchange. § 367(a)(1). If the appreciated property consists of stock, section 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 one of the exceptions in section 1.367(a)-3(c) applies.

Certain reorganizations under section 368(a)(1)(A) and (a)(2)(D) trigger section 367(a)(1). § 1.367(a)-3(d)(1)(i). These types of mergers consist of a section 361(a)

transfer of property followed by an exchange of stock under section 354 or 356. The exchange of stock takes place between the target corporation and its shareholders. When, however, the target corporation is domestic, and the corporation that controls the acquiring corporation is foreign, the reorganization is recast for the purposes of applying section 367(a)(1). § 1.367(a)-3(d)(1). Instead of being treated as a section 361(a) transfer followed by a section 354 or 356 exchange, the reorganization falls under the indirect stock transfer rules of section 1.367(a)-3(d). § 1.367(a)-3(d)(1)(i). There, the U.S. persons that are shareholders in the domestic corporation are treated as having made an indirect transfer of the stock in the domestic corporation. As a result, unless the requirements of section 1.367(a)-3(c) are satisfied, the indirect transfer of appreciated stock constitutes a taxable exchange under section 367(a)(1) to the extent that the exchange would otherwise have qualified for non-recognition treatment under section 354 or 356.

Pursuant to section 1.367(a)-3(c)(1), the indirect transfer of stock by the U.S. person will qualify for an exception to section 367(a)(1) if the following five requirements are met:

(1) The U.S. target company must comply with the reporting requirements of section 1.367(a)-3(c)(6). § 1.367(a)-3(c)(1).

(2) U.S. transferors must receive fifty percent or less of the total voting power and the total value of the stock of the transferee foreign corporation. § 1.367(a)-3(c)(1)(i).

(3) Immediately after the transfer, fifty percent or less of each of the total voting power and the total value of the stock of the transferee foreign corporation must be owned by U.S. persons that are either officers or directors of the U.S. target company or that are five-percent target shareholders. § 1.367(a)-3(c)(1)(ii).

(4) The U.S. person must not be a five-percent transferee shareholder. § 1.367(a)-3(c)(1)(iii)(A). If the U.S. person is a five-percent transferee shareholder, that person may still qualify for the exception. § 1.367(a)-3(c)(1)(iii)(B). To do so, that person must enter into a gain recognition agreement. The gain recognition agreement must conform to the requirements set forth in section 1.367(a)-8.

(5) The active trade or business test must be satisfied. § 1.367(a)-3(c)(1)(iv). The requirements of the active trade or business test are set forth in section 1.367(a)-3(c)(3).

To satisfy the active trade or business test, the transaction must meet three additional requirements. § 1.367(a)-3(c)(3)(i). First, the transferee foreign corporation must be engaged in an active trade or business outside of the United States for the entire thirty-six month period immediately preceding the transfer. § 1.367(a)-3(c)(3)(i)(A). For the purposes of this test, the term “active trade or business” is defined under section 1.367(a)-2T(b)(2) and (3). Second, at the time of the transfer, the

transferors and the transferee foreign corporation must not intend to dispose of or discontinue the trade or business in a substantial way. § 1.367(a)-3(c)(3)(i)(B). Third, the substantiality test must be satisfied. § 1.367(a)-3(c)(3)(i)(C).

Generally, to satisfy 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 corporation at the time of the transfer. § 1.367(a)-3(c)(3)(iii)(A). To calculate these figures, the fair market value of the transferee foreign corporation must be reduced by the value of certain prohibited assets. § 1.367(a)-3(c)(3)(iii)(B). Specifically, the fair market value of the transferee foreign corporation must be reduced by the amount of any asset that it acquired outside the ordinary course of business during the thirty-six month period preceding the exchange to the extent that: (1) the asset produces or is held for the production of passive income at the time of the exchange; or (2) the asset was acquired for the principal purpose of satisfying the substantiality test. § 1.367(a)-3(c)(3)(iii)(B)(1)(i). The value of the transferee foreign corporation is further reduced by the value of any assets that it received within the thirty-six month period preceding the exchange if those assets were owned by the U.S. target company or an affiliate. § 1.367(a)-3(c)(3)(iii)(B)(3). 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, then generally the substantiality test will be satisfied. § 1.367(a)-3(c)(3)(iii)(A).

Under Treasury Regulation section 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 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).

UST represents that it will satisfy the reporting requirements under section 1.367(a)-3(c)(6). It also represents that it will satisfy the requirements in section 1.367(a)-3(c)(1)(i) and (ii). Nevertheless, there is a question as to whether TFC's fair market value will be at least equal to UST's at the time of the transfer. If this calculation takes into account the market premium paid for UST, and if the rule under section 1.367(a)-3(c)(3)(iii)(B) were to apply to: (1) the options issued by TFC, (2) the shares that TFC issued for convertible debt, and (3) the shares that TFC issued for the credit facility, TFC's fair market value might be less than UST's on the date the merger closes. UST therefore requests a ruling that this transaction will substantially comply with the active trade or business test notwithstanding that TFC's market capitalization might be less than UST's on the date of the transfer.

TFC's market capitalization was greater than UST's for a significant amount of time before the merger was announced. In addition, TFC's market capitalization has continued to exceed UST's when these figures are measured on an outstanding share basis after the announcement of the proposed transaction. UST represents that, within

the thirty-six months immediately preceding the exchange, TFC has not engaged in any transactions whose principal purpose was to satisfy the substantiality test. The issuance of shares during month cc was undertaken in connection with the acquisition of Foreign Sub Y, and Foreign Sub Y is in the same business as TFC.

Conclusion

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

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

(2) Any U.S. persons who are five-percent transferee shareholders 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 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 is expressed or implied as to whether the merger qualifies as a reorganization within the meaning of section 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 section 6038B and the regulations thereunder.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(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.

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.

Sincerely,

Associate Chief Counsel (International)

By: /s/ Charles P. Besecky
Charles P. Besecky
Branch Chief
Office of the Associate Chief Counsel (International)

Enclosure:
Copy for 6110 Purposes