NEW YORK STATE BAR ASSOCIATION
One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

TAX SECTION

2019-2020 Executive Committee

DEBORAH L. PAUL
Chair
Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York,. NY 10019
212/403-1300
ANDREW H. BRAITERMAN
First Vice-Chair
212/837-6315
GORDON E. WARNKE
Second Vice-Chair
212/997-0500
ROBERT CASSANOS
Secretary
212/859-8278
COMMITTEE CHAIRS:
Bankruptcy and Operating Losses
Daniel M. Dunn
Stuart J. Goldring
Compliance, Practice & Procedure
Elliot Pisem
Bryan C. Skarlatos
Consolidated Returns
William Alexander
Shane J. Kiggen
Corporations
Daniel Z. Altman
Michael T. Mollerus
Cross-Border Capital Markets
Philip R. Wagman
Andrew R. Walker
Cross-Border M&A
Joshua M. Holmes
Ansgar A. Simon
Debt-Financing and Securitizations
John T. Lutz
Michael B. Shulman
Estates and Trusts
Austin Bramwell
Alan S. Halperin
Financial Instruments
Lucy W. Farr
Jeffrey Maddrey
"Inbound" U.S. Activities of Foreign Taxpayers
Peter J. Connors
Peter F. G. Schuur
Individuals
Megan L. Brackney
Steven A. Dean
Investment Funds
James R. Brown
Pamela L. Endreny
Multistate Taxation
Arthur R. Rosen
Jack Trachtenberg
New York City Taxes
Sherry S. Kraus
Irwin M. Slomka
New York State Taxes
Paul R. Comeau
Joshua E. Gewolb
"Outbound" Foreign Activities of U.S. Taxpayers
William A. Curran
Andrew P. Solomon
Partnerships
Phillip J. Gall
Sara B. Zablotney
Pass-Through Entities
Edward E. Gonzalez
Amanda H. Nussbaum
Real Property
Marcy Geller
Jonathan R. Talansky
Reorganizations
Neil J. Barr
Peter A. Furci
Spin Offs
Tijana J. Dvornic
Lawrence M. Garrett
Tax Exempt Entities
Stuart Rosow
Richard R. Upton
Taxable Acquisitions
David W. Mayo
Richard Nugent
Treaties and Intergovernmental Agreements
Lee E. Allison
David R. Hardy

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:

Jason R. Factor
Meyer H. Fedida
Andrew M. Herman
Elizabeth T. Kessenides
Adam Kool
Brian Krause
Stuart E. Leblang
Jiyeon Lee-Lim
William L. McRae
Kara L. Mungovan
Eschi Rahimi-Laridjani
Yaron Z. Reich
David M. Rievman
David M. Schizer
Stephen E. Shay
Eric B. Sloan
Eric Solomon
Linda Z. Swartz
Dana L. Trier
Eric Wang

Report No. 1417
June 24, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1417 – Report on the Proposed "May Company" Regulations under Section 337(d)*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1417 commenting on proposed regulations under Section 337(d) issued on March 25, 2019. The proposed regulations would amend certain aspects of final regulations promulgated in 2018. We commend the Department of the Treasury and the Internal Revenue Service on the thoughtful approach of the proposed regulations.

FORMER CHAIRS OF SECTION:

Peter L. Faber
Alfred D. Youngwood
Gordon D. Henderson
David Sachs
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Herbert L. Camp
Arthur A. Feder
James M. Peaslee
Peter C. Canellos
Michael L. Schler
Carolyn Joy Lee
Richard L.Reinhold
Steven C. Todrys
Harold R. Handler
Robert H. Scarborough
Samuel J. Dimon
Andrew N. Berg
Lewis R. Steinberg
David P. Hariton
Kimberly S. Blanchard
Patrick C. Gallagher
David S. Miller
Erika W. Nijenhuis
Peter H. Blessing
Jodi J. Schwartz
Andrew W. Needham
Diana L. Wollman
David H. Schnabel
David R. Sicular
Stephen B. Land
Michael S. Farber
Karen Gilbreath Sowell

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

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

Cc:

Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury

John Cross
Associate Tax Legislative Counsel
Department of the Treasury

Michael Novey
Associate Tax Legislative Counsel
Department of the Treasury

Holly Porter
Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Robert H. Wellen
Associate Chief Counsel (Corporate)
Internal Revenue Service

Lisa Fuller
Deputy Associate Chief Counsel (Corporate)
Internal Revenue Service

Thomas Moffitt
Deputy Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Clifford Warren
Senior Level Counsel, Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Danielle Grimm
Special Counsel, Office of Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Christopher Kelley
Special Counsel, Office of Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Report No. 1417

