

Internal Revenue Service

Department of the Treasury

Index Number: 0355.00-00, 1296.00-00

Washington, DC 20224

Number: **200015028**
Release Date: 4/14/2000

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Telephone Number:

Refer Reply To:

CC:DOM:CORP:5 PLR-114745-99

Date:

January 12, 2000

Distributing =

Controlled =

Sub 1 =

Sub 2 =

Corporation X =

Corporation Z =

Newco =

Business A =

Business B =

a =

b =

c =

d =

e =

f =

g =

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h =i =j =

Country A =

Shareholder A =

Shareholder B =

Dear :

This is in reply to a letter dated August 31, 1999, requesting rulings as to the federal income tax consequences of a proposed transaction. The information submitted in that request and in subsequent correspondence is substantially as set forth below.

Distributing, a Country A corporation, has outstanding a single class of common stock. Shareholder A, Distributing's principal shareholder, owns a percent of Distributing's outstanding shares. Shareholder B owns b percent of Distributing's shares. The remaining c percent is owned by the public.

Distributing and its subsidiaries are engaged in Business A and Business B throughout Country A. These businesses have been increasingly subject to fast-paced technological change and enormous competitive pressures over the last 2 years. It has become evident to Distributing that it must participate in the consolidation of Business A in Country A in order to compete effectively. To participate in this consolidation from a position of strength, Distributing has determined that it must separate its Business A operations from its Business B operations. Following the separation, Business A will be combined with Corporation X and Business B will be acquired by Shareholder A.

The proposed transaction consists of three principal components:

1. (a) In order to allocate Distributing's debt between Business A and Business B, Distributing will transfer Sub 1, a Country A corporation through which it conducts Business B, to Sub 2, a newly organized Country A corporation. Following this transfer, Sub 1 will be converted under Country A law into an entity that the taxpayer has represented will be eligible to be treated as a disregarded entity for U.S. federal income tax purposes. Sub 1 will borrow up to h from Shareholder A and will distribute the proceeds of the borrowing to Sub 2. Sub 2 will make a corresponding distribution to Distributing, which will use the amount received to retire a portion of its indebtedness. In addition, Sub 1 will agree to assume two series of Distributing's outstanding debt

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obligations with a total principal amount of i. Sub 1 will assume these obligations in exchange for a cash payment from Distributing in an amount equal to the obligations' fair market value.

(b) Distributing will transfer the stock of Sub 2 to Controlled, a newly formed Country A corporation.

(c) Distributing will spin off Controlled to its current shareholders on a pro-rata basis. Under Country A law, the distribution will be accomplished through a reduction of capital pursuant to which Distributing will transfer Sub 2 to Controlled, which will issue its shares pro rata to Distributing's shareholders.

2. (a) Distributing's shareholders will transfer their shares in Distributing to Newco, a newly-organized U.S. holding company, in exchange for Newco stock and cash. As of the date the parties agreed to enter into the transaction, the cash component of the consideration to be received by Distributing's shareholders in respect of their Distributing shares represented approximately e percent of the total consideration offered by Newco. Distributing's public shareholders may elect to receive shares of Newco common stock, cash, or a mixture of the two. Shareholder B, the only U.S. person that owns a substantial interest in Distributing, will elect to receive solely shares of Newco stock. A public shareholder who does not elect to receive additional shares will receive predominantly cash because the public shareholders will have first call on the cash foregone by Shareholder B.

(b) As part of the same transaction, Newco will acquire 100 percent of the stock of Corporation X from Corporation X's shareholders in exchange for Newco stock. In addition, Newco will receive a large cash infusion from Corporation Z. Following the transaction, the former shareholders of Distributing will own f percent of Newco (g percent on a fully diluted basis).

3. Shareholder A will acquire the d percent interest in Controlled that it does not receive in the distribution in exchange solely for its voting shares. Following the completion of the transaction, Distributing will be wholly owned by Newco, and Controlled will be wholly owned by Shareholder A.

