REPORT #906

TAX SECTION

New York State Bar Association

REPORT ON SECTION 355

July 2, 1997

Table of Contents

Cover Letter: i

I. SUMMARY OF CONCLUSIONS.. 2

A. Morris Trust Transactions 2

B. Intragroup Spin-Offs 3

II. SECTION 355 GENERALLY.. 4

A. The Unique Role of Spin-offs in the Corporate Tax World....... 4

B. Spin-Offs and General Utilities Repeal 6

III. MORRIS TRUST TRANSACTIONS 7

A. Policy Considerations 7

B. Recommended Exception for Reasonably Allocated Leverage...... 16

C. Recommended Exception for Disposition of De Minimis Unwanted Assets... 22

D. Comments to Pending Legislation 23

IV. INTRAGROUP SPIN-OFFS.. 27

A. Current Law.. 28

B. Pending Legislation 32

1. House Bill. 33

2. Senate Bill. 36

C. Recommendations 37

1. Application of section 355 to intragroup spin-offs........... 37

2. Regulatory authority to adjust stock basis.................... 37

3. Possible basis adjustment rule................................ 38

APPENDIX I -- Possible Morris Trust Leverage Safe Harbor 46

APPENDIX II — Intragroup Spin-Off Examples 49

Tax Report #906

TAX SECTION
New York State Bar Association

July 2, 1997

The Honorable Bill Archer
Chairman House Committee on
Ways and Means
1236 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Congressman Archer:

I am pleased to enclose a Report prepared by the Tax Section of the New York State Bar Association commenting on provisions contained in the Revenue Reconciliation Bill of 1997 as passed by the House of Representatives (HR 2014) and by the Senate (S 949) (the "Bills") that would limit the application of Section 355 of the Internal Revenue Code. The limitation would apply first to so called "Morris Trust" transactions by preventing a corporation from making a tax free distribution under Section 355 if 50% or more of the stock of either the distributing corporation or the distributed corporation is acquired by a person or persons within two years before or after the spin-off unless it is shown that the acquisition and distribution are not pursuant to a plan. Second, both Bills would limit the application of Section 355 in the case of distributions of stock between members of an affiliated group, although the provisions of the two Bills differ as to the extent of such limitation. In general, the proposed amendments would apply to transactions taking place after April 16, 1997 but in certain cases the Bills provide for transitional relief.

The Report first analyzes the provisions of the Bills relating to Morris Trust transactions. It concludes that, despite arguments to the contrary, these transactions are frequently constructive and in the normal case not abusive and, therefore, recommends that any legislation limiting Morris Trust transactions should be directed only at the abuse cases.

The Report then concludes that the abuse cases are those in which there is a disproportionate allocation of debt to the merging company with the result that the transaction resembles a sale. To address this potential abuse, the Report recommends that the Bills be modified to provide Morris Trust transactions can proceed as heretofore if the debt of the group is reasonably allocated between members of the group which are being acquired and the other members of the group which are not being acquired. The Report also suggests, in Appendix 1, tests that might be applied for purposes of determining when debt is reasonably allocated for this purpose.

The Report also recommends that no tax be levied on Morris Trust transactions in which only a small percentage of the group's assets leaves the group in the spin-off. This recommendation is intended to facilitate transactions in which for legal or other reasons a small percentage of the group's assets need to be disposed of if the principal merger transaction is to be accomplished.

The Report also contains comments on the Morris Trust related provisions of the proposed legislation and suggests changes to make the provisions more equitable.

In addition, the Report comments on the provisions of the Bills which would tax intra group spin-off transactions. While the report recognizes that in some cases basis adjustments resulting from such spin-offs might be considered abusive, the report concludes that the proposed amendments are far more sweeping than is necessary to deal with the problem and would tax many completely non-abusive transactions. Hence, the report recommends that the provisions of the Bills taxing such transactions should not be adopted. However, the Report does support the provision of the Senate Bill which would authorize the Secretary to promulgate regulations dealing with the basis issues. The Report then makes a recommendation as to what form such a regulation might take.

We hope this Report is helpful to you. Of course, we are available at any time to work with you and your staff on this legislation.

An identical letter has been sent to Congressman Rangel and Senators Roth and Moynihan.

Sincerely,

Richard O. Loengard, Jr.
Chair

Enclosures

CC: Donald C. Lubick
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Michael P. Dolan
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Ave., N.W.
Washington, D.C. 20224

Kenneth J. Kies
Chief Of Staff
Joint Committee on Taxation
1015 Longworth House Office Bldg.
Washington, D.C. 20515

James B. Clark
Majority Chief Tax Counsel
House Ways and Means
Committee
1135 Longworth House
Office Bldg.
Washington, D.C. 20515

John L. Buckley
Minority Tax Counsel
House Ways and Means
Committee
1106 Longworth House
Office Bldg.
Washington, D.C. 20515

Mark Prater
Majority Chief Tax Counsel
Senate Finance Committee
219 Dirksen Senate Office
Bldg.
Washington, D.C. 20510

Nicholas Giordano
Minority Chief Tax Counsel
Senate Finance Committee
203 Hart Senate Office
Bldg.
Washington, D.C. 20510

Laurie A. Matthews
Senior Legislation Counsel
Staff of the Joint
Committee on Taxation
1622 Longworth Office
Building
Washington, D.C. 20515

Stuart L. Brown
Chief Counsel
Internal Revenue Service
Room 3026
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Kenneth J. Krupsky
Deputy Assistant Secretary
(Tax Policy)
United States Treasury
1500 Pennsylvania Avenue, N.W.
Main Treasury
Room 4206
Washington, D.C. 20220

Jonathan Talisman
Tax Legislative Counsel
Department of the Treasury
Room 3064
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Tax Report #906

NEW YORK STATE BAR ASSOCIATION TAX SECTION COMMITTEES ON CORPORATIONS AND REORGANIZATIONS

REPORT ON SECTION 355

July 2, 1997

NEW YORK STATE BAR ASSOCIATION TAX SECTION
COMMITTEES ON CORPORATIONS AND REORGANIZATIONS

REPORT ON SECTION 355

This Report[1] comments on provisions contained in the versions of the Revenue Reconciliation Bill of 1997 passed by the House of Representatives on June 27 (H.R. 2014) (the "House Bill") and by the Senate on June 27 (S. 949) (the "Senate Bill," and, together with the House Bill, the "Bills"), that would limit the application of section 355[2] in the case of (1) so-called "Morris Trust" transactions, in Which a tax-free spin-off is followed by a tax-free combination of the distributing corporation (or, in some cases, the distributed corporation) with another corporation, and (2) distributions of stock between members of an affiliated group.[3] The President's 1998 Budget Proposal contains a similar provision that would deny tax-free treatment under section 355 to Morris Trust transactions (the "President's Proposal").[4]

---

1 This report was prepared jointly by the Tax Section's Committee on Corporations and Committee on Reorganizations. The principal authors of the report are Peter C. Canellos, Patrick C. Gallagher, Robert A. Jacobs, Richard O. Loengard, Jr., Michael L. Schler, Jodi J. Schwartz and Steven C. Todrys. Significant contributions were made by Harold R. Handler, Richard L. Reinhold, Robert H. Scarborough, Eric Solomon, Lewis R. Steinberg and Dana Trier. Helpful comments were received from James T. Chudy, Benjamin J. Cohen, Mark R. Colabella, James S. Eustice, Gersham Goldstein, Liane L. Heggy, Paul S. Hong, Stephen B. Land, David W. Mayo, Ronald A. Pearlman, Jerome I. Rosenberg, Joel Scharfstein, Robert S. Schwartz, Daniel Shefter, Marc Teitelbaum and Andrew R. Walker.

2 All "section" references, unless otherwise specified, are to the Internal Revenue Code of 1986, as amended (the "Code").

3 See Section 1012 of the House Bill and Section 812 of the Senate Bill.

4 Summarized in Joint Committee on Taxation, Report on Revenue Provisions in President Clinton's Fiscal 1998 Budget Proposal, JCS-10-97 (April 16, 1997). Actual statutory language was not included with the President's Proposal. However, because the President's Proposal appears to track the March 1996 proposal included in the President's 1997 budget plan, except for differences in effective dates, reference can be made to the legislative language released on March 19, 1996.

Because any of these proposals, if enacted, would alter fundamentally the taxation of corporate reorganizations and restructurings involving distributions of stock to shareholders, we believe a careful evaluation of the proposed legislation and its potential effects is necessary. We here provide our views on certain aspects of section 355 and related issues, and our concerns with these far-reaching legislative proposals.

I. SUMMARY OF CONCLUSIONS

Our conclusions may be summarized as follows:

A. Morris Trust Transactions

1. In Part III.A of the Report, we discuss the role of Morris Trust transactions and conclude that, despite arguments to the contrary, these transactions are constructive and in the normal case not abusive. Hence, we believe that remedial legislation should be directed at the abuse cases and should not attempt to deny non-abusive Morris Trust transactions tax-free treatment.

2. In Part III.B, we conclude that the source of potential abuse in Morris Trust transactions is the disproportionate allocation of leverage to the merging company, which can cause the merger transaction to resemble economically a sale in which the non-merging company retains cash proceeds from the debt. To address this potential abuse, we recommend that proposed section 355(e) of the Bills be modified (perhaps by adding a third condition to proposed section 355(e)(2)(A)) to provide that section 355(e) will not apply if the pre-spin-off debt of the group is “reasonably allocated” between (a) the members of the pre-spin-off group that are being merged and (b)

the other members of the pre-spin-off group (determined in each case on a consolidated basis). In Appendix I we suggest objective tests that might be applied, perhaps by examples in the legislative history and ultimately in regulations, as safe harbors or presumptions in determining whether debt has been disproportionately allocated to the merging company.

3. In Part III.C, we recommend a de minimis exception to proposed section 355(e) of the Bills where the fair market value of the assets of the unwanted business (typically the controlled corporation's business) that is not being merged in the Moms Trust transaction constitutes only a relatively small percentage (e.g., 15%) of the fair market value of the aggregate pre-spin-off assets of the group. This exception is intended to facilitate non-abusive dispositions of de minimis unwanted or incompatible assets.

4. In Part III.D, we comment on the text of proposed section 355(e) and suggest changes that we think would make the legislation more equitable.

B. Intragroup Spin-Offs

1. In Part IV.A of the Report and in the examples in Appendix II, we analyze intragroup spin-off transactions, including potentially abusive cases. We conclude that concerns relating to intragroup spin-offs arise from the interaction of the fair market value basis allocation rule of section 358 and the consolidated return regulations.

2. Part IV.B criticizes the House Bill and Senate Bill provisions (proposed section 355(f)) that would cause section 355 not to apply to intragroup spin-offs. It concludes that proposed

section 355(f) of the House Bill is so over-reaching and would apply so arbitrarily as to threaten many completely unobjectionable spin-offs, and that proposed section 355(f) of the Senate Bill (limited to taxable Morris Trust transactions) is also overbroad given the severe penalties that proposed section 355(e) of the Senate Bill would impose on Morris Trust transactions. For these reasons, we recommend against adopting either the House Bill or Senate Bill version of proposed section 355(f).

3. In Part IV.C, we support proposed section 358(g) of the Senate Bill, which grants the Treasury the authority to write regulations to adjust subsidiary stock basis in connection with intragroup spin-offs. In addition, we propose a specific basis determination rule, which the regulations or other guidance eventually issued pursuant to that authority might follow. Our proposed rule — a modified conforming basis rule -- would, in some or all cases, conform the stock bases of the distributing and distributed subsidiaries after an intragroup spin-off to their respective net asset bases, with modifications further discussed in Part IV.C.