New York State Bar Association Tax Section

REPORT ON THE PROPOSED "MAY COMPANY" REGULATIONS UNDER SECTION 337(d)

June 24, 2019

TABLE OF CONTENTS

Page

I. Introduction 1

II. Summary of Recommendations 2

III. Background 3

1. The Original Proposed, Temporary, and Current Regulations 3

2. The Proposed Regulations 6

IV. Controlling Corporations and Attribution Rules 7

1. Downward Attribution—Effect of the Expanded Scope of the Definition of Stock of the Corporate Partner 7

2. Modifications to the Proposed Application of Downward Attribution 13

a. Direct or Indirect Ownership Threshold 14

b. Percentage Ownership Limitation 15

3. Value Rule and Subsequent Transactions 16

a. Value Rule 16

b. Subsequent Transactions 18

4. Limited Application of Section 318 for Purposes of Determining Direct or Indirect Ownership 21

V. Value Rule 22

1. The Ownership Threshold 22

2. Determining Direct or Indirect Ownership Under the Value Rule 24

3. Calculating the Value of the Equity Interest Attributable to Corporate Partner Stock 25

4. Applying the Value Rule Formula to Non-Stock Equity Interests 28

5. Coordination with the Controlling Corporation Rules; Other Matters 30

VI. Affiliated Group Exception....31

VII. Effective Date and Implementation....33

VIII. Technical Issues in Other Areas of the Current Regulations....35

1. Treasury Regulations Section 1.337(d)-3(e)(3)....35

2. Treasury Regulations Section 1.337(d)-3(e)(1)....35

3. Treasury Regulations Section 1.337(d)-3(f)(2)....36

New York State Bar Association Tax Section

Report on the Proposed "May Company" Regulations under Section 337(d)

I. INTRODUCTION

This report[1] (this "**Report**") comments on proposed regulations under Section 337(d)[2] issued on March 25, 2019 (the "**Proposed Regulations**").[3] The Proposed Regulations would amend certain aspects of final regulations promulgated in 2018 (the "**Current Regulations**"),[4] which were originally proposed in 1992 (the "**Original Proposed Regulations**")[5] and, with modifications, adopted as temporary regulations in 2015 (the "**Temporary Regulations**,"[6] and, the regulations under Section 337(d) pertaining to so-called "May Company" transactions generally, the "**May Company Regulations**").

This Report is divided into eight parts. Part II provides a summary of our principal recommendations. Part III provides general background information on the May Company Regulations and a summary of the Proposed Regulations. Part IV contains a detailed analysis of our recommendations regarding the proposed application of certain attribution rules. Part V provides a comprehensive analysis of our observations and recommendations pertaining to the proposed changes to the so-called "value rule." Part VI discusses our observations regarding the proposed elimination of the affiliated group exception. Part VII addresses the application of the regulations to pre-existing structures. Part VIII contains technical recommendations with respect to the Current Regulations.

---

[1] The principal author of this Report is Tijana J. Dvornic. Substantial assistance in the drafting of this Report was provided by Elizabeth L. Brandt. Helpful comments were received from William Alexander, Andrew H. Braiterman, Robert Cassanos, Phillip J. Gall, Brian D. Krause, Stephen B. Land, William L. McRae, Erika W. Nijenhuis, Amanda H. Nussbaum, Deborah L. Paul, Michael L. Schler and Eric Sloan. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Unless otherwise indicated, all "Section" references in this Report are to the sections of the Internal Revenue Code of 1986, as amended (the "**Code**") and all "Treasury Regulations Section" and "Treas. Reg. §" references are to the sections of the Treasury Regulations promulgated under the Code.

[3] Partnership Transactions Involving Equity Interests of a Partner, 84 Fed. Reg. 11,005 (Mar. 25, 2019) (and the preamble, the "**2019 Preamble**").

[4] Partnership Transactions Involving Equity Interests of a Partner, T.D. 9833, 83 Fed. Reg. 26,580 (June 8, 2018) (and the preamble, the "**2018 Preamble**").

[5] Partnership Transactions Involving Equity Interests of a Partner, 57 Fed. Reg. 59,324 (Dec. 15, 1992). The Original Proposed Regulations have been withdrawn.

[6] Partnership Transactions Involving Equity Interests of a Partner, T.D. 9722, 80 Fed. Reg. 33,402 (June 12, 2015) (and the preamble, the "**2015 Preamble**").

II. SUMMARY OF RECOMMENDATIONS

This Report makes the following principal recommendations:[7]

1. The definition of "Stock of the Corporate Partner" should not be adopted in its proposed form. In particular, it should be considered whether application of the downward attribution rules of Section 318 is necessary to police abusive transactions in light of other applicable rules (including the Value Rule).

