Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201340016**
Release Date: 10/4/2013

CC:CORP:B04:
POSTF-136412-12

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 368.03-00, 852.00-00

date: April 04, 2013

to: Associate Area Counsel, LB&I: Area 4: NRC – Jacksonville, FL

from: Lewis K. Brickates
(Office of Associate Chief Counsel (Corporate)

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subject:

This memorandum responds to your request for assistance and our recommendation as to whether a notice of deficiency should be issued with regard to certain of the transactions undertaken by the Taxpayer's affiliated group in Year 1. A conference was held with the Taxpayer and with various Service personnel on Date 1. This memorandum has been coordinated with CC: INTL.

This memorandum may not be used or cited as precedent.

LEGEND

Taxpayer =

US Sub 1 =

F Sub 1 =

F Sub 2 =

F Sub 3 =

F Sub 4 =

F Sub 5 =

F Sub 6 =

F Corporation =

Date 1 =

Year 1 =

Year 2 =

Year 3 =

Country A =

Country B =

Country C =

a =

b =

c =

d =

e =

Summary of the Facts

The relevant background and transactions are detailed in your request for advice, so we state here only a general summary. Taxpayer, through its wholly-owned US subsidiary US Sub 1, had highly profitable operations generating cash in Country A through a Country A corporate group held by a Country A parent, F Sub 1. In addition to its Country A operating subsidiaries, F Sub 1 also owned a non-Country A finance company and subsidiary, F Sub 2 and F Sub 3. Taxpayer documented potential foreign currency volatility and foreign tax reasons for restructuring the ownership of its Country A operations and its non-Country A financing activities.

The restructuring occurred in two stages a few months apart during Year 1. The first stage (the “F Reorganization”) generally consisted of the contribution of F Sub 1 to

F Sub 6, a Country B corporation, after which F Sub 1 elected to be treated as a disregarded entity ("DE"). Following the DE election, F Sub 1 distributed $a million of its cash to F Sub 6. Taxpayer treated the contribution of F Sub 1 to F Sub 6, following by F Sub 6's DE election, as qualifying as a reorganization described in section 368(a)(1)(F). Also in this stage, F Sub 1 distributed the stock of F Sub 2 to F Sub 6.[1] Further, selected subsidiaries of F Sub 1 were sold to F Corporation, a Country A corporation, and F Corporation and its subsidiaries filed elections to be treated as DEs; F Corporation also paid off various third-party debentures.

The second stage (the "Transaction") generally consisted of creating a leveraged acquisition vehicle, F Sub 5, a Country C corporation held by F Sub 4, which was a Country B entity treated as a corporation for U.S. tax purposes. The leverage consisted of preferred equity certificates, a term note, and a demand note totaling approximately $c issued to F Sub 4 in exchange for F Sub 4 stock. F Sub 5 used the F Sub 4 stock, which Taxpayer established had not appreciated since the exchange described in the preceding sentence, to acquire F Sub 6 from US Sub 1. Following this acquisition, F Sub 6 elected to be treated as a DE, and F Sub 2 was distributed up through F Sub 5 to F Sub 4.

During Years 2 through 3, F Sub 5 repaid the term and demand notes, totaling $d (including interest), to F Sub 4 (the "Payments").

The Taxpayer treated the foregoing F Reorganization, Transaction, and Payments as nonrecognition transactions and tax free repayment of debt. You have requested our views whether, under applicable Code provisions or judicial doctrines, the transactions may be treated as giving rise to taxable gain, or distributions taxable as dividends or under Subpart F.[2] As will be explained, we conclude that neither judicial doctrines nor applicable Code provisions should be applied as the basis for a Notice of Deficiency in this particular case.[3]

Based on a consideration of the relevant authorities in light of the particular facts and circumstances of this case, in our view the F Reorganization and the Transaction

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[1] This stock distribution helped alleviate concerns that the TP had with proposed Country A corporate tax legislation that would have subject the income of F Sub 1's non Country A subsidiaries (including F Sub 2), retroactively, to Country A's corporate income tax. At the time of this distribution, the stock of F Sub 2 was worth $b million dollars.

[2] The foregoing transactions, although described in Notice 2006-85, 2006-2 C.B. 677 (the "Notice"), will not be governed by the regulations pursuant to the Notice which will only apply to transactions occurring on or after September 22, 2006. However, as indicated, you request our views on whether the transactions may still be challenged under applicable Code provisions or judicial doctrines, possibilities left open by the Notice. Because your specific questions are interrelated, the discussion is combined.