II. SECTION 355 GENERALLY

A. The Unique Role of Spin-offs in the Corporate Tax World

Section 355 provides for the separation of one or more businesses formerly operated, directly or indirectly, by a single corporation into two or more corporate entities without the shareholder or the distributing corporation being required to recognize gain or loss with respect to stock distributed in the separation. The very nature of the corporate separation, with its inherent potential for (i) converting ordinary dividend income into immediate or ultimate capital gain at the shareholder level and (ii) avoiding tax on the gain inherent in the distributed stock of the controlled corporation owned by the distributing corporation, renders section 355 a potential vehicle for unacceptable tax avoidance.

On the other hand, Congress has long recognized tax-free corporate separations as important means of allowing the business community to adjust its form of conducting business. As early as 1918 Congress approved tax-free split-ups.[5]; spin-offs and split-offs followed in 1924.[6] In 1934 Congress eliminated the tax free treatment of spin-offs (but not of split-ups and split-offs)[7] but in 1951 reversed this decision and reinstated the tax free status of spin-offs?[8] Shareholders who receive pro rata spin-off distributions do not receive any additional economic interest as a result of the distributions. The changes in corporate organization are essentially changes only in form, with the shareholders continuing their former interest in the original enterprise, albeit in two pockets instead of one. All the assets remain in “corporate solution” and, absent some subsequent act on the part of one of the corporations (for example, a liquidation) or the shareholder (for example, a sale of stock in one of the post-distribution corporations), we believe no economic change sufficient to warrant immediate taxation occurs. Nor do the Bill

[5] Revenue Act of 1918, ch. 18 §202(b), 40 Stat. 1060.

[6] Revenue Act of 1924, ch. 234, §203(c), 43 Stat. 256 (spin-offs); Revenue Act of 1924, ch. 234, §§203(b)(2),(h), 43 Stat. 256 (split-offs). Arguably split-offs may have received tax-free treatment under §202(b) of the Revenue Act of 1918 and §202(c)(2) of the Revenue Act of 1921. See H.R. Rep. No. 179, 68th Cong., 1st Sess. (1924), reprinted in 1939-1 (Part 2) CB 241,252¬53.

[7] See H.R. Rep. No. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 (Part 2) CB 554,564.

[8] See Sen. Rep. No. 781, 82nd Cong., 1st Sess., reprinted in 1951-2 CB 458,499.

provisions relating to Morris Trust transactions seek to fundamentally alter section 355.

B. Spin-Offs and General Utilities Repeal

Before the repeal of the General Utilities doctrine in 1986, corporations were able to transfer their assets in transactions that provided no gain to the “selling” corporation and a stepped-up basis in the assets acquired by the “purchaser,” whether that purchaser was a corporation or an individual. That mismatch -- non-recognition of corporate level gain and stepped-up asset basis — prompted many to support a change in law prohibiting the double benefit. The 1986 repeal of 1954 Code sections 311(a)(2), 336 and 337 effected that change.

When Congress repealed the General Utilities doctrine in 1986, however, it knowingly did not repeal section 355. Thus, in our post-General Utilities world, section 355 is the only remaining mechanism permitting a corporation to distribute appreciated property (in the form of an incorporated active business) to its shareholders without recognizing gain at the corporate or shareholder level.[9] Section 355 often provides the only economically efficient method for a corporation to dispose of a business it no longer wants.

---

9 “By permitting the division of a corporation through the distribution of stock (in one form or the other) without recognition of gain or loss at either the shareholder or the corporate level, § 355 is one of the few remaining Internal Revenue Code provisions under which the tax-free movement of corporate assets can occur (the § 368 reorganization provision is another)”. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders (6th ed. 1994) at ¶11.01[2][a] 11-7.

There is disagreement as to the implications of General Utilities repeal for section 355 spin-offs. To many, General Utilities repeal means only that when appreciated assets are removed from corporate solution or acquire a new basis, that movement or basis acquisition should attract a tax at the corporate level; they believe there is no inconsistency between repeal of the General Utilities doctrine and the preservation of section 355. To others, General Utilities repeal means that, with rare exceptions, whenever appreciated assets move from a corporation — whether or not the assets leave corporate solution and even if there is no change in asset basis — a tax must be paid. Even the proponents of the latter tax philosophy concede no tax should be due on transfers qualifying as tax-free acquisitive reorganizations described in section 368, and many concede that a spin-off qualifying under section 355 (at least one unaccompanied by an acquisitive transaction) should not attract a General Utilities tax.

In any event, as noted, although both the Bills and the President’s Proposal would limit the scope of section 355, neither would go so far as to generally repeal section 355. We support the position that section 355 on the whole should be preserved, and that only spin-off transactions that are considered “abusive” in some manner should be the subject of any legislation. The remainder of the Report reflects this approach by attempting to distinguish abusive from non-abusive transactions under section 355 and considering how the abusive transactions might be addressed.

III. MORRIS TRUST TRANSACTIONS

A. Policy Considerations

The principal issue raised by the Bills (and by the President's Proposal) is whether tax-free treatment should continue to be accorded section 355 transactions in which, as part of the plan of the transaction, the distributing corporation ("D" or "Distributing") (or, in certain circumstances, the distributed or controlled corporation ("C" or "Controlled")) subsequently takes part in a transaction with an unrelated corporation ("P") resulting in a 50%-or-more change in ownership of D (or C) -- a so-called "Morris Trust transaction."[10]

We believe the change proposed by this legislation -- to tax all Morris Trust transactions involving a change of control -- is unwise tax policy. Morris Trust transactions have been settled law for over 30 years; the case itself was decided in 1966. During that time these transactions have proved to be an extremely useful mechanism for carrying out mergers and other reorganizations in which it was necessary or desirable as a preliminary step to spin off one or more of the businesses formerly held by one of the parties to the reorganization. For example, two companies desiring to merge may find the merger prevented because anti-trust regulations, FCC restraints or other governmental rules mandate that a business conducted by one of the parties to the merger cannot be carried on by the merged corporation. In these cases, the transaction can go forward only if the business in question is disposed of to a third party, either in a taxable transaction or by using the Morris Trust technique. A taxable sale may be an unacceptable solution, either because it involves too high a tax cost or because it will have to be negotiated under governmental or other pressure that will

[10] See Mary Archer W. Morris Trust v. Commissioner, 42 T.C. 779 (1964), aff'd, 367 F.2d 794 (4th Cir. 1966).

depress the price; in some cases it may not even be possible to find a buyer prepared to pay an acceptable price. Another circumstance in which a Morris Trust transaction may be the only available means of effecting a merger is where publicly-owned D owns C and wishes to combine C with P, which refuses to enter into the transaction if the merger will result in D gaining control of the combined company. The alternative, merging C and P and then having D distribute the shares of the combined company to its shareholders, may give rise to a tax cost that renders the transaction impossible to consummate, especially as it will leave D with a large tax without providing any cash to pay it. In this circumstance, causing D to become a stand-alone company first may be crucial to accomplishing the merger of C with P.

Enactment of the Bills would have a serious impact on transactions of a type that have long been permitted under the tax law and that serve a legitimate business purpose. Accordingly, the treatment of Morris Trust transactions is not purely a technical tax issue. Serious questions of policy are involved in erecting tax barriers to the restructuring of corporate groups needed for business reasons. We see no good tax policy reason to require groups of incompatible businesses to remain together, or alternatively to pay a heavy tax surcharge. There is no step-up in the basis of business assets in a Morris Trust transaction, and hence corporate level gain does not escape tax. The typical Morris Trust transaction is one in which business holdings are divided and combined but no assets leave corporate solution. Hence, we consider the typical transaction indistinguishable as a policy matter from other forms of corporate reorganizations, and we think it should be treated like an acquisitive reorganization described in section 368 and allowed to proceed without adverse tax consequences. It is not a wide open door; these transactions must still pass muster as having a “business purpose,” must not violate continuity of interest, and must not be a device to avoid shareholder tax. But the legitimate business-motivated Morris Trust transaction should not face the undue tax impediments proposed by the Bills.

We therefore think this proposed change in the law is, at best, an overreaction to a perceived abusive use of the Morris Trust transaction that unfortunately would impact many non-abusive business transactions. We recognize that there has been substantial recent publicity concerning Morris Trust transactions that commentators have argued were abusive; the nature of these transactions and possible methods of preventing abuses are discussed later in this report. That some Morris Trust transactions may be considered abusive, however, is not alone sufficient reason for banning this technique in all cases. Therefore, subject to the discussion below regarding leveraged Morris Trust transactions (see III.B below) and intragroup spin-offs (see IV below), we urge preserving the tax-free status of Morris Trust transactions, including those in which D is combined with P in a transaction in which D’s shareholders receive or retain less than 50% of the stock of the combined companies.

To summarize, Morris Trust transactions may be the only way to accomplish legitimate business purposes without incurring substantial tax. Under current law, these transactions are required to serve a business purpose. The form of the transaction has long been known and accepted by the Treasury Department. Consequently, we think that before the law is changed and tax is imposed upon all Morris Trust transactions, there must be very good reason for taxing this useful form of transaction.

We recognize that the following arguments have been made against preserving the tax-free status of Morris Trust transactions, though we believe none of them justifies taxation of all Morris Trust transactions:

1. Analogy to taxable sale. Some believe Morris Trust transactions are not justifiable from a tax policy point of view, in contrast to spin-off transactions that merely divide the assets of a single corporation among its existing shareholders. It is argued that a Morris Trust transaction resembles a sale of part, but not all, of the assets of the original corporation to P. Moreover, Morris Trust transaction are not limited to the situation of a mandated divestiture of a small part of the assets of a target corporation. Rather, any time P wishes to acquire one or more (but not all) of the trades or businesses of D (even if only a very small part of the total assets of D), D can voluntarily spin off the remainder of its assets (even if the spin-off involves most of its total assets) and D's remaining business can be acquired on a tax-free basis.[11] The transaction is analogized to one in which a corporation exchanges one or more of its divisions for P stock in a tax-free reorganization and then distributes the P stock to its shareholders tax-free. The exchange by D of a division of D for P stock, followed by a tax-free distribution of the P stock, would be inconsistent with the explicit rules for tax-free reorganizations, and it is argued the result in a Morris Trust transaction should be the same.

[11] As for the possibility that even a relatively small division can be "sold" tax-free by distributing the substantial assets to be retained in a spin-off, we note that there are serious practical impediments to such a lopsided transaction, which makes this possibility more often theoretical than real. Where such a transaction takes place, it is because existing tax rules encourage that format by preferring a traditional "Morris Trust" transaction (D acquired) to a "spin-merge" transaction (C acquired).

We are not persuaded by this argument.[12] That the transaction could be structured as a taxable one does not mandate that every other form of the transaction reaching the same commercial result must also be taxable. Perhaps it would be more sensible for the law to produce similar results whether the transaction is cast in the Morris Trust mode or in the form of a merger followed by a distribution by the parent of the shares it received in the merger, but there are many instances in subchapter C in which form -- not substance -- dictates tax consequences. In an ideal world, it might well be that neither should be taxed. In the world we have, it is not odd that one should be taxed and the other not.