2. If the downward attribution rules of Section 318 are to be applied for purposes of defining "Stock of the Corporate Partner," then stock in a corporation should not be treated as Stock of the Corporate Partner unless the entity owns, directly or indirectly, a threshold percentage (*e.g.*, five percent) of the stock of the Corporate Partner. In addition, only a portion of the stock of a Controlling Corporation equal to its direct or indirect ownership percentage in the Corporate Partner should be treated as Stock of the Corporate Partner.

3. The application of the Deemed Redemption Rule upon certain subsequent transactions involving related parties should be clarified.

4. The final regulations should clarify that, for purposes of determining an entity's direct or indirect ownership of an equity interest in the Corporate Partner, the operating rules of Section 318(a)(5) apply to the extent relevant to the application of Downward Attribution and Option Attribution.

5. Given the unique way in which the rules of Section 318 apply in the context of the May Company Regulations, the final regulations should include examples illustrating the application of Section 318 in a limited fashion for purposes of determining whether a direct or indirect ownership exists, as contrasted with their application for purposes of determining the existence of Section 304(c) control by a Controlling Corporation.

6. The threshold direct or indirect ownership percentage that must exist before the Value Rule applies to treat equity interests in an entity as Stock of the Corporate Partner should be increased (at least in the case of entities that are corporations).

7. An ownership threshold (*e.g.*, similar to that contained in Section 304(c)(3)(B)(i)) should apply for purposes of applying the Section 318 attribution rules to determine indirect ownership, especially in the context of the Value Rule.

8. To facilitate compliance with the Value Rule, taxpayers should be entitled to rely on the absence of a Schedule 13-D, Schedule 13-G or similar filing to conclude that a relevant entity does not own the requisite five percent interest in the stock of the Corporate Partner, absent actual knowledge to the contrary.

---

[7] Capitalized terms used in this summary are defined in Part III below.

9. For purposes of determining the value of an equity interest in an entity that is attributable to the Stock of the Corporate Partner, the regulations should look to the portion of the relevant entity's assets that is represented by the Stock of the Corporate Partner (as opposed to comparing the value of the Stock of the Corporate Partner held by the entity to the value of all of the equity interests in the entity).

10. In determining the value of an entity's assets for purposes of the Value Rule, taxpayers should be permitted to add back the entity's net debt to the value of all of the equity interests in the entity. Where such information is not otherwise available, taxpayers should be entitled to rely on publicly filed financial statements of the relevant entity as of the closest point in time to the relevant transaction.

11. For purposes of determining the value of an equity interest in an entity that is attributable to the Stock of the Corporate Partner, the regulations should clarify how the relevant calculations are to be made in circumstances where a partnership owns non-stock equity interests in the relevant entity.

12. If the Downward Attribution rules are ultimately not incorporated for purposes of the definition of Controlling Corporation, or, if they are incorporated, the percentage of the stock of a Controlling Corporation that is treated as Stock of the Corporate Partner is limited in certain circumstances per our recommendation, certain coordinating changes should be made to the operation of the Value Rule.

13. The exception for partnerships that are wholly owned by members of an affiliated group (within the meaning of Section 1504(a)) should be removed. Relief should be provided, however, for preexisting structures as discussed below.

14. To the extent that the final regulations expand the definition of Stock of the Corporate Partner, the regulations should clarify how the Deemed Redemption Rule would apply to partnerships that already hold stock that is not Stock of the Corporate Partner under the Current Regulations but is Stock of the Corporate Partner under the final regulations.

15. We recommend that a handful of technical and/or clarifying changes be made to the Current Regulations.

III. BACKGROUND

1. The Original Proposed, Temporary, and Current Regulations

The Proposed Regulations are the latest installment of regulatory guidance under Section 337(d), which directs the Secretary to prescribe such regulations as may be necessary or appropriate to prevent the circumvention of *General Utilities* repeal.[8] Since the repeal of the *General Utilities* doctrine, corporations have generally been required to recognize gain upon the distribution of appreciated property to shareholders under Section 311(b) and Section 336(a). However, corporations began using partnership structures and the interaction of the rules of Subchapter C and Subchapter K to avoid this result, including through the use of so-called May Company transactions.[9]

In a classic May Company transaction, a corporation would contribute appreciated property to a partnership, which would then either buy, or receive a contribution from another partner of, the corporation's stock. After some period of time,[10] the partnership could distribute the corporate partner's stock to the corporate partner. While the basis and any built-in gain in property contributed to a partnership by a partner generally would be preserved in the property distributed (including the stock of the corporate partner), a corporate partner would never be required to recognize gain with respect to its own stock under Section 1032. