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INTERNAL REVENUE SERVICE
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MEMORANDUM FOR NEW ENGLAND DISTRICT
ATTN: JOHN FEELEY,
International Examiner, International Group 1111/1109

FROM: ELIZABETH U. KARZON
Chief, Branch 1 CC:INTL:BR1

SUBJECT:

This Field Service Advice responds to your request for assistance evaluating the Protest dated August 14, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND:

A	=
B	=
C%	=
D%	=
E%	=
F	=
Source H	=
Country I	=
Country J	=
Country K	=
Country L	=
USCo	=
FCo	=
M	=
FTrust	=
Company N	=
P	=
Q	=
Year 1	=
Year 2	=
Year 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=

ISSUE 1:

Whether a principal purpose for A's expatriation on Date 4 was the avoidance of U.S. taxes for purposes of I.R.C. § 877.

ISSUE 2:

Whether I.R.C. § 351 does not apply to the transfer on Date 5 by A of stock of USCo to FCo in exchange for FCo stock because it was not undertaken for a valid business purpose, thereby permitting the transfer of such stock to be taxable as a sale or exchange under I.R.C. § 877(c)(2), as in effect on Date 5.

CONCLUSIONS:

1. Based on the evidence presented to date, A's loss of U.S. citizenship appears to have for one of its principal purposes the avoidance of U.S. taxes. A is therefore subject to tax for the 10-year period following such loss pursuant to I.R.C. § 877, in effect at the date of A's expatriation.

2. Based on the evidence presented to date, A has asserted a sufficient business purpose to conclude that his transfer of USCo stock in exchange for FCo stock qualifies as a non-recognition exchange under I.R.C. § 351. Thus, such transfer is not treated as a sale or exchange of domestic stock for purposes of section 877(c)(2).

FACTS:

A was born in Year 1 in the United States. A is a very successful business person who has made his career managing a number of large international businesses. According to information provided to the Service, A maintained his primary residence in Country I from Year 3 until Date 4. A did not indicate whether his Country I address remains his primary residence.

No information has been provided concerning his continuing personal and business contacts with the United States, including how often he has been present in the United States since Date 4. However, it is public knowledge that A remained a member of the Board of Directors for Company N, a large U.S. multinational enterprise after expatriating.

A first visited Country I in Year 2. A asserts that in Year 3, he decided to make Country I his principal home and acquired an office in Country I, hiring full time administrative and accounting staff. A also has an office available for his use in the United States. A asserts that beginning in Year 3, he and his wife became active members of a church in Country I and began supporting several charitable institutions in Country I. A enrolled his sons in a private Country I school, where A is a Founding Trustee. A also constructed a residence over the course of six years in Country I.

According to A, Country I's economy is largely tourism based and stagnant. However, because of A's considerable business acumen:

> [v]arious Country I government members as well as opposition members of parliament solicited A's assistance in helping them develop and implement an economic development and diversification

program. A's background as a successful corporate executive was well known and the government was anxious to have the benefit of his experience and his extensive contacts in the business community.

For a number of years, A became an unpaid advisor to the Country I government, regularly meeting with government officials and introducing these officials to United States business people who were considering investing in Country I .

COUNTRY I LAW

Country I imposes no income or inheritance taxes on resident individuals. It is a favored location for international investors because of its accommodating investment climate. A contends that he felt restricted in his ability to invest in Country I because he was not a citizen. However, Country I actively seeks to attract foreign investors for 17 major areas of its economy and offers an array of foreign investment incentives, including exemptions from customs duties and property taxes. In addition, in the year prior to A's expatriation, Country I liberalized the rules for foreign ownership of residences and real estate and for obtaining annual and permanent residency certificates.

Despite this climate, A felt that he was a second class citizen in Country I and that he carried the stigma of being considered an outsider. Although he held a significant financial investment in Country I, he felt that Country I's policies concerning non-citizen investment were annoying obstacles. Additionally, A contends that the fact that Country I has the right to revoke non-citizen work permits might some day jeopardize his significant financial investment in Country I, which would make it impossible for him to continue to live in Country I.

Country I immigration law provides for the naturalization of aliens through an application to the official responsible for nationality and citizenship. The official will grant a certificate of naturalization provided that the alien meets certain residency and character qualifications.[1] One such qualification is that an alien must be a Country I resident for six of the nine years prior to naturalization. A's Country I residence was in its sixth year of construction when A filed his application for Country I citizenship.

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[1]Source H.

