OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM:

SUBJECT:

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LEGEND

Parent =

DSub1 =

FDistributing =

FControlled =

FSub1 =

FSub2 =

FSub3 =

FSub4 =

Country A =

Country B =

Business X =

Business Y =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

Date A =

Date B =

Date C =

Date D =

Date E =

Date F =

FACTS:

Publicly traded Parent is the parent of an affiliated group of corporations filing a consolidated return ("Taxpayer"). Taxpayer conducts Business X and Business Y, among others, through both domestic and foreign corporations. Parent had requested rulings as to the federal income tax consequences of the transaction described below that was consummated beginning on Date A.

Before the steps described below, Parent wholly owned DSub1 and FSub1, and a percent of FDistributing. FSub1 owned the remaining b percent of FDistributing and wholly owned FSub2, which was represented to be classified as disregarded as an entity separate from FSub1 under section 301.7701-3 of the Income Tax Regulations.

After the steps described below, Parent wholly owned DSub1 and FSub1. DSub1 wholly owned FControlled. FSub1 wholly owned FSub2 and FSub2 wholly owned FDistributing.

Taxpayer represented that, pursuant to its plan the steps of the Country A restructuring transaction (the "Plan of Reorganization") occurred as follows:

Step 1. On Date A, Parent sold its entire interest in FDistributing to FSub1 for c, which Taxpayer represented to be an amount equal to fair market value.

Step 2. On Date B, FSub1 contributed its interest in FDistributing to FSub2.

Step 3. On Date C, FDistributing contributed all of its Business Y assets, including its subsidiaries, to newly formed FControlled in exchange for FControlled stock and the assumption by FControlled of related liabilities.

Step 4. On Date C, Parent contributed d to DSub1.

Step 5. On Date C, DSub1 purchased the shares of FControlled from FDistributing in exchange for d, which Taxpayer represented to be an amount equal to fair market value.

Step 6. On Date C, FDistributing distributed e, the full extent of its "known available distributable earnings"[1], to FSub1 (through FSub2).

Step 7. On or about Date D, FDistributing and FControlled were renamed, FSub3 and FSub4, respectively.

Step 8. On Date E (more than 12 months after Step 1), FDistributing distributed f, to the full extent of FDistributing's known available distributable earnings, to FSub1.

Step 9. On Date F (16 months after Step 1), FDistributing distributed g, out of FDistributing's available distributable earnings, to FSub1.

DISCUSSION:

Taxpayer sought several related rulings to the effect that there was a "circle of cash" in the amount of d that would be disregarded under the authority of Rev. Rul. 83-142, 1983-2 C.B. 68. Thus, Taxpayer proposed that the steps described in Step 1 through Step 9 of the Plan of Reorganization, set forth above, would be treated for federal income tax purposes as if:

(a) FDistributing had transferred its Business Y assets, including the stock of its Business Y subsidiaries, to newly formed FControlled in exchange for FControlled stock and the assumption by FControlled of related liabilities;

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[1] "known available distributable earnings" is the amount of earnings that Taxpayer represented could be distributed without causing FDistributing to incur a Country A tax.

(b) FDistributing had distributed all the stock of FControlled to Parent in redemption of Parent's entire stock interest in FDistributing, and

(c) Parent had transferred the stock of FControlled to DSub1.

No ruling was requested with respect to the amount of m (c less d) received by Parent from FSub1 in exchange for the FDistributing stock.

However, we do not believe that the distributions of f and g in Step 8 and Step 9, respectively, of the Plan of Reorganization should be treated as part of a "circle of cash" so as to be disregarded. Among the factors taken into consideration were: (1) there was no binding agreement for Step 8 and Step 9 to occur ab initio; (2) the period of time that Step 8 and Step 9 occurred after Step 1 through Step 6 suggests that these steps were not transitory; (3) the amounts of f and g were not segregated by FDistributing and could be used for general corporate purposes including to earn income or be pledged; (4) to treat these amounts as part of a circle of cash would result in Parent making funds available to FDistributing for a period of time without receiving payment for the use of these amounts; (5) there was no intention for FDistributing to pay these amounts to Parent until an independent separate event occurred, i.e., until FDistributing had available distributable earnings, the presence of which would avoid incurring a Country A tax upon their distribution; and (6) there was no apparent legal prohibition under applicable Country A law preventing Step 8 and Step 9 from occurring prior to 12 months and 16 months, respectively, after Step 1.

Thus, we concluded that the cash in the amount of k should not be disregarded and should be given tax significance pursuant to the Plan of Reorganization.

To the extent of e (the "circle of cash amount"), Step 1 through Step 6 of the Plan of Reorganization should be characterized in the manner requested by Taxpayer (i.e., to the extent of h of the FControlled stock that was distributed by FDistributing to Parent) as a reorganization under §§ 368(a)(1)(D) and 355. See Rev. Rul. 83-142, 1983-2 C.B. 68. Thus, to this extent, Taxpayer's characterization of the steps is to be respected.