In common parlance, a company is “sold” when it is combined with another company whose shareholders will control the combined company.[13] Financial accounting also generally follows this model in “purchase” transactions, largely ignoring the form of transaction and consideration paid. Tax law, however, distinguishes taxable sales from a host of non-recognition transactions (e.g., reorganizations, spin-offs, like-kind exchanges, etc.) and attaches different consequences to the two categories: gain or loss recognition and cost basis to the one, non-recognition and carryover or transferred basis to the other. Form of transaction and nature of consideration distinctly do make a tax difference. Accordingly, a decision to tax Morris

---

[12] This report does not discuss the Court Holding and other special issues raised by a transaction such as that described in Revenue Ruling 96-30 in which Controlled (rather than Distributing) is subsequently merged with P. Those issues are not involved in the classic Morris Trust transaction in which Distributing is the party to the merger with P.

[13] By analogy, many sale-leaseback and securitization transactions are in legal form, and for financial statement purposes, “sales” of assets. Few tax lawyers would argue that this lay characterization should determine whether the transaction is a sale or borrowing for tax purposes, which in those transactions is instead determined by the substance of the arrangement.

Trust transactions because they resemble “sales” is inconsistent with the treatment of other corporate reorganizations, many of which might be described as “sales” of the smaller company to the larger. We believe it more appropriate to generally continue to view a Morris Trust transaction as a combination of a tax-free spin-off and reorganization. As to each step the consequences appropriate to tax-free treatment are engendered. If spin-offs and reorganizations can be separately consummated on a tax-free basis, and the proposed legislation clearly countenances Morris Trust transactions that are not pre-arranged, there is no obvious reason they cannot succeed each other in a two-step transaction.

2. Role of General Utilities repeal. In recent years Congress has consistently prevented corporations from transferring appreciated assets to third parties without gain recognition, as evidenced by General Utilities repeal in 1986. Most significantly, these rules have applied even when the assets would not receive a stepped-up basis in the hands of the third party, as illustrated by the narrowing and finally the repeal of the section 311(d) provisions allowing a corporation to distribute subsidiary stock to its shareholders tax-free, and the prohibition on “mirror” transactions in section 337(c). Moreover, Congress has never expressed an interest in “elective carryover basis,” under which a corporation could sell assets for cash on a tax-free basis as long as the purchaser elected carryover basis for the acquired assets.[14] Taxation of Morris Trust transactions could be viewed as consistent with, and a logical consequence of, this line of Congressional action.

---

[14] Compare American Law Institute, Federal Income Tax Project Subchapter C 6, 24-50 (1982).

We do not think repeal of section 355, or limitations on its scope, is a corollary of the repeal of the General Utilities doctrine. Pre-1986 provisions, such as sections 311,337 and 334(b)(2), permitted a corporation to dispose of its appreciated assets without payment of corporate income tax on the appreciation, but the acquirer could obtain a stepped-up basis in those assets. This regime permitted the appreciation in the value of corporate assets to escape tax entirely and was properly subject to the criticism that eventually led to General Utilities doctrine repeal. It was not by accident, however, that in the course of repealing that doctrine, section 355 was not amended. In a spin-off transaction, the business assets remain in corporate solution, and the gain inherent in those assets continues to await tax. Moreover, section 355 imposes strict tests designed to thwart tax-motivated transactions. If, in a subsequent transaction, those assets are sold or otherwise disposed of, other than in a transaction (such as a re-organization) that is tax-free, tax will be collected at the corporate level. Hence, to levy tax on a corporation when it distributes stock of a controlled subsidiary is not to safeguard the corporate tax on business assets -- the aim of General Utilities repeal -- but to add an additional third layer of corporate tax on top of that which eventually will be collected on the sale of the appreciated assets. There is thus no obvious tax reason to turn all Morris Trust type spin-offs into events on which gain is realized, and it is not surprising that neither the 1986 legislation, nor subsequent legislation, nor any of the proposed legislation would repeal section 355 altogether. For this reason, we believe General Utilities repeal is not a reason to tax most Morris Trust transactions.

We also believe that the extensions of General Utilities repeal that require gain recognition despite absence of basis step-up do not mandate taxing Morris Trust transactions. Indeed, Morris Trust transactions, though known at the time, were defined as clearly outside the scope of two changes in question. In particular:

- The 1987 Congressional rejection of so-called “mirror transactions,” found in section 337(c), resulted in corporate tax in connection with section 332 liquidations not involving a stepped-up asset basis. We do not believe the rejection of mirror transactions supports taxation of all Morris Trust transactions. Mirror transactions involved the cash purchase of stock of a corporation and then the corporation’s tax-free division into several companies, the stock of which then could be sold for cash without gain. This raises issues far different from whether a series of non-cash transactions should be treated as taxable dispositions. In addition, that change was made in the climate of Congressional concerns over highly leveraged (especially hostile) takeovers. No small part of the Congressional objection to the mirror transaction is that it was a technique available to the purchaser making a taxable acquisition of an existing group of corporations, but was not available to the pre-acquisition corporate group itself. Hence, this device was viewed as unfairly favoring takeover transactions.[15]

- Section 355(d), enacted in 1990, taxes Distributing in a split-off following a taxable purchase of stock. That provision is best seen, however, as an attempt to preempt “Mobil-Esmark” transactions effected by split-off. It is distinguishable from Morris Trust

[15] See H.R. Rep. No. 100-391 (Part II) at 1082 (1987).

transactions in that cash goes to shareholders and the acquiring corporation obtains a stepped-up basis in target subsidiary stock (though not its assets). In addition, the complexities of section 355(d) and the inability of Treasury to promulgate much needed clarifying regulations on a timely basis suggest caution in using that provision as a model.

B. Recommended Exception for Reasonably Allocated Leverage

As discussed above, we believe Morris Trust transactions serve a useful commercial purpose and do not differ in kind from other forms of tax-free reorganization. Hence, they should not be prevented unless there is an abuse. We recognize that some recent Morris Trust transactions have been regarded by some as abusive because of the manner in which debt has been used. As indicated above, we believe the appropriate solution to the problems presented by those cases is not to ban all Morris Trust transactions. We believe a more limited response is practicable and reflects sounder tax policy. We therefore urge that if legislation curbing Morris Trust transactions is enacted, it be targeted at the abuse case and otherwise permit continued use of the technique where it is the salutary mechanism by which business organizations can rearrange their affairs to meet changing conditions.

The principal form of Morris Trust transaction that some observers consider an abuse is one in which the merging company (generally Distributing) is laden with debt in contemplation of the spin-off of Controlled. We do not believe the liabilities of the corporation that is not merged or acquired after the spin-off raise the concern discussed below, because the corporation that continues to be owned by the historic shareholders remains burdened by those liabilities and does not receive excess cash. Therefore we do not focus on that case. We do agree, however, that there is abuse potential in Morris Trust transactions in which the merging company is unduly burdened with debt.

An example will illustrate the concern (even if it sets forth an exaggerated case): Example III.1: D has a fair market value of $250, consisting of the stock of its subsidiary, C (which has a fair market value of $150), and other assets worth $100 with a zero tax basis. D borrows $100, transfers the proceeds to C, and then spins off C. Hence D is left with assets with a $100 fair value and an offsetting $100 liability. D then merges into P, with the D shareholders receiving a nominal amount of P stock. The result is similar to a sale of the D business for $100 cash, in which the cash is retained by C, no gain is recognized, and there is no step-up in the basis of the D assets sold. This extreme case is, of course, not a typical Morris Trust transaction.

That this type of transaction may be considered abusive is no reason to tax all Morris Trust transactions. Many Morris Trust transactions involve creation of little or no new debt, and no attempt is made to manipulate values so as to minimize in an abusive manner the stock received in the subsequent merger. In other cases new debt may be created for legitimate purposes:

> Example III.2: D has assets with a fair value of $500 (including stock of C worth $150) and has $250 of debt. For good business reasons D wishes to spin off C, which will then acquire P in exchange for more than 50% of C’s stock. D’s creditors are unwilling to permit C, which represents over 50% of D’s net worth, to leave the group

without a reduction in D's debt. Therefore, C borrows $75 and distributes it to D, which repays $75 of its debt. As a result, after the spin-off D has $350 of gross asset value and $175 of debt, and C has $150 of assets and $75 of debt. This seems clearly non-abusive.

The following discussion assumes that the leverage is legitimate debt of the corporation that incurs it. Excessive debt may be treated not as debt incurred by D, the merging company, but as debt incurred by its merger partner and used by it to purchase D's assets.[16]

We believe the issue is therefore to draw a line between the two illustrative cases to determine when debt of the merging company is excessive. We consider the issue one of proportionality, aggravated in some circumstances by the creation of new debt incurred in contemplation of the spin-off. Thus, we believe there is no abuse if the pre-spin-off debt of the group is reasonably allocated between (a) the members of the pre-spin-off group that are being merged and (b) the other members of the pre-spin-off group, determined in each case on a consolidated basis, in a manner that is roughly proportionate to the value of their respective assets, and that takes into account the nature of their businesses. Hence, we believe a Morris Trust transaction satisfying this test should not be subject to tax under proposed section 355(e).

---

[16] See Waterman Steamship v. Comm'r, 430 F. 2d 1185 (5th Cir., 1970), cert. den. 401 U.S. 939 (1971). Cf. Plantation Patterns v. Comm'r, 462 F. 2d 712 (5th Cir. 1972), cert. den. 409 U.S. 1076(1972).

In Appendix I we discuss objective tests that might be used as presumptions or safe harbors to determine whether debt of the group has been properly allocated. We recognize that, in determining the proper allocation of debt, consideration needs to be given to the nature of the business. For example, real estate and financial businesses have historically operated on a more leveraged basis than most other businesses, especially service businesses in which capital is not a material income producing factor. In addition, we recognize that in applying any proportionality test, anti-abuse rules may be necessary to deal with potential manipulation arising from the objective nature of the test (such as the use of a sale-lease-back transaction to reduce debt, or the use of plain vanilla preferred stock in lieu of debt). Nonetheless, we are of the view that such a test can be applied by taxpayers and effectively monitored by the Service. In fact, we understand that the Service, in connection with its consideration of ruling applications, is already analyzing the allocation of debt in spin-off transactions. Thus, we believe a test of this type, subject to such safe harbors and limitations as Congress and the Treasury may deem appropriate, is workable.

We have considered and rejected various other possible approaches:

a. Tracing. We rejected a tracing rule, i.e., one in which liabilities would be tested by reference to the use of the proceeds, with special concern for a separation, in the spin-off, of borrowing and the assets acquired with the proceeds derived from the borrowing. We view the difficulty of applying such a rule to intangible assets, as well as the opportunities for manipulating the rule, as overwhelming objections to its use.[17] Furthermore, we recognize that a tracing rule in and of itself could not easily be used to distinguish Example III.1 from Example III.2.

b. Purpose test. We considered a purpose test, in which debt would taint a Morris Trust transaction only if it was incurred as part of a plan to disguise a sale as a spin-off. That test suffers from the difficulty the Service would encounter in policing the area and the difficulty taxpayers would encounter in applying it with certainty. Nonetheless, such a rule, in a context where rulings are frequently sought because of the inherent uncertainties in the "business purpose" test, may not be as difficult to apply as would normally be assumed. In a ruling context, the Service is put on notice of the facts and, assuming a favorable ruling is obtained, taxpayers receive the necessary assurance of tax-free treatment. However, while such a rule may well be feasible in the ruling context, we believe it should not be adopted as an exclusive rule, and that some form of more objective standard must be developed.

c. Debt-equity test. Another approach would limit the amount of debt the merging company may have to a specified percentage of the fair market value of its stock. Cf. Code sections 163(j) and 279. Alternatively, one might simply provide that debt that is "excessive" in relation to equity is not permitted. We do not consider either approach viable.