As A has asserted, no certificate will be granted unless the alien first renounces any other citizenship that he possesses.[2] However, the alien may obtain a waiver in some cases:

> [i]n the case of a person who cannot renounce his citizenship of some other country under the laws of that country, he makes instead such declaration concerning that citizenship as may be prescribed.[3]

Despite his considerable business acumen, access to professional counsel, alleged residence in Country I since Year 3, and six years of construction on his Country I residence, A asserts that he was taken by surprise by the requirement that he relinquish any other citizenship. A asserts that he had never been told by anyone at any time prior to the receipt of an official Country I letter, that he would be required to relinquish his United States citizenship in order to become a Country I citizen.

A contends that he immediately took action in a series of fruitless attempts to retain his United States citizenship. Neither his contacts in the Country I government nor his Country I counsel could assist him. Apparently defeated, A asserts that he reluctantly filed the appropriate papers to renounce his United States citizenship.

However, it appears that Country I does not prohibit its citizens from acquiring citizenship in additional countries. Since renouncing his United States citizenship, A has also become a citizen of Country J. The United States does not require Country J citizens to acquire a visa prior to entering the United States for tourism or business purposes for 90 days or less. Therefore, A may enter the United States more easily than his Country I countrymen who rely solely on their Country I citizenship. Country J also imposes income tax solely on a territorial basis. Income that is neither earned nor remitted to Country J is not taxed in that jurisdiction.

THE ENTITIES

Prior to expatriating, A owned a domestic grantor trust (USTrust), which owned C% of the stock of USCo, a domestic corporation. As an estate planning matter, A had initially decided to establish the domestic trust in order to avoid

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[2] *Id.*

[3] *Id.*

United States and foreign probate proceedings. The bulk of A's property was to remain in trust after A's death, during the lifetime of A's wife, and possibly through the lives of his children. B is A's longtime business partner, personal friend, C% USCo shareholder and chief operating officer. B was appointed as the USTrust successor trustee. However, A's wife became uncomfortable with the amount of control B would have over the lives of herself and her children after A's death.

A desired to appoint a successor trustee who not only had the extensive business experience of B, but who would live long enough to manage the trust through the lives of A's young children. A felt that although an institutional trustee would be long-lived, such a trustee would lack the ability to actively manage USCo and would sell USTrust's interest in USCo for less than its maximum potential value in order to ease the administration of the trust.

After consultation with his lawyers, accountants, B, and his family, A decided that a holding company / trust structure would accomplish his goals. A is familiar with the benefits of holding company structures and has considerable experience managing a number of such companies in the role of Chairman and CEO. A determined that he should implement a strategic oversight management team in the holding company while he was alive and well so that his death or disability would not trigger a forced sale which could be harmful to his family's interest.

According to A, the foreign holding company / trust structure was also designed to shelter A from personal liability and to allow him to segregate assets from the claims of creditors. A asserts that USCo is engaged in a type of business that is highly susceptible to tort claims. According to A, "[i]n certain instances, persons who have suffered damages are allowed to pierce the corporate veil and seek compensation from the corporation's shareholders, as well as its officers and directors."

One of the inconveniences of Country I citizenship, from A's perspective, is their exchange control policies. However, a holding company / trust structure circumvents these requirements. A asserts that his ability to invest worldwide would be severely hampered if he were required to secure Country I Central Bank approval for all non-Country I investments or if he were required to convert hard currency reserves to Country I dollars. A was also concerned about sheltering his assets from the potential of political unrest and expropriation in Country I. Country I, although politically stable at the moment, is still is a small developing country where there can be no guarantee of long term stability. A also contends that he chose a holding company / trust structure to insulate himself from liability through conducting business in other less developed countries where corporations are not necessarily recognized as a separate legal entity from its shareholders.

In addition, A defends his choice of a foreign trust in part because of a strong reluctance of many U.S. trustees to assume fiduciary obligations with respect to such high-risk businesses as USCo. He asserts that foreign trustees are less concerned with potential claimants. He also decided that because he intended to live outside of the United States, he had no reason to limit himself to a domestic trust.

THE TRANSACTIONS

On Date 4, A renounced his U.S. citizenship. On Date 5, 10 days later, A caused FCo, a Country K corporation to be formed.[4] On Date 6, (11 days after expatriating), A transferred his entire interest in USCo to FCo in exchange for all the outstanding shares of FCo stock. Also on Date 6, A settled FTrust, a Country L trust. On Date 7, (24 days after expatriating), A contributed his FCo stock to FTrust, a foreign trust, of which A and his family are the beneficiaries.

