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December 1, 2015

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The Honorable William J. Wilkins
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Re: Report No. 1333 on the Allocation of Earnings
and Profits in Connection with Divisive Transactions

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report makes proposals regarding the allocation of earnings and profits ("E&P") in connection with divisive transactions described in section 355 of the Internal Revenue Code. Because a section 355 distribution of a controlled corporation ("Controlled") by a distributing corporation ("Distributing") results in the division of a single corporation into two corporations, it is necessary to have rules to determine the post-transaction E&P of Distributing and Controlled after the division in order to preserve the relationship of the shareholders to the E&P.

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The allocation of E&P in connection with a spin-off is currently governed by Treas. Reg. §1.312-10. This Regulation was issued in 1955, when individuals were taxed at significantly higher rates on dividend income than capital gains, multinational corporations with complex structures and attribute profiles were uncommon, and the tax law generally was less complex. The Regulation is ambiguous in certain respects, resulting in uncertainty, and in certain contexts does not reach appropriate results.

Today, the location and category of E&P following cross-border section 355 transactions is critical for determining the tax consequences of future distributions by foreign corporations. In this context, clear rules are essential in order to minimize inappropriate repatriation opportunities and provide taxpayers with certainty. In the domestic context, the amount of E&P allocated is critical when the dividing company does not have E&P in excess of contemplated shareholder distributions by Distributing and Controlled, or where Controlled must manage its E&P for qualification as a real estate investment trust.

The report recommends relatively modest changes to the Regulation to: (i) provide certainty to taxpayers and the government, (ii) minimize inappropriate tax planning, (iii) minimize differences between a spin-off of a newly-formed Controlled and a pre-existing Controlled, and (iv) provide guidance for a divisive section 368(a)(1)(D) reorganization (“divisive D reorganization”) where Controlled is pre-existing. Our recommendations provide consistent results regardless of whether there is a divisive D reorganization and regardless of whether Controlled is pre-existing or newly-formed.

Specifically, in the context of a spin-off of a newly-formed Controlled corporation:

1. Retain the fair market value method for allocating Distributing’s E&P to Controlled.
2. In order to address the inadequacy of the fair market value method to maintain the shareholders’ relationship to potential E&P created by the recognition of gains following the spin-off, consider adjusting the basis of Distributing’s and Controlled’s assets *solely for purposes of computing their E&P*.
3. Eliminate the ambiguity created by the provision that the net basis method (or any other method) may be used in a “proper” case.

In the context of a spin-off of a pre-existing Controlled:

4. Retain the Regulation’s rule that Distributing’s E&P is reduced by the amount by which Distributing’s E&P would have been reduced had it transferred the stock of Controlled to a newly-formed Controlled.
5. Eliminate the net worth limitation in the Regulation.

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6. Eliminate the possibility of disappearing E&P when Distributing reduces its E&P by a larger number than Controlled increases its E&P (because pre-existing Controlled has its own E&P). While there are alternatives for accomplishing this goal, we propose increasing Controlled's E&P by the entire amount of the reduction in Distributing's E&P.

In the context of a divisive D reorganization with a pre-existing Controlled:

7. Treat the assets transferred in the divisive D reorganization as historic assets of the pre-existing Controlled and apply the allocation rule for a spin-off of a pre-existing Controlled.

In addition, the Report addresses certain related common issues raised in the context of determining the amount of E&P to be allocated in a spin-off for which clear guidance is needed:

8. Except for extraordinary items, pro rate Distributing's E&P for the year on a daily basis to the day immediately prior to the spin-off.
9. Allocate extraordinary items on a closing-of-the-books basis.
10. Reduce Distributing's current E&P available for allocation by all section 301 distributions, regardless of the timing of such distributions.
11. If Controlled is less than wholly-owned, allocate E&P on the basis of the value of Controlled owned by Distributing.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,

David R. Sicular
Chair

CCs: Erik H. Corwin
Deputy Chief Counsel (Technical)
Internal Revenue Service

The Honorable Mark Mazur
The Honorable John Koskinen
The Honorable William J. Wilkins
December 1, 2015

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