To the extent that the cash exceeded e, the circle of cash amount, in steps one through six of the Plan of Reorganization, the tax consequences may be viewed as follows:

First, with respect to Step 1, the amount of i (c less e) may be treated as the purchase price paid by FSub1 for the acquisition from Parent of approximately j of the outstanding FDistributing stock. However, we do not express any opinion as to the applicability of section 304(a)(1) to such purchase.

Second, with respect to Step 4, the amount of k (d less e) may be treated as a transfer by Parent to DSub1.

Third, with respect to Step 5, the amount of k (d less e) may be treated as the purchase price paid by DSub1 for the acquisition from FDistributing of approximately j of the outstanding FControlled stock. However, we do not express any opinion as to the applicability of section 304(a)(1) to such purchase.

Fourth, with respect to Step 8 and Step 9, since only the distribution of e on Date C should be treated as part of the circle of cash amount, the remaining distributions from FDistributing to FSub1 in the amount of f and g on Date E, and Date F, respectively, may be treated as dividend distributions under section 301. To the extent dividend treatment is applicable, such distributions may be foreign personal holding income under section 954(c)(1)(A) since FDistributing and FSub1 were incorporated in Country A and Country B, respectively.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

If your office determines that an adjustment is appropriate, we are setting forth below tax consequences that your office may associate with the characterizations described above.

First, with respect to the characterization of Step 1, we note that if section 304(a)(1) were applicable, it would treat the amount of i as being distributed to Parent in redemption of stock of FSub1; and, if the amount of i is treated as a distribution to which section 301 applies, Parent is treated as making a transfer of FDistributing stock to FSub1 in exchange for stock in FSub1 in a transaction to which section 351 applies (consequently, section 367(a) would apply as

appropriate) followed by FSub1's redemption of the FSub1 stock it was treated as issuing to Parent.

Second, with respect to the characterization of Step 4 as a transfer from Parent to DSub1, the characterization may be viewed as a transfer described in sections 118 and/or 351.

Third, with respect to the characterization of Step 5, we note that if section 304(a)(1) were applicable, it would treat the amount of k as being distributed to FDistributing in redemption of stock of DSub1; and, if the amount of k is treated as a distribution to which section 301 applies, FDistributing is treated as making a transfer of FControlled stock to DSub1 in exchange for stock in DSub1 in a transaction to which section 351 applies (consequently, section 367 would apply as appropriate) followed by DSub1's redemption of the DSub1 stock it was treated as issuing to FDistributing. Further, to the extent the redemption is treated as a dividend under § 301, § 1442(a) may have required the deduction and withholding of taxes by DSub1 imposed under section 881(a)(1).

In addition, we are including two alternative characterizations of the amounts in excess of the e circle of cash amount. These alternatives were set forth by Parent and may be expected to be set forth again. We are also including some of our initial thoughts on these alternatives in order that you have the benefit of them for discussion purposes or determining the risks of litigation, if necessary.

One alternative would characterize the undistributed amount as of Date E (i.e., g) and/or Date C (i.e., k) as a capital contribution from FSub1 to FDistributing based on the substance of the transaction. Under this alternative, the distributions in the amount of g and/or f on Date F and Date E, respectively, would be dividend distributions under section 301 and would constitute foreign personal holding company income under section 954(c)(1)(A). This alternative was not adopted, partially based upon Nestle Holdings Inc. v. Commissioner, 152 F3d 83 (2nd Cir. 1998).

Another alternative would characterize the transaction as (i) a sale by Parent of j of its interest in FDistributing to FSub1 in return for i, (ii) a purchase by Parent of l of the stock of FControlled from FDistributing for k, and (iii) a contribution of such FControlled stock by Parent to DSub1. This characterization reflects the actual transfer of the cash by wire from Parent to FDistributing, rather than from Parent to DSub1 to FDistributing as set forth in Step 4 and Step 5. However, we

partially declined to accept this characterization because we understood that the wire transfer from Parent to FDistributing, rather than from DSub1 (as set forth in the ruling request and the Plan of Reorganization), was unknown to any of the persons at the conference of right until after we had advised that we were tentatively adverse. Our discussions with Parent personnel indicated that the cash received by FDistributing was intended to be the consideration for the sale by it to DSub1 of the stock of FControlled. Further, in this case, the short-cutting of the steps of the Plan of Reorganization was ignored as it appeared that the parties to the transaction gave credence to each of the planned transfers as a step, as appropriate, although, the circle of cash in the amount of e was a series of steps that were transitory and, thus, to be disregarded in accordance with Rev. Rul. 83-142, supra. Also, Nestle Holdings Inc. v. Commissioner, 152 F3d 83 (2nd Cir. 1998) may support this approach.

If you have any further questions, please call Aaron Farmer at (202) 622-3860.

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