Approximately seven weeks after the above transactions, USCo filed a Form S-1 Registration Statement with the Securities and Exchange Commission to register newly-issued shares of USCo in advance of an initial public offering ("IPO"). Despite being a C% shareholder of USCo, A contends that he did not control the filing or the timing of the filing of the Registration Statement. A vigorously argues that he was not obligated to sell any of his existing shares in USCo. However, the Registration Statement was drafted to allow for a secondary offering, whereby A's existing shares could be sold at the time of an IPO if A decided to do so.

The IPO was halted at this point. In addition to denying his control over this decision, A cites various non-tax factors for delaying the IPO, such as USCo's pending litigation, negative equity and decreasing profits. After waiting 20 months, after the date A's expatriation, USCo's IPO proceeded. A, through FCo and Ftrust, decided to sell a portion of his existing shares in USCo at a gain of $F. Through FCo and Ftrust, A decided to reinvest the gain from this sale in other foreign investments. After this sale, A continues to hold, through FCo and Ftrust, shares of USCo stock representing approximately D% of all the shares entitled to vote and E% of the value of all classes of stock.

LAW AND ANALYSIS:

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[4] FCo changed its name to M on August 16, 1994. For the sake of convenience, we will continue to refer to this corporation as FCo.

ISSUE 1: I.R.C. § 877

In general, I.R.C. § 877 imposes an alternative scheme of income, gift and estate taxation on U.S. citizens (and since 1996, on lawful permanent residents) who expatriate with a principal purpose of avoidance of U.S. income or transfer taxes.

Under the version of I.R.C. § 877 in effect at the time of A's expatriation, for the 10-year period following the year of expatriation, an expatriate with a principal purpose of avoidance of U.S. taxes was subject to the normal rules applicable to the income taxation of nonresident aliens, with three major differences. First, the expatriate was taxed as a U.S. citizen on U.S. source income at the income rates applicable to U.S. citizens if it resulted in a tax greater than the tax that would have been imposed on the expatriate at the rates applicable to nonresident aliens. *See* former I.R.C. § 877(a) and (b). Second, capital gain on the sale or exchange of property (other than stock) located in the United States was considered U.S. source income. Former I.R.C. § 877(c)(1).

Third, an expatriate who was subject to former I.R.C. § 877 was required to include in gross income gains from the sale of stocks and securities issued by U.S. persons. Former I.R.C. § 877(c)(2). Gain on the sale or exchange of property that had a basis determined in whole or in part by reference to stock issued by a domestic corporation was also treated as a sale of stock of a domestic corporation. *Id.*

Prior to the 1996 amendments to I.R.C. § 877, it was possible for a tax-motivated expatriate to evade the consequences of I.R.C. § 367 by expatriating prior to an I.R.C. § 351 exchange with a controlled foreign corporation.

> Under the existing section 367 regulations, and the expatriation provisions of prior law, a U.S. person who expatriated, even for a principal purpose of avoiding U.S. tax, could subsequently engage in transactions that involve the transfer of property to a foreign corporation without any adverse consequences under section 367, since expatriation (even for a principal purpose of tax avoidance) is not an event covered by section 367 or the current regulations under that section.... For example, under section 877, if a principal purpose of tax avoidance existed, an expatriate would be taxed for 10 years on any sale of U.S. corporate stock. However after expatriation, the person would no longer be a U.S. person for purposes of section 367, and thus generally could have transferred U.S. corporate stock to a foreign corporation controlled by the expatriate under section 351 without any section 367 effect. The foreign corporation generally could

have then sold the U.S. corporate stock within the 10-year period, but the gain would not have been subject to U.S. tax.

Joint Committee General Explanation of the Health Insurance Portability and Accountability Act of 1996, 104th Cong., 2nd Sess., (Dec. 18, 1996).

I.R.C. § 877 was substantially revised in August 1996 as part of the Health Insurance Portability and Accountability Act (HIPAA). The 1996 amendments eliminated this particular practice. See I.R.C. § 877(d)(2).

BURDEN OF PROOF

Former I.R.C. § 877(e) shifted the burden of proof to the taxpayer to show that the avoidance of U.S. taxes was not a principal purpose of expatriation where the Service establishes that it is reasonable to believe that an individual's loss of U.S. citizenship would result in a substantial reduction in U.S. taxes in the year of expatriation.