A formula approach does not take into account variations between the appropriate debt-equity ratios in various types of businesses. For example, normally the debt-equity ratio found in

---

[17] We recognize that, especially within an affiliated group, opportunities to move assets and liabilities between members abound, which would make it almost impossible to police a tracing rule. Cf. section 864(e)(1).

a financial business can be expected to be far higher than in a service business. The debt that can be borrowed against real estate has historically been higher than what can be borrowed against intangible assets such as goodwill. On the other hand, at least in the public context, the difficulty of valuing the equity of a company should not be a deterrent to applying a debt-equity test, notwithstanding that, in a volatile market, the ratio may fluctuate substantially over a short period.

Attempts to define “excessive” debt under section 385 have been unsuccessful. The application of that section was made more difficult because certain issues, such as the treatment of insider debt and hybrid instruments, were of greater concern than in the current context. Nevertheless, we do not think the basic approach of the regulations promulgated under that section -- that straight debt held by an outside lender was not excessive -- is viable in this context. Consequently, we do not believe a section 385 type of debt-equity analysis would be helpful here.

An objective debt-equity test has also been suggested: So long as the debt-equity ratio of the merged company at the time of the spin-off does not exceed 125% of the historic debt-equity ratio (as defined) of the group, it would be permitted to engage in a Morris Trust transaction. Such a rule would engender complexity: the method of determining the historic debt-equity ratio has to be chosen, and one must define concepts such as debt and equity for this purpose -- e.g., are payables and other current liabilities taken into account; do special rules apply to nonrecourse and partnership debt; how is preferred stock treated, etc.? Nonetheless, as the basis for possible objective safe harbors or presumptions to be used in determining whether debt has been reasonably allocated among members of a consolidated group, we regard this methodology as promising. To some extent this approach is reflected in the proposal set forth in Appendix I to this Report.

C. Recommended Exception for Disposition of De Minimis Unwanted Assets

The typical Morris Trust transaction is one in which the company to be combined with P (typically D) (the "merging corporation") holds the bulk of the D-C group's pre-spin-off assets, and all that is spun off is a smaller business (typically C) (the "unwanted business") that is incompatible with the businesses to be combined, e.g., for anti-trust reasons.

As noted earlier, some observers are particularly concerned with Morris Trust transactions in which, contrary to the normal arrangement, the merging corporation constitutes only a relatively small part of the pre-spin-off group's assets, and believe those transactions resemble sales of corporate assets and should be taxed as such. However, the Bills go much further than that and would tax Morris Trust transactions in which the merging corporation owns the vast majority of the pre-spin-off group's assets, and the unwanted business being spun off represents only a small portion of the group's assets. Accordingly, if the approach of the proposed legislation (i.e., taxing Morris Trust transactions if there is a change of control) is to be adopted, we recommend an exception for Morris Trust transactions in which the fair market value of the assets of the unwanted business -- i.e., that which is not involved in the merger -- constitutes only a relatively small percentage (e.g., 15%) of the total fair market value of the D-C group's assets before the spin-off. For this purpose, we suggest determining fair market value of a corporation's assets by reference to the fair market value of its stock plus the corporation's liabilities, determined on a consolidated basis. This rule would permit the merging corporation to dispose of de minimis unwanted or incompatible assets without tax, while subjecting those transactions that more closely resemble divisional sales to the general anti-Morris Trust rule.

We believe that a spin-off of an unwanted business with total gross assets of only 15% of the group’s gross assets does not afford the group an opportunity to engage in a Morris Trust transaction in which the merging corporation can be so disproportionately leveraged that the transaction resembles a sale. Accordingly, we recommend adoption of this de minimis exception whether or not our preceding recommendation regarding an exception for reasonably allocated leverage is adopted.

D. Comments to Pending Legislation

In most respects the two Bills are identical in their application to Morris Trust transactions, and the comments below apply to each. In this discussion we assume (for simplicity) that D has distributed C in a spin-off and then merged with another corporation in a transaction to which proposed section 355(e) might apply.

Our comments are as follows:

1. Proposed section 355(e)(1)(B).

(a) In all cases the Bills would tax the corporation not involved in the merger (“C”) on the gain that would have been realized had the merging corporation (“D”) sold its assets in a taxable transaction. This may exceed -- perhaps substantially -- the gain that would have arisen if C had not been spun off but instead had been sold in a taxable transaction. We recommend permitting taxpayers to elect to be taxed as though D had sold C's stock (i.e., the approach in proposed section 355(e)(1)(A)), rather than as though C had sold D's assets. The election should be available at all times prior to the expiration of the relevant statute of limitations to avoid the need for a protective election where application of the provision is in doubt (e.g. because the existence of a plan is in dispute).

In this respect, the President's Proposal took a different approach from that of the Bills by taxing the distributing corporation, D, on a deemed sale of C's stock in all cases. While we prefer our recommended elective approach, we believe the approach of the President's Proposal is better than that of the Bills, because we see as the paradigm a larger D spinning off a relatively small C, with D then merging in the Morris Trust transaction. In such a transaction, we think the approach of the President's Proposal is more likely to produce the proper amount of tax than that now embodied in the Bills.

(b) In any event, the sale should be deemed to occur immediately before the spin-off, so that the pre-spin-off group's tax attributes are available to offset the gain. In addition, this would have the effect of making both C and D liable for the tax.

(c) If a gain is recognized as a result of the Morris Trust transaction, there should be a corresponding step-up in the basis of D's assets (or C's assets if the election suggested in (a) above is available). Any other result is both unfair and inconsistent with the philosophy of section 336(e), because it will result in multiple taxation of the same gain. Where appropriate, an election under section 338(h)(10) should be available. We recognize that the statute presently provides for capital gain treatment, and that our proposal may be inconsistent with a step-up in basis for depreciable assets and inventory, for example. The proper solution is to levy whatever tax is appropriate to the assets sold (taking any section 338(h)(10) election into account) and give a step-up in basis.[18]

2. 50% change of control test. The scope of the statute is unclear in certain cases. For example, if after a spin-off, D effects a public offering and sells 60% of its stock to the public, we assume the statute would apply (although it is not clear to us that this result was intended).[19] However, even if the new capital was raised by a rights offering and the old shareholders of D continued to own substantially more than 50% of the stock (even 100% of the stock), it is not clear that the statute does not apply. Stock acquired by an old shareholder does not appear to be “good” stock per se, and such an acquisition also does not appear to be within any of the exceptions found in proposed section 355(e)(3)(A).

Similarly, if individual A owns all of D, which spins off C to him and then merges with Z, also wholly owned by A, with A, as a Z shareholder, receiving 60% of the D stock, it is not clear that the statute will not apply.

---

[18] We also recommend that the basis step-up and section 338(h)(10) election regime described in text apply where C is the merging corporation and D is treated as having sold C’s stock under proposed section 355(e)(1)(A).

It seems strange to us that, after Morris Trust transactions have been permitted by a knowing Treasury Department and Congress for over 30 years, this legislation - absent a basis step up - would now treat them with such severity.

[19] cf. Treas. Reg. § 1.382-3(j)(3)(i), which deems one-half of stock issued to the public for cash as having been purchased by “old shareholders.”

We believe it should be clear in both of these latter cases that, for purposes of determining whether one or more persons acquired control of D, acquisitions of D stock by old shareholders of D should only be counted to the extent they represent an increase in such shareholder’s percentage ownership in D.

It also should be made clear that if the spin-off is a split-off and over 50% of the D stock is redeemed as part of the transaction, the increase in the interest of the remaining shareholders of D (from say 40% to 100%) is not an acquisition of D stock that will cause the provision to apply.

3. Proposed section 355(e)(2)(B). We believe the “plan” definition in proposed section 355(e)(2)(B) is too harsh. We strongly encourage a rule that all transactions occurring more than two years before or after the spin-off are disregarded, with an exception for transactions carried out pursuant to a binding contract entered into during the relevant period. We believe that, certainly in the case of public companies, “plans” are not executed more than two years after conception, and in general, absent a binding commitment, any transaction not carried out within two years is subject to sufficient market risks that it cannot be called “planned.” On the other hand, we are concerned that without some outside cut-off date, transactions may be challenged as being pursuant to a “plan,” which in fact represented only some random thoughts of a member of management or an investment banker at the time of the spin-off. Similarly, in the case of private companies, absent some cut-off date, it may be extraordinarily difficult for the shareholders to demonstrate the absence of a plan, especially since it is not clear how specific the plan must be -- e.g., must it be a plan to

merge with a specific corporation or will a generalized desire to merge with a larger company suffice?[20]

4. Proposed section 355(e)(4)(c)(ii). The purpose of the reference in proposed section 355(e)(4)(C)(ii) to section 355(d)(8)(A) is unclear. For example, we are uncertain as to what portion of §355(e) it is relevant. If it were to be used in applying proposed section 355(e)(3)(A)(ii), it would appear to defeat the purpose of the latter provision.

5. Merger preceding spin-off. It is unclear whether proposed section 355(e) is intended to apply where the spin-off occurs after the merger and the stock of C is distributed pro rata, to both the old shareholders of D and the new shareholders of D (or its successor) resulting from the merger. We do not see why this transaction should be regarded as a deemed sale and hence urge clarification that the provision would not apply in such cases.

IV. INTRAGROUP SPIN-OFFS

Both the House Bill and Senate Bill specifically address “intragroup spin-offs,” in which a parent corporation causes a second- or lower-tier subsidiary to be spun off within the parent affiliated group.[21] An intragroup spin-off can occur either as an isolated transaction or in anticipation of an external spin-off of a subsidiary or division to parent’s shareholders.

---

[20] if our recommendation to disregard transactions occurring outside the four-year measurement period is not adopted, at the very least we believe there should be presumption that a transaction taking place outside that period is not pursuant to a plan (subject to a binding contract exception). Cf. Treas. Reg. §1.707-3.

[21] The President’s Proposal does not contain a provision specifically addressing intragroup stock distributions.

The following discussion analyzes the treatment of intragroup spin-offs under current law, including certain transactions that may be considered abusive (see IV.A below and the accompanying examples in Appendix II), comments on the current House and Senate Bill proposals concerning intragroup spin-offs (see IV.B below), and presents our recommendations on this issue, which support the Senate Bill in part (see IV.C below).

In this part of the Report, "P" denotes the parent of a consolidated group that is undertaking an intragroup and/or external spin-off, and "S", "S1" and "S2" are direct or indirect subsidiaries of P.

A. Current Law

Under current law, intragroup spin-offs can be used to produce a tax benefit in one or both of the following ways:

First, under the fair market value basis allocation rule of section 358, an intragroup spin-off can result in a post-distribution disparity between the net asset basis and stock basis of the distributing and distributed subsidiaries. That is, the post-distribution stock basis of one of the subsidiaries will exceed its net asset basis, and the post-distribution stock basis of the other subsidiary will be less than its net asset basis by an equal amount. This can produce a future tax benefit to the group if the stock of the subsidiary with the stepped-up stock basis is sold (after a waiting period sufficient to avoid disqualifying the internal spin-off). The group can eliminate the stepped-down basis in the stock of the other subsidiary by (1) liquidating that subsidiary under section 332, (2) spinning it off to the parent's shareholders, or (3) after an appropriate waiting period, selling that subsidiary’s higher-basis assets and liquidating the subsidiary. The net result of these steps is that the group has reduced its aggregate taxable income by the amount of the basis disparity created in the intragroup spin-off.

