Tax Report #922

New York State Bar Association

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NYSBA

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

Dear Mr. Brown:

We write to urge the Internal Revenue Service to issue guidance confirming that a post-distribution stock transaction involving a controlled corporation does not prevent the distribution from satisfying the "distribution of control" requirement under section 355 of the Internal Revenue Code. We urge the IRS to take this action because of the enactment of section 355(e) and the statements in its accompanying legislative history.

Section 355 permits a corporation to distribute the stock of a subsidiary without income recognition to the distributing corporation or its shareholders. One of the requirements for tax-free treatment is that, immediately before the distribution, the distributing corporation must "control" the subsidiary within the meaning of section 368(c) and that control must be distributed to the distributing corporation's shareholders (the "distribution of control" requirement). Section 368(c) defines "control" as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

In Rev. Proc. 96-39, 1996-2 C.B. 300, the IRS announced it would not issue a favorable private letter ruling that a distribution qualified under section 355 if there were negotiations, agreements or arrangements with respect to transactions or events which, if consummated before the distribution, would have resulted in the distribution of stock or securities of a corporation that was not controlled by the distributing corporation. We understand that Rev. Proc. 96-39 was issued in response to concerns raised about Private Letter Ruling 9637043 (June 17, 1996). In particular, some commentators questioned whether the distribution of the subsidiary's stock in that case violated the distribution of control requirement because of a pre-existing agreement for an investor to purchase, from the controlled corporation immediately after its distribution, stock possessing all of the controlled corporation's voting power.

Congress examined this subject in connection with its review of "*Morris Trust*" transactions that involved an acquisition of the distributing corporation or the controlled corporation after a spin-off. The Taxpayer Relief Act of 1997 (the "1997 Act") added section 355(e) to the Internal Revenue Code. Section 355(e) generally provides that if, pursuant to a plan (or series of related transactions), at least 50% of the voting power or the value of the stock of either the distributing corporation or the controlled corporation is acquired by persons other than shareholders of distributing corporation, gain on the stock of the controlled corporation is recognized by the distributing corporation.

The 1997 Act also modified the rules for determining control immediately after a distribution in those cases where assets are contributed to a subsidiary prior to its distribution. For the transfer of assets to the subsidiary to be tax-free, section 368(a)(1)(D) (or section 351) requires that the transferor or its shareholders must "control" the transferee subsidiary immediately after the distribution of the subsidiary (the "control immediately after" requirement). For this purpose, "control" was formerly determined under section 368(c). The 1997 Act modified the definition of control for this purpose to mean the ownership of stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote and more than 50% of the total value of shares of all classes of stock of such corporation.

The Conference Committee Report for the 1997 Act states:

> The House bill does not change the present-law requirement under section 355 that the distributing corporation must distribute 80 percent of the voting power and 80 percent of each other class of stock of the controlled corporation. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the proposal regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80-percent control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80-percent controlled subsidiary, but would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

On November 10, 1997, the IRS revoked Rev. Proc. 96-39. Rev. Proc. 97-53, 1997-47 I.R.B. 10. Following the enactment of section 355(e) (with its accompanying legislative history) and revocation of Rev. Proc. 96-39, taxpayers require guidance as to the potential impact of post-distribution transactions involving the controlled corporation on the distribution of control requirement.

Consider the following example. D corporation has two active businesses, each conducted in a separate division. D has no other assets. D proposes to incorporate the two businesses into two subsidiaries C and C-1 and then distribute the stock of one of the subsidiaries, C, to D's shareholders under section 355. C will then issue 21% of its stock in a public offering[1].

The D shareholders, by owning 79% of C after the distribution, will own more than 50% of C immediately *after* the distribution and consequently the section 355(e) 50% stock ownership requirement immediately after distribution will be satisfied. We believe guidance should confirm that, for purposes of the distribution of control requirement, the public offering will not be treated as occurring before the distribution, making clear that D will control C immediately *before* the distribution and therefore D will satisfy the distribution of control requirement.