In this case, if A had remained a U.S. citizen at the time he transferred the stock of USCo to FCo, he would have been subject to substantially more U.S. taxes. A would have been a "U.S. person" pursuant to I.R.C. § 7701(a)(30) and A's transfer of property to a foreign corporation (FCo) in connection with an I.R.C. § 351 exchange would have invoked I.R.C. § 367(a). Treas. Reg. § 1.367(a)-3(c)(3). Under I.R.C. § 367(a), FCo would not have been considered a corporation for purposes of I.R.C. § 351 non-recognition, therefore A would have recognized P gain on this transfer, resulting in a U.S. tax liability of Q.

However, A expatriated 11 days prior to exchanging USCo stock for FCo stock, thereby circumventing the application of I.R.C. § 367(a). By doing so, A avoided taxation on P of gain and reduced his U.S. tax liability on this exchange from Q to zero. Therefore, it is reasonable to believe that A's loss of citizenship resulted in a substantial reduction in U.S. taxes during the year of his expatriation. Therefore, even under the law prior to 1996, former I.R.C. § 877(e) shifted the burden of proof to the taxpayer to show that the avoidance of U.S. taxes was not a principal purpose of expatriation.

The two central cases which discuss whether a taxpayer has expatriated with a principal purpose of the avoidance of U.S. taxes are: *Kronenburg v. Commissioner*, 64 T.C. 428 (1975) and *Furstenberg v. Commissioner*, 83 T.C. 755 (1984). *Kronenburg* dealt with a native born Swiss citizen who emigrated to the United States in 1949. He became a naturalized United States citizen in 1955, the same year in which he founded an importing business ("PIC"). He retained dual

citizenship. In 1966, Kronenberg entered into a contract to sell his business. Kronenberg was to become an employee of the new corporation and would live and work in the United States until April 30, 1967. At that time the contract provided that he would move to Europe and continue to work for the new corporation for the remainder of his contracted five year employment term. Rather than purchase the shares of PIC, the new owner wished to form a new corporation. Therefore, on February 26, 1966, a plan of liquidation for PIC was adopted under which the liquidation would be complete by February 25, 1967.

In December, 1966, Kronenberg's accountant informed him that if Kronenberg renounced his U.S. citizenship prior to receiving liquidating distributions from PIC, the distributions would not be subject to U.S. taxes. Kronenberg decided to move to Switzerland before the planned distribution date in February, rather than waiting until April of 1967 as he had originally planned. During January and February of 1967, Kronenberg sold his house and made all of the necessary arrangements to wind up his business and personal affairs and to move his family to Switzerland before receiving the distributions from PIC. He instructed his attorneys to make the distributions at the latest possible time. *Id*. at 431.

Kronenberg and his family left the United States on February 21, 1967, and arrived in Switzerland on February 22. On February 23, Kronenberg and his wife renounced their U.S. citizenship at the U.S. Consul in Zurich. On February 24, Kronenberg's attorneys transferred some of PIC's former assets into Kronenberg's personal account. *Id.*

The Tax Court held that one of Kronenberg's principal purposes in expatriating was the avoidance of U.S. taxes. Kronenberg testified that when he returned to Switzerland, he renounced his U.S. citizenship because he believed that its retention would be inconsistent with his participation in the privileges and duties of a Swiss citizen. However, the evidence failed to show that he gave any consideration to renouncing his U.S. citizenship before he learned of the possible tax advantage of doing so. The Tax Court felt that Kronenberg's activities during the first two months of 1967 were "too perfect to be unplanned." *Id*. at 435.

In *Furstenberg*, the Tax Court held that an oil heiress originally from the United States did not have a principal purpose of avoiding U.S. taxes by expatriating shortly after her marriage to an Austrian aristocrat. By the time she expatriated, Furstenberg's ties to the United States were relatively few. Her parents were dead and her children were grown. She had been living in Europe for many years before her marriage and her personal effects were maintained outside of the United States.

Prior to expatriating, she informed her accountant that she intended to marry Prince Furstenberg, adopt Austrian citizenship, and to continue to live in Paris. He told her that adopting Austrian citizenship would complicate her taxes and warned her that French taxes could be very high. They had no further discussions in 1975. Her income in 1975 and 1976 came from trust distributions to her and from the sale of stock. The distribution from one of the trusts occurred on the day of her expatriation. In addition, she sold a large amount of stock in 1976, after her expatriation.