Second, through the interplay between this section 358 basis allocation rule and the consolidated return regulations, leverage can be used in an intragroup spin-off to reduce current or future taxes, in connection with a related or subsequent external spin-off or other disposition transaction, that might otherwise be imposed on similar transactions under section 357(c) or the excess loss account (“ELA”) recapture rules. As is the case in Morris Trust transactions (see III.B above), the form of leverage most useful in this connection involves borrowing against the assets of one subsidiary or division and directing the borrowed funds to another. Leverage of this type can also exacerbate the inside/outside basis disparity described in the preceding paragraph.

Significantly, either of the above tax benefits might be achieved (1) in the absence of a related Morris Trust transaction or (2) in the absence of any external spin-off at all.

The examples in Appendix II illustrate the application of current law to intragroup spin-offs and highlight potential concerns. Each of Examples 3 through 7 illustrates the first tax benefit described above (basis shifting); Examples 3 through 6 illustrate tax benefits arising from leverage. Examples 1 and 2 provide a framework for considering potential abuses arising from intragroup spin-offs by illustrating the application of current law to several basic external spin-off transactions that do not involve a preparatory internal spin-off; none of the proposed legislation would alter the current law treatment of Examples 1 and 2 (except in connection with a related Morris Trust transaction).

More specifically, each of Examples 3 through 7 raises one or more of the following issues:

1. Liabilities in excess of basis; eliminating ELA. The coordination of section 358 and Treas. Reg. §1.1502-19 permits P, through a preparatory intragroup spin-off, to eliminate an ELA in stock of a subsidiary that ultimately is spun off to P’s shareholders, where the ELA mirrors the excess of the subsidiary’s liabilities over its asset basis (see Example 3). This result, though confirmed only recently by changes in the Treasury Regulations, is arguably inappropriate, because it could not be achieved if P were to spin off stock of a first-tier subsidiary in which P had an ELA (compare Example 2b).

2. Liabilities in excess of basis; avoiding section 357(c). Under Treas. Reg. §1.1502-80(d), section 357(c) does not apply to a P subsidiary’s (S1’s) drop-down of division assets to a new subsidiary (S2) unless SI or S2 is spun off to P’s shareholders “as part of the same plan or arrangement” (compare Examples 4A and 4B). Although this transaction produces an ELA in S2’s stock, that ELA can be eliminated through an internal spin-off of S2 to P. Arguably these steps are troublesome, because they permit P to spin off a lower-tier division whose liabilities exceed its asset basis if the section 351 asset drop-down occurs sufficiently in advance of the external spin-off (or other disposition) of SI or S2. Again, this result could not be

achieved with respect to division assets held directly by P.[22]

3. Liabilities in excess of basis; avoiding formation of ELA. A preparatory intragroup spin-off can create positive stock basis in a subsidiary whose net asset basis is negative, without the creation of an interim ELA or a Treas. Reg. §1.1502-80(d) issue (see Examples 5A and 5B, which are based on the Viacom transaction). Arguably this is inappropriate, because it is not a result that could be achieved through the spin-off of a direct P subsidiary or division.

4. Leverage per se. Examples 3 through 6 all involve leverage in which the debt proceeds are directed to one division or subsidiary and the debt liability is borne by another. In Examples 3 through 5, this separation of debt proceeds from repayment obligation causes the obligor subsidiary's liabilities to exceed its asset basis, raising issues under the ELA rules and section 357(c). In Example 6 this is not the case, since each subsidiary's asset basis exceeds its liabilities at all times. Nevertheless, Example 6 shows that even in this circumstance borrowing can significantly affect how stock basis is allocated under section 358.

5. "Basis shifting" per se. As noted above, in all of Examples 3 through 7, the intragroup spin-off results in "basis shifting" of some sort. That is, stock basis is allocated under

---

22 This technique is limited to a section 351 asset drop-down by a P subsidiary (rather than by P itself), because it depends on a later, unrelated internal spin-off to eliminate the ELA created in the drop-down. By contrast, if P itself contributes assets to a first-tier subsidiary without the application of Reg. §1.1502-80(d), the ELA created in the subsidiary stock would be triggered in any subsequent external spin-off of the subsidiary (see Example lb and the accompanying footnote).

the fair market value rule of section 358 in an manner that creates a disparity between the net asset basis and stock basis of the distributed and distributing subsidiaries. Section 358 (even in the absence of ELA-elimination and the other techniques described above) can be used advantageously by (1) structuring an intragroup spin-off to create a mismatch between net asset basis and stock basis, (2) selling (after an appropriate waiting period) or holding the stepped-up- basis stock to reduce future taxes and (3) eliminating the basis-reduced stock through a spin-off to P's shareholders, a section 332 liquidation, or (after an appropriate waiting period) a sale of that subsidiary's higher-basis assets.

Because basis shifting is inherent in the application of section 358 to spin-offs (whether intragroup or external), basis shifting per se would not appear to be inappropriate in the absence of one or more aggravating factors, such as an excess of liabilities over basis or a contemporaneous borrowing, as in Examples 1 through 6. For example, the transaction in Example 7 (where the intragroup spin-off shifts basis in the absence of any borrowing or liabilities-over-basis issue) does not seem abusive. On the other hand, the basis shift in Example 7 also does not seem particularly compelling, so that depriving the taxpayer of any attendant benefit may not be unduly harsh.

B. Pending Legislation

The House Bill (in proposed section 355(f)) would cause section 355 not to apply to any distribution of stock by one member of a consolidated group to another. The Senate Bill (in proposed sections 355(f) and 358(g)) would limit that rule to spinoffs incident to a transaction to which Section 355(e) applies and would authorize the Secretary to require certain adjustments to the basis of subsidiary stock in connection with intragroup stock distributions.[23]

1. House Bill. Proposed section 355(f) of the House Bill provides that, except as specified in regulations, section 355 will not apply to "the distribution of stock from 1 member of an affiliated group filing a consolidated return to another member of such group." As a result, any such distribution would give rise to deferred intercompany gain or loss under section 311(b) and Treas. Reg. § 1.1502-13(f), which generally would be triggered when either the distributing or the distributed subsidiary leaves the group (e.g., by spin-off).

As in the case of the proposed anti-Morris Trust legislation (see III.D above), we are greatly concerned by the proposed enactment of this sweeping rule. The best that can be said about proposed section 355(f) is that it appears to prevent most or all of the ELA-elimination and basis-shifting transactions described in IV.A above. However, the House Bill language is so over-broad and disproportionate as to threaten virtually all spin-offs.

More specifically, we believe the House Bill's general rule treating all intragroup stock distributions as intercompany transactions, rather than as qualifying under section 355, is unreasonable and inappropriate for the following reasons:

a. Overreaching. The essential problem with the proposal is that, by creating intercompany gain in every intragroup distribution of appreciated stock, it reaches non-abusive as well as abusive transactions and provides no mechanism

[23] The President's Proposal does not contain a provision specifically addressing intragroup stock distributions.

for distinguishing between them (other than authority to issue regulatory exceptions, which may be long-delayed). Hence, proposed section 355(f) would apply whether or not the transaction raised any of the concerns described in III. A above, including by taxing an intragroup spin-off that either results in no basis shifting or increases the basis of stock of a subsidiary that is subsequently spun off to the public (which renders meaningless any basis increase in the distributed stock arising from the intragroup spin-off). To illustrate the excessive breadth of this provision, assume a P subsidiary (S1) distributes all the stock of its subsidiary (S2) to P for a legitimate business purpose. Section 355(f) would apply, and any built-in gain in the S2 stock would be deferred under Treas. Reg. §1.1502-13. However, that gain would be triggered upon any of the following events: (1) a spin-off of S1 or S2 at any time in the future (so that in this respect proposed section 355(f) is even more restrictive than the two-year rule applicable to Morris Trust transactions under proposed section 355(e)); (2) a section 332 liquidation of S2 (even though no stock or property ever leaves the affiliated group);[24] or (3) the deconsolidation of S1 or S2 for any reason from the P group.

b. Arbitrary distinctions. Proposed section 355(f) would make it impossible in many cases to distribute an appreciated second-tier or lower-tier subsidiary or division to shareholders of the parent corporation without triggering intercompany gain in connection with the spin-off. Thus, the legislation would lead to completely arbitrary results, taxing certain corporate groups that must reorganize multiple tiers of subsidiaries to effect a spin-off while not affecting corporate groups that operate through first-tier subsidiaries or divisions.

[24] See Treas. Reg. §1.1502-13(f)(5)(i); cf. Treas. Reg. §1.1502-13(f)(7) Ex. 5.

This would create an irrational divergence from the rules applicable to spin-offs of a first-tier division or subsidiary.

> Example. P owns the stock of S1 and S2 and wishes to distribute S1's stock to P's shareholders under section 355. The Bills create no obstacle to this. By contrast, assume the businesses conducted by S1 and S2 instead are operated as two divisions of S1 (D1 and D2, respectively). To spin off the D1 business, S1 would need to contribute either the D1 business or the D2 business to a newly-formed second-tier subsidiary (S2) and do an internal spin-off of S2 in preparation for the spin-off of S1 or S2 (whichever contains the D1 business) to P's shareholders. Under the Bills, the internal spin-off of S2 would result in deferred intercompany gain, which would be triggered by P's external spin-off of S1 or S2 to P's shareholders. This arbitrarily penalizes groups that conduct their operations through second- or lower-tier subsidiaries and divisions rather than first-tier subsidiaries.

Along the same lines, it appears that proposed section 355(f) could be avoided entirely by a parent corporation that converts all of its subsidiary operations into limited liability companies or first-tier divisions.

c. <u>State tax exposure</u>. If an intragroup spin-off does not qualify as tax-free, the transaction could trigger an immediately taxable gain for state income tax purposes in states that do not permit consolidated filings or require deferred intercompany gain recognition, even if the transaction is not currently subject to federal income tax. Pennsylvania and New Jersey, for example, would tax an intragroup stock distribution.

d. Propriety of legislative action. Because the House Bill, by its terms, applies only to corporations filing consolidated returns, we question the efficacy of a sweeping new statute to address these issues. As further discussed in IV.C below, it would seem that any concerns relating to intragroup spin-offs could be addressed in a more expeditious and targeted manner by appropriate amendments to the consolidated return regulations.[25]

e. Retroactive effective date. The retroactive effective date of the House Bill's proposed section 355(f) (which generally would apply to intragroup distributions after 4/16/97) would bring to a halt many non-abusive transactions. Given the breadth and unexpected nature of this proposed change and the concerns with the proposal expressed above, we strongly recommend that any changes in the treatment of intragroup spin-offs either apply prospectively or specifically identify the types of potentially abusive transactions for which the legislation may have retroactive effect.

2. Senate Bill. The Senate Bill, apparently in response to public criticism of the House Bill and, we hope, as a general acknowledgment of the House Bill's over-breadth, includes a more tailored version of proposed section 355(f). As modified, the proposal would tax only internal spin-offs that are part of a taxable Morris Trust transaction.

