Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200751024**
Release Date: 12/21/2007

CC:INTL:B04:JHSeibert
PRESP-121580-07

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 367.01-00

date: September 07, 2007

to:

(Large & Mid-Size Business)

from: Charles P. Besecky
Branch Chief, Branch 4
(International)

subject: Withdrawal of Letter Ruling Request by Target

This Chief Counsel Advice is issued pursuant to section 7.07(2) of Revenue Procedure 2007-1, 2007-1 I.R.B. 1. Chief Counsel Advice is not binding on Examinations or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

Foreign Acquirer =

Majority Shareholder =

Target =

Date 1 =

x =

PURPOSE

Target, a taxpayer in your area, submitted a private letter ruling request dated December 20, 2006 requesting a ruling that an acquisition of Target by Foreign Acquirer was not subject to taxation under the provisions of section 367(a) and Treas. Reg. § 1.367(a)-3(c) pursuant to a private letter ruling issued under Treas. Reg. § 1.367(a)-3(c)(9). On notification of our adverse position, the taxpayer withdrew the request on April 27, 2007. Pursuant to section 7.07(2)(b) of Revenue Procedure 2007-1, 2007-1 I.R.B. 1, we are advising you of the taxpayer's withdrawal of its request for the letter ruling. In addition, this memorandum provides our views on the issues raised by the taxpayer's request.

FACTS

On Date 1, the shareholders and option holders of Target exchanged all their outstanding shares and options of Target for voting shares and options of Foreign Acquirer in a transaction intended to qualify as a reorganization under section 368(a)(1)(B). During the 36 month period prior to the transaction and as of Date 1, Foreign Acquirer had cash on hand from sales to customers. Shortly before the transaction, Foreign Acquirer had an outstanding debt obligation owed to Majority Shareholder.

Five days prior to Date 1, Majority Shareholder contributed the outstanding debt obligation receivable to Foreign Acquirer in exchange for additional shares of Foreign Acquirer stock. The amount of the debt obligation and interest owed to Majority Shareholder by Foreign Acquirer was x.

In a calculation provided by the Taxpayer, the prior equity holders of Target owned slightly more equity in Foreign Acquirer immediately after the exchange than the prior equity holders of Foreign Acquirer.

ISSUES

1. Whether the cash held by Foreign Acquirer from sales to customers in the normal course of business should be taken into account in applying the "anti-stuffing" rule of the substantiality test of Treas. Reg. § 1.367(a)-3(c)(3)(iii).

2. Whether Majority Shareholder's contribution of outstanding debt receivable to Foreign Acquirer in exchange for additional Foreign Acquirer stock five days prior to the acquisition of Target is subject to the "stuffing rule" of Treas. Reg. § 1.367(a)-3(c)(3)(iii)(B) and should be excluded in applying the substantiality test of Treas. Reg. § 1.367(a)-3(c)(3)(iii).

3. Whether Foreign Acquirer was larger than Target under the substantiality test of Treas. Reg. § 1.367(a)-3(c)(3)(iii).

CONCLUSIONS

1. The cash held by Foreign Acquirer from sales to customers in the normal course of business is not taken into account in applying the "stuffing" rule and is not excluded from the value of Foreign Acquirer in applying the substantiality test of Treas. Reg. § 1.367(a)-3(c)(3)(iii), which requires the fair market value of Foreign Acquirer be equal or greater than the fair market value of Target.

2. The contribution of the debt obligation receivable by Majority Shareholder to Foreign Acquirer prior to the acquisition of Target is subject to the "stuffing" rule and is excluded from the value of Foreign Acquirer in applying the substantiality test of Treas. Reg. § 1.367(a)-3(c)(3)(iii).

3. The substantiality test of Treas. Reg. § 1.367(a)-3(c)(3)(iii) is not met because, under the information supplied by Target, after the transaction the equity interests held by Target share and option holders is greater than the equity interests held by Foreign Acquirer share and option holders. Thus, Target was greater in value than Foreign Acquirer

LAW AND ANALYSIS

When a U.S. person transfers the stock or securities of a domestic corporation to a foreign corporation in an otherwise nontaxable transaction, section 367(a) generally requires that gain be recognized. However, Treas. Reg. § 1.367(a)-3(c) allows a transfer without gain recognition provided that four conditions are met. One of these conditions is the substantiality requirement of the active trade or business test as defined by Treas. Reg. § 1.367(a)-3(c)(3). This test provides that a "transferee foreign corporation will be deemed to satisfy the substantiality test if, at the time of the transfer, the fair market value of the transferee corporation is at least equal to the fair market value of the U.S. target company." In determining the value of the foreign corporation, special rules to prevent "stuffing" transactions are provided in Treas. Reg. § 1.367(a)-3(c)(3)(iii)(B). These rules prevent the foreign corporation from including the value of certain assets acquired within a 36 month period prior to the exchange.

Treas. Reg. § 1.367(a)-3(c)(9) provides, in part, that

> (t)he Internal Revenue Service may, in limited circumstances, issue a private letter ruling to permit the taxpayer to qualify for an exception to the rule under section 367(a)(1) if –
>
> (i) A taxpayer is unable to satisfy all of the requirements of paragraph (c)(3) of this section relating to the active trade or business test of paragraph (c)(1)(iv) of this section, but such taxpayer meets all of the other requirements

> contained in paragraphs (c)(1)(i) through (c)(1)(iii) of this section, and such taxpayer is substantially in compliance with the rules set forth in paragraph (c)(3) of this section

The cash held by Foreign Acquirer and comprised of receipts from sales to customers in the ordinary course of business operations is not subject to the “stuffing” rule and is includible as part of the value of Foreign Acquirer under Treas. Reg. § 1.367(a)-(c)(3)(iii)(B). Such amounts are acquired in the ordinary course of business from customers and not as an infusion of capital into Foreign Acquirer.

The contribution by the Majority Shareholder of the outstanding debt obligation of x owed by Foreign Acquirer to Majority Shareholder in exchange for additional Foreign Acquirer stock five days prior to the transaction is subject to the “stuffing” rule. We view the contribution of the debt receivable as a transaction not in the normal course of business and analogous to a cash contribution or capital infusion into Foreign Acquirer that increases the value of Foreign Acquirer for purposes of the stock exchange (*see, e.g.*, Rev. Rul. 78-330, 1978-2 C.B. 147, *modified by* Rev. Rul. 2007-8, 2007-7 I.R.B. 469). Accordingly, the value of Foreign Acquirer is reduced by this amount for purposes of the substantiality test under Treas. Reg. § 1.367(a)-(c)(3)(iii) and a ruling is not given under Treas. Reg. § 1.367(a)-(c)(9).

Finally, in determining whether the fair market value of the transferee foreign corporation is greater than the domestic target under Treas. Reg. § 1.367(a)-(c)(3)(iii)(A), we concluded that the Target was the larger corporation. The interest holders of Target held more that 50% of the interest in Foreign Acquirer after the stock exchange. This indicates that the fair market value of Target was greater than Foreign Acquirer. A ruling under Treas. Reg. § 1.367(a)-(c)(9) was not granted.

Please call (202) 622-0171 if you have any further questions.