REPORT #900

TAX SECTION

New York State Bar Association

Letter on Proposed Legislation to Impose Tax on Morris Trust Transactions

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TAX SECTION

New York State Bar Association

May 19, 1997

Honorable Bill Archer
U.S. House of Representatives
Washington, DC 20515

Re: H.R. 1365 and S. 612

Dear Congressman Archer:

We respond to your request for <u>comments on HR 1365 and S.612 that would amend Section 355 of the Internal Revenue Code</u>. In particular, the proposal would bar "*Morris Trust*" transactions by preventing a corporation from making a tax-free distribution under Internal Revenue Code §355 if more than 50% of the stock of either the distributing corporation or the distributed corporation is acquired by a person within the two years before or after the spin-off, unless it is shown the acquisition and distribution are not pursuant to a plan. The bill would also repeal Code §355 with respect to transactions within an affiliated group of corporations filing a consolidated tax return. In general, the proposed amendments would apply to transactions taking place after April 16, 1997, but in the case of the limitation on Morris Trust transactions, the bill provides for limited transitional relief.

The proposed legislation raises difficult issues concerning the role of Code §355 following repeal of the *General Utilities* doctrine by the Tax Reform Act of 1986, issues that are of practical, as well as theoretical, concern. *Morris Trust* transactions have been permitted under the Internal Revenue Code for over 30 years and under certain circumstances are the only way in which corporate restructurings can be accomplished. For example, if two companies wish to merge but non-tax considerations mandate that one of the corporations first dispose of one or more of its active businesses, the tax-free spin-off of that business may be the only way in which the transaction can be structured to solve the commercial problem without resulting in such heavy taxation that the transaction is impractical.* Similarly, a corporation may wish to merge with the subsidiary of another corporation but is unwilling to issue substantial stock to the parent of that subsidiary because the parent would become the controlling shareholder of the merged company. Again a spin-off followed by a merger may be the only practical way to accomplish the business goals.

Hence, we do not view the study of the Morris Trust issue as being purely a technical tax issue; serious questions of policy are involved in erecting tax barriers to the break-up of corporate groups for business reasons. Nor, in terms of tax policy, do we believe the repeal of General Utilities implied that Code §355 should be repealed. Prior to 1986, 1954 Code §§337 and 334(b)(2) permitted a step-up in the basis of corporate assets without any corresponding corporate level tax, and it was this result many tax professionals thought should be eliminated. On the other hand, a Code §355 spinoff does not involve any step-up in the basis of assets held in corporate solution; the stock of the subsidiary spun-off inherits a portion of the parent company shareholders' basis but the basis of its assets is unchanged. In view of the foregoing, we think the treatment of Code §355 transactions after General Utilities repeal is an appropriate subject for additional study.

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* These considerations frequently arise from restraints imposed by the Government, e.g., the antitrust laws, FCC restrictions on ownership, etc.

This is not to say that there may not be abuses of Code §355, some involving Morris Trust transactions. We recognize that considerable comment has arisen with respect to recent Morris Trust transactions in which movements of debt and cash incident to the spin-off of a subsidiary are alleged to have given the transaction some of the characteristics of a sale. What factors justify "sale" characterization are not clear, and the issues presented by these transactions merit further consideration and study. Because some Morris Trust transactions may ultimately be regarded as abusive and we are not able to define them at this time, we do not object to an effective date that temporarily bars Morris Trust transactions pending prompt completion of that study and a decision as to the circumstances, if any, in which Morris Trust transactions should no longer be permitted. However, we believe that any barrier to important business transactions should be continued for only a limited time and that therefore consideration of the issues relating to the tax treatment of Morris Trust transactions must be undertaken and completed soon.

On the other hand, we are quite concerned about the proposed bar to tax free intragroup spin-offs both as to its impact and its effective date. While anti-Morris Trust legislation had previously been proposed, the repeal of Code §355 as applied to intragroup spin-offs is new and unexpected. While certain intragroup spin-offs have the effect of increasing the basis of the shares of a subsidiary or eliminating negative basis (excess loss accounts), the proposed legislation is so broad as to eliminate many spin-off transactions that do not have that effect, including an intragroup spin-off of stock with a positive basis preparatory to a public spin-off (which renders meaningless any increase in basis arising during an intermediate step in the transaction). Moreover, in the non-abusive case, the legislation produces results that are completely arbitrary, 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. We are unaware of the reason the proposed legislation would tax all intragroup spin-offs, including those that effect no basis shifting or eliminations of excess loss accounts or other potential tax avoidance.