---

[25] See e.g., Treas. Reg. §1.1502-19(e). Because proposed section 355(f) of the House Bill would apply only to corporations that file consolidated returns, section 355(a) would continue to apply to affiliated corporations that do not file consolidated returns. Hence, under the House Bill, intragroup spin-offs involving nonconsolidated corporations would not attract a tax on the distribution. We question whether this distinction is appropriate. By contrast, the Senate Bill would extend the rule to affiliated but nonconsolidated corporations.

Despite its narrower scope, we believe proposed section 355(f) of the Senate Bill is unnecessary and inappropriate for the following reasons. First, the very narrowness of the Senate Bill provision makes it a wholly unnecessary addition to the government's arsenal against spin-offs that may be considered abusive, because it applies only to Morris Trust transactions upon which proposed section 355(e) already would have inflicted a draconian tax. Indeed, this proposal creates the disturbing possibility that a taxable Morris Trust transaction involving an internal spin-off could result in full taxation of Distributing's assets plus a tax on Controlled if Controlled had first been distributed in an intragroup spin-off. Second, as discussed in IV.A above, any abuse potential inherent in intragroup spin-offs does not depend upon a related Moms Trust transaction (or even an external spin-off). Hence, we believe it makes no sense to link the two through legislation that conditions intragroup spin-off restrictions on the presence of a Morris Trust combination.

The basis adjustment proposal contained in proposed section 358(g) of the Senate Bill, which we support as a more appropriate means of addressing the concerns targeted by proposed section 355(f), is discussed in IV.C below.

C. Recommendations

1. Application of section 355 to intragroup spin-offs. For the reasons given in IV.B above, we oppose the provisions of the House and Senate Bills that would cause section 355 not to apply to certain intragroup spin-offs.

2. Regulatory authority to adjust stock basis. Regulatory authority to adjust stock basis. We support proposed section 358(g) of the Senate Bill, providing for adjustments to

subsidiary stock basis in connection with intragroup spin-offs. As discussed in III.A above, we believe any abuse potential inherent in intragroup spin-offs arises, in one form or another, from basis-shifting through the application of section 358. Proposed section 358(g) of the Senate Bill precisely targets this issue.

Moreover, proposed section 358(g) appropriately directs that the specific basis adjustments to be made be addressed through the issuance of regulations or other guidance from the Treasury, rather than by legislation. We support this approach because we believe most or all potential abuses in this area depend upon the application of the consolidated return regulations, which can be modified appropriately to address concerns.[26]

3. Possible basis adjustment rule. In addition to supporting proposed section 358(g) of the Senate Bill, we suggest that the specific basis adjustment guidance eventually adopted pursuant to the legislation take the form of a modified conforming basis rule of the type described below. This rule, while somewhat complex, would, in some or all circumstances, conform the stock bases of the distributing and distributed subsidiaries after an intragroup spin-off to their respective net asset bases, with modifications. The rule is described in Section 3.a below. Some considerations relating to the possible scope of the rule (i.e., whether it should apply to all or only some intragroup spin-offs) are discussed in 3.b below.

---

[26] Because proposed section 358(g) would apply to all affiliated groups, whether or not consolidated, separate regulations would need to be drafted to address affiliated, non-consolidated taxpayers. Cf. Treas. Reg. §1.358-6 and §1.1502-30 (rules for determining stock basis in triangular reorganizations for non-consolidated and consolidated taxpayers, respectively).

a. Modified conforming basis rule. Any abuse potential arising from intragroup spin-offs could be viewed as flowing from the disparity created between the net asset basis and the stock basis of the distributing and distributed subsidiaries (S1 and S2). To the extent any "basis shifting" of this type is considered inappropriate, one direct approach that would seem to address all cases is to conform the stock bases of SI and S2 after the intragroup spin-off to the net tax bases of their respective assets. That is, apply a form of asset carryover basis rule, rather than a substituted stock basis rule, to intragroup spin-off transactions.

In particular, pursuant to the authority granted by proposed section 358(g) of the Senate Bill, the consolidated return regulations could be amended to provide that, in lieu of the fair market value allocation rule of section 358, the stock basis of each of S1 and S2 after an internal spin-off will be deemed equal to the subsidiary's net asset basis immediately after the spin-off. Hence, if S1 or S2 has a negative net asset basis (i.e., its liabilities exceed its asset basis), the member owning the subsidiary's stock after the spin-off will have an ELA in the stock equal to the amount of the negative asset basis. If SI or S2 has a positive net asset basis, the member owning the stock after the spin-off will have a basis in the stock equal to that positive net asset basis. To illustrate, if this rule were applied to Examples 3, 4B, 5A and 5B in Appendix II, in each case P, after the intragroup spin-off, would have a $90 basis in S1's stock (rather than $30 under current law) and a $40 ELA in S2's stock (rather than a $20 positive basis under current law). This strict rule would conform stock basis and asset basis in a similar manner in the other Appendix II examples.

The above rule addresses all of the potential concerns raised by Examples 3 through 7 in a much more targeted manner than the House Bill. Moreover, as discussed below, if its application were limited to cases covered by the Senate Bill, we believe it would be a superior alternative to proposed section 355(f) of the Senate Bill as well.

However, we believe that a strict conforming basis rule is broader than necessary to address abusive cases. Moreover, it could produce harsh and unfair consequences where a member’s pre-distribution basis in the stock of the distributing subsidiary is more than the subsidiary’s pre-distribution net asset basis. For example, assume P originally purchased S1’s stock for a substantial premium above S1’s net asset basis, and that Si later contributes one of its divisions to S2 and spins off S2 to P under section 355. Current law (section 358) would preserve P’s higher cost basis in S1’s stock by allocating it between S1 and S2. By contrast, the above strict conforming basis rule would eliminate P’s historic outside basis in S1 by substituting S1’s and S2’s net asset bases. This seems harsh and inconsistent with the basic, and usually noncontroversial, section 358 principle that after an intragroup spin-off P’s aggregate post-spin-off bases in S1’s and S2’s stock should equal P’s pre-distribution basis in S1.

To address this concern, we would modify the strict conforming basis rule to provide that, in an intragroup spin-off:

(1) The post-distribution stock basis of the distributed subsidiary (S2) would be determined under the strict conforming basis rule. Hence, S2’s post-distribution stock basic would equal S2’s post-distribution net asset basis (resulting in a positive stock basis if S2’s net

asset basis is positive and an ELA if S2's net asset basis is negative).[27]

(2) The post-distribution stock basis of the distributing subsidiary (S1) would equal the greater of (x) S1's post-distribution net asset basis and (y) S1's pre-distribution stock basis reduced by the greater of the post-distribution fair market value or basis of S2's stock.

This modified rule reaches the same result as the strict conforming basis rule (including in each of Examples 3 through 7) except where P's pre-distribution basis in S1's stock is greater than S1's pre-distribution net asset basis. In those cases, the rule is intended to give P in many instances some or all of the benefit of any excess of P's historic basis in S1's stock over S1's net asset basis, which is a fair objective. However, it does so in a manner that does not appear to raise basis-shifting or other abuse concerns, because (a) S2's post-distribution stock basis is determined under the strict conforming basis rule, (b) S1's post-distribution stock basis is limited to the greater of its net asset basis, or its historic stock basis less the greater of the fair market value or basis of the S2 business distributed by it, and (c) S1's and S2's aggregate post-distribution stock bases cannot exceed the greater of their post-distribution net asset bases or S1's pre-distribution stock basis.

We have suggested that P's basis in Si be reduced to the greater of (x) S1's net inside asset basis, or (y) P's historic basis in Si reduced by the greater of the fair market value or

---

[27] Alternatively, consideration could be given to preserving S2's historic stock basis rather than matching its net asset basis, so that any built-in gain inherent in the S2 stock before the spin-off would be preserved after the spin-off.

basis of S2's stock, because we believe this approach preserves to the maximum extent possible P's former basis in S1, without creating abuse potential. Just as in the case of P's basis in S2, reducing P's stock basis in S1 to S1's net inside asset basis will generally avoid the basis shifting results described above. This is because, after S1's spin-off of S2, P is free to spin off either SI or S2, retaining the other for eventual sale. As a result, it is important that neither stock basis be artificially high following S1's spin-off of S2. This is the reason for clause (2)(x) of our rule, namely that P's basis in S1 may be reduced to S1's net inside asset basis.

Clause (2)(y) of our rule is in substance a floor under which the first part will not cause P's basis in S1 to fall. We see no need to reduce P's basis in S1 by more than the greater of fair market value or the basis of S2's stock.

> Example IV.A: Suppose P has a basis of $100 in the S1 stock, the S1 stock is worth $150, and S2 is worth $40 and has a net asset basis of $20. Following S1's spin-off of S2, a reduction of P's basis in S1 by $40 would leave P with a $60 basis in S1, and S1 would have a value of $110. This preserves P's $50 built-in gain in the S1 stock. As long as that gain is fully preserved, we see no potential for abuse.

Clause (2)(y) of the rule reduces S1's basis by the greater of the fair market value or basis of S2 to ensure that S1's basis is not artificially inflated where S2 has a built-in loss.

> Example IV.B: Assume the same facts as above except that S2 is worth $40 and has a net asset basis of $70 (rather than $20). Under this rule, S2 would have a post-distribution

stock basis of $70. Because P’s initial basis in S1 was only $100, P’s post-distribution basis in S1 should be limited to $30 (i.e., $100 original basis less S2’s $70 post-distribution stock basis).

Where P’s initial basis in S1’s stock exceeds S1’s net asset basis, this modified conforming basis rule continues to be somewhat punitive to the extent it causes S1’s and S2’s aggregate post-distribution stock bases to be less than S1’s pre-distribution stock basis (which could occur, for example, if the value of S2’s stock exceeds S2’s net asset basis). However, this does not seem an unreasonable “toll charge” for section 355 treatment, i.e. for permitting S1 to distribute S2’s stock without creating a deferred intercompany gain.

Conversely, where P’s pre-distribution basis in S1’s stock is less than S1’s aggregate net asset basis, both a strict conforming basis rule and the modified rule described above would give P a combined post-distribution basis in S1 and S2 that is higher than P’s pre-distribution outside basis in S1. This too is inconsistent with section 358.

Example IV.C: P owns S1 and S1 owns S2. S1’s assets (other than its S2 stock) have a basis of $100 and a fair market value of $0, and S2’s assets also have a basis of $100 and a fair market value of $0. P has a $0 basis in S1’s stock. Under both the strict conforming basis rule and the modified conforming basis rule, if S1 spins off S2, P will have basis of $100 in S2. P’s basis in S1 will be $100 under the strict conforming basis rule, and $0 under the modified rule. Either rule results in an aggregate post-distribution stock basis that exceeds P’s original basis ($0) in S1’s stock.