The Tax Court defined the term "principal purpose" as a "first-in-importance" purpose, and held that Furstenberg did not have tax avoidance as a principal purpose in expatriating. *Id.* at 776. In reaching this conclusion, the court found that the timing of Furstenberg's expatriation was inextricably linked to her marriage because she expatriated four days following her honeymoon. *Id.* at 778. In addition, the court stated that at the time of her expatriation, Furstenberg was not aware of any tax advantages in doing so.

The court distinguished *Furstenberg* from *Kronenberg* by stating that Mrs. Furstenberg's actions were "too imperfect from a tax standpoint to have been planned" instead of "too perfect to be unplanned" as in *Kronenberg*. *Id.* at 780.

> [P]etitioner engaged in no "flurry of activity" in connection with her expatriation. She decided to expatriate before she knew anything about the tax consequences thereof; she had lived in Europe for more than 7 years; at the time of her expatriation she knew of only possible negative tax effects; and her activity, or lack of it, viz-a-viz the trust distributions indicates that she did no planning whatsoever to delay them until after her expatriation.

Id. at 780.

In the present case, A's actions are clearly more closely aligned to *Kronenberg.* Within 11 days of expatriating, A transferred his USCo stock to FCo and then gifted the foreign corporation stock to a foreign trust. The USCo IPO was originally scheduled to follow only seven weeks after the above transactions. If the IPO had proceeded at that time, it would have been even more clear that A's U.S. tax liability was substantially reduced in the year of his expatriation, thereby even more clearly shifting the burden to A to prove that he was not tax motivated. An IPO following so closely on the heels of his expatriation would have squarely placed A in the shoes of Mr. Kronenberg. A argues that he did not control the timing of the IPO. However, as a C% shareholder, A must have been a key participant in the decision to take USCo public.

A also argues that because he has not personally received any of the proceeds of the sale of the USCo stock and that the sale of the stock was designed to diversify the FTrust's holdings, this is further evidence that the IPO was not part of a tax-avoidance plan. However, FTrust holds all of A's FCo stock, and A and his family remain the FTrust beneficiaries.

A claims that he became a Country I citizen in order to undo the discrimination that he asserts Country I imposes on non-citizens and to more completely integrate into his new home. However, A has not accepted the "inconveniences" of Country I citizenship. A has planned around Country I exchange controls by implementing the foreign holding company / trust structure. A also opted out of Country I's foreign relations policies by adopting Country J citizenship that will allow him to travel and invest more conveniently. Citizens of Country J are permitted to enter the United States without a visitor's visa. Country I citizens must apply for a visa. In addition, Country J taxes on a territorial basis. Therefore, because FCo is not a Country J corporation, and FTrust is not settled in Country J, he will not be subject to Country J taxes on this income unless it is remitted to Country J.

The combination of all of the above facts clearly show that a principal purpose in A's expatriation was to avoid U.S. taxes.

ISSUE 2: I.R.C. § 351

If A expatriated with a principal purpose to avoid U.S. taxation, former I.R.C. § 877(c)(2) would have required him to include in his gross income gains from the sale of stocks and securities issued by U.S. persons for the 10 year period following the date of his expatriation. Former I.R.C. 877(c)(2) also would have required him to include in his gross income gain on the sale of stock which had a basis determined in whole or in part by reference to his basis in U.S. stock. However, A argues that because he transferred his USCo stock to FCo in a bona fide tax-free I.R.C. § 351 exchange, there were no gains associated with his disposition of the USCo stock. Furthermore, he never sold or exchanged any FCo stock, but rather made a completed gift of the FCo stock to FT. A's position depends, however, on the initial exchange of USCo stock for FCo stock being in a bona fide I.R.C. § 351 exchange.

In general, under I.R.C. § 351(a), no gain or loss is recognized when property is transferred to a corporation by one or more persons, solely in exchange for stock in the second corporation and immediately after the exchange, the transferors are in control of the corporation. "Control" is defined as having ownership of stock possessing at least 80 percent of the vote and value of the

corporation. I.R.C. § 368(c). The transferor in an I.R.C. § 351 exchange takes the same basis in the stock received from the transferee corporation as the aggregate basis that the transferor had in the property transferred to the transferee. I.R.C. § 358(a)(1). Similarly, the transferee corporation takes the same basis in the property it received from the transferor as the transferor had in such property. I.R.C. § 362(a)(1). Thus, gain or loss built into the transferred property is deferred until either the stock is sold by the transferor or the property is sold by the transferee (or both).