For a transitional period, not to exceed j months following the distribution, Controlled will provide certain administrative and support services to Distributing for a fee.

In connection with the proposed transaction, the taxpayer has made the following representations:

- (a) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other

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than that of a shareholder of the corporation.

- (b) The 5 years of financial information submitted on behalf of Distributing is representative of the corporation's present operations, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted. The gross assets of Distributing's active business to be conducted directly by Distributing will have a fair market value greater than 5 percent of the total value of the gross assets of Distributing after the distribution.
- (c) Immediately after the distribution, at least 90 percent of the fair market value of the gross assets of Controlled will consist of stock of controlled corporations that are engaged in the active conduct of a trade or business as defined in § 355(b)(2) of the Internal Revenue Code.
- (d) The 5 years of financial information submitted on behalf of the corporations to be transferred to Controlled is representative of the present operations, and with regard to such corporations, there have been no substantial operational changes since the date of the last financial statements submitted.
- (e) Following the transaction, Distributing and Controlled will each continue the active conduct of its business (either directly or through its subsidiaries), independently and with its separate employees.
- (f) The distribution of the stock of Controlled is carried out to facilitate the acquisition of Distributing. The distribution of the stock of Controlled is motivated in whole by this corporate business purpose.
- (g) Except as described in steps 2. (a) and 3., there is no plan or intention by any shareholder who owns 5 percent or more of the stock of Distributing, and the management of Distributing, to its best knowledge, is not aware of any plan or intention on the part of any particular remaining shareholder or security holder of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any stock in, or securities of, either Distributing or Controlled, or their successors, after the transaction.
- (h) There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Rev. Proc. 96-30.
- (i) There is no plan or intention to liquidate either Distributing or Controlled, to merge either corporation with any other corporation or to sell or other-

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wise dispose of the assets of either corporation subsequent to the distribution, except in the ordinary course of business.

- (j) No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the stock in Controlled.
- (k) Payments made in connection with all continuing transactions between Distributing and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (l) No two parties to the transaction are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).
- (m) Distributing was not a passive foreign investment company ("PFIC") within the meaning of § 1297 for any taxable year prior to the taxable year in which the distribution takes place.
- (n) Distributing's passive income (within the meaning of § 1297(b)(1)) derived from sources other than the transactions described in this ruling request in the taxable year in which the distribution takes place will represent less than 5 percent of the income arising from those transactions.
- (o) The average percentage of assets held by Distributing during the taxable year of the distribution which produce passive income or which are held for the production of passive income (in each case, within the meaning of section 1297) will be less than 50 percent of Distributing's total assets.
- (p) Corporation X represents that Distributing will not be a PFIC within the meaning of § 1297 with respect to any shareholder after the distribution for either of the 2 taxable years following the taxable year in which the distribution takes place.
- (q) Corporation X represents that it does not intend to sell any of the shares of Distributing within the 2 taxable years following the taxable year in which the distribution takes place.

Section 1297(a) provides that a foreign corporation is a PFIC if (1) 75 percent or more of the gross income of the corporation for the taxable year is passive income, or (2) the average percentage of assets (by value) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent.

Section 1297(c) provides a look-thru rule for 25-percent owned corporations. If a foreign corporation owns (directly or indirectly) at least 25 percent of the stock of

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another corporation, for purposes of determining whether such foreign corporation is a PFIC, such foreign corporation shall be treated as if it held its proportionate share of the assets of such other corporation and received directly its proportionate share of the income of such other corporation.

Section 1297(e) provides an exception to PFIC status for U.S. shareholders of controlled foreign corporations. Section 1297(e)(1) provides that for purposes of the PFIC provisions of the Code, a corporation shall not be treated with respect to a shareholder as a passive foreign investment company during the qualified portion of such shareholder's holding period with respect to stock in such corporation. Section 1297(e)(2) defines qualified portion as the portion of the shareholder's holding period which is after December 31, 1997, and during which the shareholder is a U.S. shareholder (as defined in § 951(b)) of the corporation and the corporation is a controlled foreign corporation.