While we also support a review of the issues related to intragroup spin-offs, we do not support a generally retroactive effective date that will effectively bring to a halt many non-abusive transactions. Pending the analysis of the issues and the adoption of legislation, we urge you to revise the effective date as it applies to intragroup spin-offs, either to make all changes prospective or to specifically identify the types of potentially abusive transactions (e.g., those involving excess loss accounts) for which the legislation may have retroactive effect. Even if this effective date is not changed, we strongly urge prompt confirmation that the transition rules applicable to intragroup spin-offs set forth in your joint announcement of April 18, 1997 are applicable to spin-offs that do not involve Morris Trust transactions. Statements made about the announcement have created uncertainty, impeding completion of transactions which, prior to April 17, 1997, were publicly announced, submitted to the IRS or SEC, etc.

We are currently working on a detailed study of the proper treatment of the transactions addressed in the proposed legislation. In the course of the study, we will consider such issues as (1) whether we regard taxation of all Morris Trust transactions as appropriate, (2) if not, whether there are some identifiable forms of Morris Trust transactions that should be taxed, (3) if so, how those transactions can be differentiated from those that should not be taxed, (4) the proper method of determining the taxable income arising on taxed transactions and (5) whether an intragroup spin-off should be subject to special rules and, if so, when. We expect to have this study completed by July 1, 1997 and will send it to you upon its completion.

Pending completion of our in-depth study, we do note several consequences of the proposed legislation we believe were unintended. Their presence may tend to confirm the judgment reached by observers outside the legislative process that these proposals were drafted in haste, without due regard for the complexities they introduce or their far reaching practical significance. First, it appears the statute will not apply to Morris Trust transactions in which the distributing corporation merges into the acquiring corporation; in such a case, no "person acquires stock representing a 50 percent or greater interest" in either the distributing corporation or the controlled corporation. Second, the requisite 50% control may be considered to have been acquired if (i) the distributing corporation transferred assets to a new subsidiary which is then spun- off to the shareholders of the distributing corporation without any subsequent Morris Trust type transaction occurring, or (ii) following a spin-off, another corporation acquires the distributing corporation's stock in a tax-free reorganization in which the former shareholders of the distributing corporation receive more than 50% of the acquiring corporation's shares. We see no reason Code §355(e) should apply to these transactions.

Finally, we note the potential juxtaposition of the usual parties. Assume, for example, the contemplated combination of two oil companies, X and Y. The Antitrust Division compels Y to divest itself of its gasoline stations owned and operated by Y Sub prior to or immediately after the merger; Y Sub represents only a small percentage of Y's total assets, and there would be comparatively little gain on its disposition. If, for good business reasons, the divestiture takes the form of a tax-free spin-off of Y Sub, followed by a merger of Y into an X subsidiary, under proposed Code §355(e)(1)(B), Y Sub will recognize taxable income equal to the net gain that would have been realized had Y sold all its world-wide assets for cash to an arm's length buyer. Under these circumstances, the total tax would greatly exceed that which would arise if Y sold Y sub for cash, and hence, we would not be surprised to see the Commissioner argue the spin-off of Y Sub is tax-free, while Y and X would argue the spin-off was taxable, thereby preventing Code §355(e) from applying to the X-Y combination.

Another unintended result of Code §355(f) may occur at the state level. If an intragroup spin-off does not qualify as tax-free, the transaction will trigger an immediately taxable gain for state income tax purposes in states that do not permit consolidated filings or provide deferred intercompany gain recognition. States that would tax an intragroup stock distribution include Pennsylvania and New Jersey.

We hope this letter is helpful to you. Of course, we are available at any time to work with you and your staffs to attempt to craft workable and sensible rules.

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

Very truly yours,

Richard O. Loengard, Jr.
Chair

cc: Hon. Donald C. Lubick
Acting Assistant Secretary (Tax Policy)
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