As indicated above, the legislative history for the 1997 Act states the distribution of control requirement is expected to be administered in a manner that would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if the restrictions would not apply to the distributing corporation. The distribution of control requirement would not be implicated, and thus could not be violated, if D immediately after distributing C, issues 21% of its own stock in a public offering. Alternatively, assume D, instead of distributing C, distributes the stock of its other subsidiary, C-1, and then D issues 21% of its stock in a public offering. The effect of this alternative transaction is the same as if D had spun off C with its business

1 All "public offerings" described in the examples in this letter are "primary" offerings, *i.e.*, sales by the corporation to the public and all sales proceeds will be retained by the issuing corporation for use in its business. Thus, the device test of Code §355(a)(1)(B) is not implicated.

and C had issued 21% of its stock in a public offering. In the example involving D's distribution of C, treating the public offering of C stock as occurring before the distribution for purposes of the distribution of control requirement would have an effect inconsistent with the legislative history requiring similar tax treatment of post distribution restructurings for both the distributing and controlled corporations. The same tax result should apply to both the D and C public offering cases.

Consider a second example. D corporation has two businesses, business 1 and business 2. D and Y, an unrelated corporation engaged in business 1, desire to combine their business 1 operations. Pursuant to a prearranged plan, D will transfer its business 1 to a newly formed corporation (C), distribute the stock of C to D's shareholders, and then C will merge into Y. The D shareholders will own 79% of the stock of Y and the previous Y shareholders will own 21% of the stock of Y.

As a result of the modification of the definition of "control immediately after" in the 1997 Act, reducing the "control" requirement from 80% to more than 50% of vote and value, the ownership of 79% of Y by the D shareholders after the distribution should satisfy the "control immediately after" requirement.[2] Guidance is needed to confirm this point and to confirm that, for purposes of the distribution of control requirement, D will not be treated as transferring business 1 directly to Y for 79% of Y's stock followed by D's distribution of this Y stock to the D shareholders in a transaction that violates the distribution of control requirement. The guidance would make clear that D will control C

[2] That C does not survive the merger should not affect whether the "control immediately after" requirement is satisfied. Clearly this requirement would be satisfied if Y merges into C, with C surviving, and the D shareholders continue to own 79% of C. A similar issue regarding the "control immediately after" requirement arises in a section 368(a)(1)(D)/section 355 transaction if D transfers business 1 to C, D distributes the stock of C, and then Y acquires C in a section 368(a)(1)(B) reorganization, with the D shareholders owning 79% of Y after the transaction. *See* Rev. Rul. 70-225, 1970-1 C.B. 80.

immediately before the distribution and therefore D will satisfy the distribution of control requirement.

In this second example, the distribution of control requirement would not be implicated, and thus could not be violated, if D transfers business 2 to C, D distributes the stock of C, and then D merges into Y with the D shareholders receiving 79% of the stock of Y. In this second example, as in the first, recharacterizing the steps for purposes of the distribution of control requirement would have an effect inconsistent with the legislative history.[3]

For these reasons, we urge you to issue guidance confirming that a post-distribution transaction involving a controlled corporation does not prevent the distribution from satisfying the distribution of control requirement if the same transaction involving the distributing corporation would not prevent the distribution from satisfying the distribution of control requirements. Because Congress has spoken directly by enacting section 355(e) and by its statements in the accompanying legislative history, IRS guidance would not have an effect on application of substance over form or step transaction principles in other areas. As part of this guidance project, we suggest the IRS obsolete Rev. Rul. 70-225, 1970-1 C.B. 80, Rev. Rul. 75-406, 1975-2 C.B. 125, and Rev. Rul. 96-30, 1996-1 C.B. 36 to avoid any continuing confusion.

As you know, because of the enormous tax stakes, many taxpayers seek private letter rulings for section 355 distributions.[4]

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[3] The IRS could also consider extending the legislative history to cases in which, as a result of a subsequent transaction, the shareholders of the distributing corporation hold less than 50% of the vote or value of the stock of the controlled corporation. In such a case, section 355(e) would result in a corporate-level tax to the distributing corporation, but gain would not be recognized by the shareholders of the distributing corporation.

[4] An unusually large number of Tax Section Executive Committee members are members of firms that have pending rulings that would involve the questions discussed here. Those members did not vote on the resolution authorizing our sending this letter.

Extended consideration of this matter may result in substantial delays in the private letter ruling process with respect to transactions the legislative history accompanying the 1997 Act reveals should receive favorable treatment. For this reason, we urge the IRS to address the effect of the 1997 Act on the distribution of control requirement promptly.

If we can be of further assistance in your consideration of this matter, please do not hesitate to call me.

Respectfully submitted,

Steven C. Todrys

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