Courts have recognized that a taxpayer may benefit from non-recognition treatment under I.R.C. § 351 as long as a valid, non-tax business purpose partially motivated the transaction. See e.g., Caruth v. United States, 688 F. Supp. 1129, (N.D. Tex. 1989), aff'd 865 F2d 644 (5th Cir. 1989); Stewart v. Commissioner, 714 F.2d 977, 987 (9th Cir. 1983), aff'g T.C. Memo 1982-209; and Estate of Kluener v. Commissioner, 154 F.3d 630 (6th Cir. 1998), (aff'g in relevant part and rev'g in part (on another issue)) T.C. Memo 1996-519.

In determining whether a valid, non-tax business purpose partially motivated the transaction, courts examine all the facts and circumstances, with particular emphasis on the following factors: whether the transfer fulfilled its stated purpose; the extent to which the transferor, rather than the transferee, benefitted from the transfer; the extent to which the transferee needed the property; the length of time between the transfer and subsequent events; the number of such transfers; the taxpayers' expertise in tax matters; and the transactions' form. Courts also examine any indicators of a taxpayer's intent, such as documents or negotiations that confirm or belie the existence of a pre-arranged plan. Estate of Kluener at 635.

Cases involving business purpose in the I.R.C. § 351 context also focus on whether the corporation to which property was transferred in a purported I.R.C. § 351 transaction was used solely as a mere conduit to accomplish tax benefits that could not have been accomplished directly. Under circumstances where a transfer of property to a corporation is undertaken to advance a tax avoidance plan and serves no other independent business purpose, courts generally disregard the transfer. See e.g., Estate of Kluener, supra; Gregory v. Helvering, 293 U.S. 465 (1935), aff'g 69 F.2d 809 (2d Cir. 1934). See also Rev. Rul. 70-140, 1970-1 C.B. 73 (a transfer to a controlled corporation in a purported I.R.C. § 351 exchange is disregarded under circumstances demonstrating that the transfer was motivated by tax avoidance considerations) and Hallowell v. Commissioner, 56 T.C. 600 (1971) (transfer of appreciated securities by shareholder to corporation followed by the corporation's sale of the securities treated as a sale by shareholder of the securities).

In this case, A asserts that he transferred his USCo stock to FCo, a holding company containing essentially no other assets (*i.e.*, other than his FCo stock), for valid business reasons, *i.e.*, to effectuate his estate planning goals and to protect himself from the liability inherent in USCo's business.

A states that his decision to move his USCo stock into a foreign holding company structure will allow a skilled board of directors to oversee USCo in the event of his death or disability so that his heirs will not be forced to either manage USCo or to sell their interest at a potentially discounted price.

A also asserts that he and the co-owner of USCo were threatened with a lawsuit alleging that they were personally liable for damages for which USCo was allegedly responsible. A states that while it is generally accepted in the United States that a corporation is a separate legal entity and that shareholders are not liable for the debts or liabilities of the corporation, the separate entity principle is not recognized in every jurisdiction, including some in which A might have business interests. Thus, A argues that additional levels of corporate ownership, and the existence of a trust between A and A's investments, including USCo, would enhance the protection afforded by corporate ownership alone. A states that he chose a foreign trust over a domestic trust to hold the FCo stock because many U.S. trustees have a strong reluctance to assume fiduciary responsibility over high risk businesses such as USCo.

A also states that indirect ownership of his USCo stock is preferable over direct ownership because Country I is still a developing country, with no guarantee that it will continue to have a stable political environment. In addition, he admits that both FCo and FTrust are non-Country I entities in order to plan around Country I foreign exchange control regulations.

Although there is a business purpose requirement under I.R.C. § 351, based on the information presented by A, we believe that there may be sufficient non-tax reasons for A to have contributed USCo stock to FCo under I.R.C. § 351. Thus, despite the fact that there are strong indications of a principal purpose of U.S. tax avoidance, the exchange of USCo stock for FCo stock does not appear to be a sale or exchange within the meaning of I.R.C. § 877(c)(2) as it existed on the date of A's expatriation. However, if upon inquiry it is found that the foreign holding company structure is no longer in place or that the board of FCo is not actively managing its affairs, A's business purpose may be challenged. Of course, had A transferred USCo stock to FCo after the 1996 legislative amendments to I.R.C. § 877, the exchange would have constituted a taxable exchange regardless of whether there was a business purpose. *See* I.R.C. § 877(d)(2).

This Field Service Advice has been coordinated with the Office of Assistant Chief Counsel (Corporate, Branch 6). If you have any further questions, please call (202) 622-3880.

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ELIZABETH U. KARZON
Chief, Branch 1 (International)