Section 1298(b)(3) provides an exception to PFIC status for certain corporations changing businesses. Under § 1298(b)(3), a corporation will not be treated as a PFIC for any taxable year if (A) neither such corporation (nor any predecessor) was a PFIC for any prior taxable year, (B) it is established to the satisfaction of the Secretary that substantially all of the passive income of the corporation for the taxable year is attributable to proceeds from the disposition of 1 or more active trades or businesses, and that such corporation will not be a PFIC for either of the first 2 taxable years following such taxable year, and (C) such corporation is not a PFIC for either of such 2 taxable years.

Corporation X represents that Distributing will not be a PFIC for either of the first 2 taxable years following the taxable year in which the distribution takes place. In addition, Corporation X represents that it does not intend to sell any of the shares of Distributing within the 2 taxable years following the taxable year in which the distribution takes place. Finally, because Corporation X will own 100 percent of the shares of Distributing following the distribution, Corporation X will be a U.S. shareholder of a controlled foreign corporation.

The purpose of the look-thru rule of § 1297(c) is to prevent a foreign corporation holding stock of subsidiaries primarily engaged in active businesses from being classified as a PFIC. Similarly, the purpose of the § 1298(b)(3) change of business exception is to prevent a foreign corporation in transition from one active business to another active business from being classified as a PFIC as a result of gain from the transition. Finally, the purpose of § 1297(e) is to eliminate the overlap between the subpart F and the PFIC anti-deferral rules for U.S. shareholders of controlled foreign corporations.

Based solely on the information submitted and on the representations set forth above, it is held as follows:

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- (1) Gain will be recognized by Distributing upon the distribution of the stock of Controlled as if such property were sold to the shareholders at its fair market value (§ 355(e)).
- (2) No gain or loss will be recognized by (and no amount will be included in the income of) Distributing's shareholders on receipt of the Controlled stock (§ 355(a)(1)).
- (3) The aggregate basis of the stock of Controlled and Distributing in the hands of Distributing's shareholders after the distribution will be the same as the basis of the Distributing stock held immediately before the distribution, allocated in proportion to the fair market value of each in accordance with § 1.358-2(a)(2) of the Income Tax Regulations (§ 358(a)(1)).
- (4) The holding period of the Controlled stock to be received by the Distributing shareholders will include the holding period of their Distributing stock, provided such stock is held as a capital asset on the date of the transaction (§ 1223(1)).
- (5) Provided that representation (p) is true, Distributing will not be treated as a PFIC for the year of the distribution because the gain recognized by Distributing from the disposition of shares of its non-U.S. subsidiaries as a result of the proposed transaction will not be characterized as passive income for purposes of § 1297(a).

We express no opinion about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above rulings. We express no opinion regarding the transfer of the stock of Sub 2 to Controlled. See Rev. Proc. 99-3, I.R.B. 1999-1, 103, 105. In addition, we express no opinion about the federal income tax treatment of the transfer of Sub 1 to Sub 2, Newco's acquisition of the stock of Corporation X from Corporation X's shareholders in exchange for Newco stock, or Shareholder A's acquisition of the d percent interest in Controlled in exchange solely for its voting shares. Finally, we express no opinion regarding any transactions entered into to facilitate an election to be treated as a disregarded entity under federal income tax law or the effect of any such election.

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

It is important that a copy of this letter be attached to the federal income tax

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returns of the taxpayers involved for the taxable year in which the transaction covered by this letter is consummated.

Pursuant to the power of attorney on file in this office, a copy of this letter has been sent to the taxpayer's authorized representative.

Sincerely yours,
Assistant Chief Counsel (Corporate)

By: *Filiz A. Serbes*
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