The potential for reducing gain through a subsequent sale of the "inflated"-basis subsidiary stock may not seem troublesome to the extent the P group could achieve an equivalent result by instead selling the subsidiary's high-basis assets (rather than its stock) or selling the subsidiary's stock with a section 338(h)(10) election, and then liquidating the subsidiary. On the other hand, giving P a higher combined post-distribution basis in S1's and S2's stock than its original basis in S1's stock may create the potential for a duplicated loss, for example, to the extent the basis of S1's or S2's assets exceeds their value (in which case P might later sell stock at a loss, delivering the built-in-loss assets in corporate solution to the purchaser). To the extent it is desirable to impose a cap on P's aggregate post-distribution bases in S1's and S2's stock equal to P's original Si stock basis, the modified conforming basis rule could be further modified to reduce (under some proportional method) the basis of the S1 and S2 stock to the extent the cap would otherwise be exceeded. If this cap were adopted, it would also address the concern identified in Example IV. B. Therefore, if this cap were adopted, we would recommend that clause (2)(y) of the modified conforming basis rule be simplified by deleting the reference to S2's stock basis.

b. Scope of rule. The modified conforming basis rule described above could be applied to all intragroup spin-offs. Alternatively, to the extent some basis- shifting cases (such as Example 7) were not considered abusive, the rule could be limited to cases involving more egregious devices, such as ELA elimination and the like.

For example, our rule could easily be limited to cases covered by proposed section 355(f)(1) of the Senate Bill (i.e., taxable Morris Trust transactions). Even if so limited, we recommend this approach over the Senate Bill's proposed treatment of Morris Trust transactions, because the conforming basis rule precisely addresses the source of any potential abuse in intragroup spin-offs -- namely basis shifting. By making appropriate adjustments to subsidiary basis, the conforming basis rule eliminates potential abuse without raising the difficult issues of multiple taxation, application of the deferred intercompany gain rules in the context of spin-offs, and collateral problems introduced by the Senate Bill. We note, however, that if limited in this manner none of the transactions described in Examples 3 through 7 would be covered by the rule in the absence of k related taxable Morris Trust transaction. As previously discussed, this would seem irrational.

If it were desirable to apply our rule somewhat more broadly than contemplated by the Senate Bill but not to all basis shifting transactions, another relatively straightforward approach would be to limit the rule to cases in which the either the distributing or the distributed subsidiary's post-distribution liabilities exceed its post-distribution asset basis. Limited in this manner, the conforming basis rule would apply to Examples 3 through 5, but not to Examples 6 and 7. If it were desirable to cover Example 6 as well (but not Example 7), so that the application of the rule depended on an analysis of leverage, it would be necessary to grapple with the issues discussed in III.B above.

APPENDIX I -- Possible Morris Trust Leverage Safe Harbor

As stated in Part III.B of this Report, we believe the proper method for identifying abusive Morris Trust transactions is to examine whether debt has been "disproportionately" allocated to the corporation that is being merged -- generally the distributing corporation ("D"). We do not think a simple mechanical test can be devised to determine "disproportionality" because of differences in the amount of leverage that various types of businesses generally utilize, and *hence the principle should be that the allocation is disproportionate if it is unreasonable under all the facts and circumstances. Nonetheless, we do think it is possible to devise formulas (which may give rise to safe harbors or presumptions) to govern typical cases, leaving the exceptional case to be determined by the Service and the courts under the facts and circumstances test.

For example, we believe that if the following standard were met the Morris Trust transaction might be treated as tax-free, while in other cases the transaction might be presumed taxable, with the burden on the taxpayer to demonstrate the reasonableness of the allocation.

The following standard might be considered: (1) the debt-equity ratio of D, the merging company, after the spin-off does not exceed 120% of the pre-spin-off debt-equity ratio of the group, and (2) either (A) the total debt, excluding accounts payable (and possibly certain other routine operating liabilities), of the group immediately before the spin-off does not exceed 110% of the group's total debt twelve months before the spin-off or (B) the taxpayer can demonstrate that the additional debt was used to acquire assets* of the merging company. For these purposes the group would be the affiliated group as defined in section 1504, determined without the section 1504(b) exclusions.

Obviously, the percentages are meant to be illustrative and could be higher or lower. To prevent abuse, it might be provided that if a financial business or real estate business were among the assets of the group not included in D’s business after the spin-off, those assets and liabilities would be excluded in determining the group’s pre-spin-off ratios. Furthermore, it will not always be possible to satisfy part (1) of the test, e.g., if D’s business is a highly leveraged financial or real estate business. In such a case, the safe harbor would not apply and the burden would be on the taxpayer to demonstrate that its allocation was reasonable.

While it would be possible to condition use of this standard on obtaining a ruling from the Service before the spin-off, we do not recommend mandating a ruling, in part because we believe a ruling will be sought in most major transactions in which the standard is not met, and in part because of the administrative burden on the Service of considering ruling requests in all other cases.[28]

Part (2) of the above test is designed to limit the “new” debt that the group can incur if it is to qualify under the standard. Again the 110% is an arbitrary percentage, and in some cases (e.g., a rapidly expanding, leveraged business) it may be impossible to meet it, notwithstanding absence of any abuse. Nonetheless we believe the benefits of a mechanical “safe harbor” are sufficient to commend the test, even if the standard it imposes may be difficult to meet in some cases. Again, failure to

[28] cf. the ill-fated requirement (prior to 1976) to obtain rulings under section 367(a) of the 1954 Code.

meet the test will require the taxpayer to prove that, notwithstanding the failure, its debt allocation is reasonable.

Part (2)(B) of the test is designed to address a case in which D can demonstrate that, while its debt has increased more than 110%, the excess was used to purchase assets it retained. In those cases, became there is no attempt to borrow in one company and transfer assets to another, the principal abuse in “sale” type transactions is not involved. We believe the (2)(B) portion of the test would be useful principally if C is a pre-existing subsidiary of D. In that case, if D’s increased debt did not exceed the increase in the basis of its assets during the preceding year (less its after-tax earnings) and there was no increase in the basis of C’s stock (other than an increase due to C’s retained earnings), the test would be met. If C consists of division assets newly incorporated as part of the spin-off, application of this test would seem possible only if the division’s assets and liabilities could be identified as of the relevant date (i.e., one year before the spin-off), a requirement we anticipate would be difficult to satisfy in many cases.

As noted in Part III.B of the Report, a taxpayer safe harbor could be combined with a presumption that, if D’s debt-equity ratio appeared excessive (e.g., over 125% of the group’s pre-spin-off ratio), the transaction should not qualify for tax-free treatment. Again, while the suggested percentage is somewhat arbitrary, it would seem to offer significant protection from abuse.

Other issues might arise that could be addressed through anti-abuse rules, such as: sales-leaseback transactions used to reduce debt artificially, the use of plain vanilla preferred stock in lieu of debt, borrowing funds not used in the business before commencement of the debt-equity measurement period to artificially raise a group's historic debt-equity ratio, and other transactions designed to manipulate the test.

APPENDIX II — Intragroup Spin-Off Examples

The following examples illustrate the application of current law to intragroup spin-offs, discussed in Part IV of this report.[29] In these examples, "P" is the parent corporation of a consolidated group or a stand-alone corporation, as applicable; "S", "S1" and "S2" are wholly owned subsidiaries of P (directly owned by P unless otherwise indicated); and "D1" and "D2" are divisions of P or of a P subsidiary.

A. Current Law — Base Cases

As a framework for considering potential abuses arising from intragroup spin-offs, the following examples illustrate the application of current law to several basic external spin-off transactions that do not involve a preparatory internal spin-off.

Example 1 -- Leveraging P Divisions. P operates two divisions, D1 and D2:

	D1	D2	Total
Asset fair value:	50	100	150
Asset basis:	50	0	50

P borrows $40 secured by D2's assets but intends to use the cash in D1's business. Assume P's shareholders have tax basis of $80 in P's stock.

[29] See also J. Sheffield & H. Schlunk, Reconciling Spin-Offs with General Utilities Repeal, 74 Taxes 941 (1996).

a. Spin-off of D1 business. Assume P contributes D1's assets and the borrowed cash to a new subsidiary (S1) in a section 351 transaction and spins off D1's stock to P's shareholders. Under current law the result is as follows:

	S1	P
Asset fair value:	90	100
Liabilities:	0	(40)
Asset basis:	90	0
Shareholder stock basis:	48	32

Under section 358, P's shareholders allocate their historic basis in P's stock ($80) between their new S1 shares and their retained P shares based on the respective fair values of S1 ($90 or 60%) and P ($60 or 40%).

b. Spin-off of D2 business. Alternatively, assume P contributes D2's assets (subject to the $40 debt) to a new subsidiary (S2) in a section 351 transaction and spins off D2's stock to P's shareholders. Under section 357(c) and Treas. Reg. §1.1502-80, P will recognize gain of $40 in the section 351 contribution,[30] which under section 362 will increase by $40 S2's basis in the D2 assets. Otherwise the result is the same as in the spin-off of the D1 business:

[30] Under Treas. Reg. §1.1502-80(d), if S2 is spun off (and hence becomes a nonmember) "as part of the same plan or arrangement" as the section 351 formation of S2, then P will recognize section 357(c) gain on the transfer of assets and liabilities to S2. By contrast, section 357(c) will not apply (and no immediate gain will be recognized) if S2 remains in the P group, and instead P will acquire a $40 ELA in S2's stock as a result of the section 351 contribution to S2. In the latter case, if P were to spin off S2 later and not as part of same plan as the contribution of D2's assets to S2, P would recognize gain equal to the $40 ELA in S2's stock under Treas. Reg. §1.1502-19.

	P	S2
Asset fair value:	90	100
Liabilities:	0	(40)
Asset basis:	90	40
Shareholder stock basis:	48	32

The different tax results in the two cases (resulting from the application of section 357(c) in the second case but not the first) seems irrational given the similar non-tax result of the two spin-off transactions (historic P shareholders holding the D1 and D2 businesses through separate corporations). Nevertheless, these consequences follow from basic statutory principles and do not appear to present abuse potential. Accordingly, subject to the discussion of leveraged Morris Trust transactions in Part III.B of this Report, we assume for purposes of the Report that any new legislation should not alter the above results.

Neither Bill would alter the tax consequences of the above transactions (except in connection with a related Morris Trust transaction).

Example 2 -- Leveraging Direct P Subsidiaries. P owns two subsidiaries, S1 and S2:

	S1	S2	Total
Asset fair value:	50	100	150
Asset basis:	50	0	50
P’s basis in stock:	50	0	50

S2 borrows $40 and distributes the cash to P, creating a $40 ELA in S2’s stock. P contributes the cash to S1, increasing S1’s stock and asset basis by $40.

a. Spin-off of S1. If P spins off S1's stock: P has no gain or loss, P's shareholders allocate their historic basis in P's stock 60% ($48) to the S1 stock and 40% ($32) to their retained P stock under section 358. P will continue to have a $40 ELA in S2's stock, which corresponds to S2's net asset basis.

	S1	S2	P
Asset fair value:	90	100	
Liabilities:	0	(40)	
Asset basis:	90	0	
P shareholder stock basis:	48		32
P basis in S2 stock:		(40) ELA	

The result is analogous to the divisional analysis in Example la. Note that P's basis in S1's stock before the spin-off of S1 is irrelevant provided it is positive, since (by operation of section 358) it is eliminated in the spin-off of S1.

b. Spin-off of S2. If P spins off S2 instead of S1, P's $40 ELA in S2's stock will be triggered under Treas. Reg. §1.1502-19(b)(2)(ii) and (c)(1)(ii). This is consistent with the $40 section 357(c) gain recognized by P in the divisional spin-off in Example 1b above. In contrast to the section 357(c) result, however, there is no corresponding step-up in the basis of S2's assets (due to the inapplicability of section 362 or any comparable provision) when P's $40 ELA is triggered. P will continue to have a $90 basis in S1's stock, which corresponds to S1's net asset basis.