[3] You have specifically asked whether section 269 may be applied to challenge the transactions. We believe that section 269 does not apply under the particular facts of this case because, as discussed later in this memorandum, the taxpayer has submitted documentation that shows non-federal income tax business purposes sufficient to support the transactions.

should each be respected as qualifying for nonrecognition treatment, respectively, under sections 368(a)(1)(F) and 368(a)(1)(C), and should not be stepped together or with the subsequent Payments. Under Rev. Rul. 96-29, 1996-1 C.B. 50, the F Reorganization is treated separately from the Transaction, even though these transactions occurred in proximity to each other. The F Reorganization was supported by a sufficient business purpose. The F Reorganization helped preserve and insulate F Sub 1's assets from the unstable Country A economy while approvals for the ultimate F Sub 4/F Sub 5 structure were being obtained.[4] Thus, the F Reorganization avoided a potentially substantial economic loss to the Taxpayer. Further, Taxpayer documented potential foreign currency volatility and exposure and foreign tax reasons for restructuring the ownership of its Country A operations and its non-Country A financing activities in the manner chosen. We conclude that these purposes in regard to the F Reorganization and the Transaction satisfy the business purpose threshold applicable to section 368 reorganizations.[5]

Under the facts and circumstances, we also do not believe the government should challenge on the basis that the acquisition vehicle, F Sub 5, was not capable of economically completing the acquisition of F Sub 6 in the Transaction because it was only capitalized with $e at the outset. In many leveraged buyouts, the acquirer is a much smaller capitalized corporation which acquires a much larger capitalized corporation. This type of capitalization occurs frequently and is considered within the norm in the area of leveraged buyouts. It is immaterial that F Sub 5 was capitalized at the outset with a lesser amount than the F Sub 4 stock it ultimately acquired in the Transaction. Furthermore, the total consideration of $c that F Sub 5 paid to F Sub 4 for the F Sub 4 stock was equal to the value of the F Sub 6 stock later acquired by F Sub 5 in the Transaction.[6] Accordingly, we conclude that the Transaction was a value-for-value exchange.

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[4] The F Reorganization also helped the Taxpayer avoid the proposed adverse Country A tax legislation. *See* footnote 1, supra.

[5] The business purpose doctrine for reorganizations originated in case law. *See Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935). The doctrine does not entirely proscribe the existence of a tax motive for transactions. Even *Gregory* acknowledges that "… the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits cannot be doubted." *Gregory* at page 467; *see also David's Specialty Shops*, 131 F. Supp. 458 (S.D. NY 1955). The business purpose doctrine has been incorporated into the section 368 regulations. In acquisitive reorganizations, one satisfactory non-Federal tax business purpose is sufficient to satisfy the business purpose requirement. *See W-L Molding Co. v. Commissioner (Appeal of Laure*), 653 F.2d 253 (6th Cir. 1981). The business purpose requirement for reorganizations described in section 368 is less rigorous than the corresponding requirement for section 355 transactions. The transactions at issue in this case implicate section 368, not section 355.

[6] The F Sub 5 notes used in the Transaction were fully repaid by the Payments. The Taxpayer also followed applicable debt criteria when it created and issued the notes, so the notes qualify as debt for federal tax purposes. This conclusion also impacts whether these instruments receive a zero basis in F Sub 4's hands, as will be discussed later in this memorandum.

F Sub 5 is not required to recognize gain due to § 1.1032-2(c) on the use of F Sub 4 stock as consideration to acquire F Sub 6. Section 1.1032-2(c) contemplates a subsidiary purchasing its parent corporation's stock and then using that stock as consideration in a triangular reorganization. *See also* Example 1 of § 1.1502-31(g) (P stock purchased by S at or about the time of a reorganization, which stock is later used in the reorganization, considered as occurring outside the contours of the plan of reorganization). Under § 1.1032-2, the subsidiary is fully taxable on any appreciation inherent in that stock upon such use. In the instant case, however, the Taxpayer represents that the F Sub 4 stock had not appreciated between the time of the receipt of such stock by F Sub 5 and such stock's use by F Sub 5 to acquire F Sub 6. Moreover, once a subsidiary's acquisition of its parent stock is respected as a purchase, it follows that the parent would receive a section 1012 cost basis in property acquired in a transaction to which section 1032 applies. Thus, we conclude that F Sub 5's acquisition of the stock of F Sub 4 in part for the two notes, which qualify as debt for federal tax purposes,[7] results in F Sub 4 receiving basis in the notes.

Finally, because we conclude that the notes should be respected as debt, the Payments should constitute repayments of such debts, not dividends or other amounts that would give rise to Subpart F income.

This memorandum may contain privileged information. Any unauthorized disclosure of this document may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call ( ) if you have any further questions.

[7] *See* footnote 6, *supra.*