	S1	S2	P
Asset fair value:	90	100	
Liabilities:	0	(40)	
Asset basis:	90	0	
P shareholder stock basis:		32	48
P basis in S1 stock:	90		

Apart from the lack of a step-up in S2’s assets, the result is analogous to the divisional analysis in Example 1b.

The tax results in Examples 2a and 2b are not entirely consistent with each other or with their divisional counterparts. Nevertheless, we again assume for purposes of this Report that, because these results follow from basic principles and do not appear to present abuse potential, they should be preserved by any new legislation (subject to the discussion of leveraged Morris Trust transactions in Part III.B of the Report). Both Bills are consistent with this position, because neither would alter the treatment of the above transactions under current law except in connection with a related Morris Trust transaction.

B. Current Law -- More Troublesome Cases

The following examples illustrate the application of current law to several transactions that raise concerns that we understand the House Bill and Senate Bill are intended to address.

Example 3 -- ELA elimination. P owns all of S1’s stock and S1 owns all of S2’s stock. S1 and S2 have the following attributes:

	S1	S2
Asset fair value:	150	100
Asset basis:	50	0
Stock fair value:	150	100
Stock basis:	50	0

S2 borrows $40 and distributes the cash to S1, thus creating a $40 ELA in S2’s stock and reducing S2’s net fair value to $60. Immediately thereafter S1 distributes S2’s stock to P under section 355, reducing S1’s value to $90. Under current law, it appears that (1) S1’s ELA in S2’s stock is eliminated, and (2) P’s basis in S1’s and S2’s stock after the distribution will be $30 and $20, respectively, under section 358 (i.e., P’s $50 pre-distribution basis in S1’s stock, allocated between S1’s and S2’s stock in proportion to their fair values of $90 and $60).[31]

	S1	S2
Asset fair value:	90	100
Liabilities:	0	(40)
Asset basis:	90	0
P’s basis in S1,S2 stock:	30	20

Because the ELA in S2’s stock has been eliminated, P thereafter may distribute the stock of S1 or S2 to P’s shareholders without recognizing gain.

In contrast to Examples 1 and 2, the internal spin-off has created a $60 disparity between net asset basis and stock basis for each of S1 and S2. S1’s net asset basis is $90, but P’s basis in S1’s stock is only $30, or $60 less. S2’s net asset basis is ($40) (i.e., $0 asset basis less $40 liability), but P’s basis in S2’s stock is $20, or $60 higher.

Even if P does not spin off S1 or S2 to P’s shareholders, the basis disparity arising from the internal spin-off can benefit P. In particular, P could, after an appropriate waiting period, sell the stock of S2 for its $60 net value and recognize gain of only $40. P could eliminate S1’s low stock basis by (1) liquidating S1 under section 332, (2) spinning off S1 to P’s shareholders, or (3) after an appropriate waiting period, selling S1’s assets for their $90 value, without gain,

31 See Treas. Reg. §1.1502- 19(g) Example (3). But see Treas. Reg. §1.1502-19(e) (anti-avoidance rule).

and then liquidating S1. P’s aggregate taxable gain of $40 would be $60 less than the aggregate built-in gain of the S1 and S2 assets disposed of (and $60 less than P’s original built-in gain in S1’s stock). None of this built-in gain has permanently escaped corporate tax, since the full $100 built-in gain inherent in S1’s and S2’s assets remains in corporate solution. Nevertheless, P has, in effect, reduced its gain in connection with a later taxable sale of S2’s stock by artificially increasing S2’s stock basis.

Example 4A -- divisions of subsidiary: section 357(c) applies. P owns all of S1’s stock, and S1 operates two divisions, D1 and D2:

	D1	D2	S1
Asset fair value:	50	100	
Asset basis:	50	0	
S1 stock fair value:			150
P’s basis in S1 stock:			50

S1 borrows $40 for use in the D1 business. S1 contributes the D2 business, subject to the $40 liability, to newly formed S2 in a section 351 transaction. Immediately thereafter S1 distributes S2’s stock to P under section 355. Assuming S1 or S2 is spun off to P’s shareholders (and hence becomes a nonmember) “as part of the same plan or arrangement” as the section 351 formation of S2, then S1 will recognize section 357(c) gain (of $40) on the transfer of the D2 assets and liability to S2 under Treas. Reg. §1.1502-80(d). This in turn will cause a $40 increase in the basis of S2’s assets (from $0 to $40) under section 362(b) and in P’s pre-spin-off basis in S1’s stock (from $50 to $90) under Treas. Reg. §1.1502-32. P’s $90 basis in S1’s stock is then allocated in the spin-off between S1’s and S2’s stock under section 358:

	S1	S2
Asset fair value:	90	100
Liabilities:	0	(40)
Asset basis:	90	40
P's basis in S1,S2 stock:	54	36

Like Example 3, the internal spin-off creates a disparity (here $36) between the net asset basis and the stock basis of S1 and S2.

Examples 3 and 4A produce similar economic results but different tax consequences. The tax difference arises partly from S2's existence as an historic subsidiary (rather than a division of S1) in Example 3, which permits an alternative financing structure. The consolidated return regulations appear to provide an advantage (not triggering the ELA) in Example 3 that is not provided in Example 4A, where separate entity treatment is inherent in the application of section 357(c) to assets leaving the consolidated group.

This particular anomaly might be addressed by amending the consolidated return regulations to provide that an ELA (such as in Example 3) will be triggered to the extent it is created "as part of the same plan or arrangement" as a spin-off of a party to the transaction outside the group. This would conform to the standard for triggering section 357(c) gain in Reg. §1.1502-80. As indicated by Examples 4B and 5, however, such a rule may be too narrow.

Example 4B -- divisions of subsidiary; section 357(c) does not apply. Same as Example 4A, except that P does not distribute S1's or S2's stock to P's shareholders "as part of the same plan" as the section 351 contribution of the D2 business to S2. Accordingly, under Treas. Reg. §1.1502-80(d), section 357(c) does not apply to the section 351 contribution. Instead, the contribution will cause S1 to have a $40 ELA in S2’s stock. This ELA is immediately eliminated, however, when S1 spins off S2 to P, since in the spin-off P allocates its original $50 basis in S1’s stock between S1 and S2 under section 358. Hence the final result is the same as in Example 3:

	S1	S2
Asset fair value:	90	100
Liabilities:	0	(40)
Asset basis:	90	0
P’s basis in S1,S2 stock:	30	20

The non-applicability of section 357(c) here produces a superior tax result for the P group than Example 4A, since under current law P can, after an appropriate delay, spin off S2 without any immediate tax. This example raises a question whether the “same plan or arrangement” test of Reg. §1.1502-80(d) is too lenient as it applies to intragroup spin-offs.

Example 5A -- liabilities exceed basis; no ELA; new S2 (based on Viacom). Same as Example 4, except that S1 contributes the D1 business plus the $40 loan proceeds to newly formed S2. S1 retains the D2 business and the debt. Immediately thereafter S1 spins off S2’s stock to P, with the following results:

	S2 (D1 assets)	S1 (D2 assets)
Asset fair value:	90	100
Liabilities:	0	(40)
Asset basis:	90	0
P’s basis in S1,S2 stock:	30	20

The economic and tax results (including the $60 disparity between net asset basis and stock basis for both S2 and S1) are identical to Example 3. As in Example 3, P could sell S1’s stock after an appropriate interval for its net $60 value and recognize only $40 of gain. In contrast, if Si had distributed the D1 assets and the $40 loan proceeds to P (rather than contributing them to D2), P would have had a $40 ELA in S1's stock (i.e., $50 initial basis less $90 of assets distributed to P) under Treas. Reg. §1.1502-32. In that case, P would have recognized $100 (rather than $40) of gain on the sale of S1's stock for $60.

In contrast to Example 3, the tax result in Example 5A is achieved without the interim creation of an ELA in S1's stock. Example 5A, which is similar in approach to the loan arrangement in the recent Viacom transaction, therefore illustrates that the issue of inside/outside basis disparity is not limited to cases involving an ELA or section 357(c).

Example 5B -- liabilities exceed basis; no ELA; existing S2 (based on Viacom). Same as Example 5A, except that S2 (a pre-existing subsidiary of S1) already owns a 5-year business (consisting of the D1 assets). Before spinning off S2 to P, S1 borrows $40 and contributes the cash to S2. The economic and tax results are the same as in Example 5A.

Example 6 -- leverage where basis exceeds liabilities. In the preceding examples, borrowing causes liabilities of a subsidiary to exceed asset basis. Instead assume the facts of Example 4A, except that D2's initial asset basis is $50 rather than $0:

	D1	D2	S1
Asset fair value:	50	100	
Asset basis:	50	50	
S1 stock fair value:			150
P's basis in S1 stock:			100

S1 borrows $40 for use in the D1 business and contributes the D2 business, subject to the $40 liability, to newly formed S2 in a section 351 transaction. Immediately thereafter S1 distributes S2's stock to P under section 355. Section 357(c) does not apply, because D2's liabilities ($40) do not exceed its asset basis ($50). Under section 358, P's initial $100 basis in S1's stock is allocated 60% ($60) to S1's stock and 40% ($40) to S2's stock:

	S1	S2
Asset fair value:	90	100
Liabilities:	0	(40)
Asset basis:	90	50
P's basis in S1,S2 stock:	60	40

As in the previous examples, the internal spin-off creates a disparity (here $30) between the net asset basis and the stock basis of S1 and S2. Hence P could, for example, later sell S2's stock at a $30 reduced gain, and eliminate its low basis in S1's stock by either liquidating or spinning off S1 or selling S1's assets.

Example 7 -- basis shifting without leverage. Same as Example 4, except there is no borrowing. That is, initially P owns all of S1's stock, and S1 operates two divisions, D1 and D2, with the following attributes:

	D1	D2	S1
Asset fair value:	50	100	
Asset basis:	50	0	
S1 stock fair value:			150
P's basis in S1 stock:			50

If S1 sells the D2 assets for $100 (or if S1 contributes the D2 assets to S2 and sells S2's stock for $100), S1 recognizes gain of $100. Alternatively, if S1 contributes the D2 assets to

S2 and distributes S2’s stock to P as a dividend (with P thereafter selling the S2 stock for $100), the end result is the same: S1’s distribution of S2 will create deferred intercompany gain of $100 to S1 (under section 311(b) and Treas. Reg. §1.1502-13(f)(2)) and a $50 ELA in the S1 stock held by P (i.e., $50 original basis less $100 distribution). When P sells S2’s stock for $100, S1 recognizes the $100 intercompany gain (increasing P’s basis in S1’s stock to $50). Both results involve the P group’s recognition of $100 gain on the taxable sale of the D2 business and are consistent with S1’s $0 basis in D2’s assets.

In contrast, if S1 contributes the D2 business to newly formed S2 and then distributes S2’s stock to P in a section 355 transaction, P’s $50 basis in S1’s stock will be allocated 1/3 ($17) to S1’s stock and 2/3 ($33) to S2’s stock under section 358, thus creating a $33 disparity between net asset basis and stock basis for each of S1 and S2:

	S1	S2
Asset fair value:	50	100
Liabilities:	0	0
Asset basis:	50	0
P’s basis in S1,S2 stock:	17	33

If P, after an appropriate delay, sells S2’s stock for its $100 fair value, P’s gain is only $67, or $33 less than in the taxable disposition scenarios previously described in this example.

This example illustrates that basis shifting can be achieved through internal spin-offs even where (1) net asset basis is positive and (2) no leverage is involved.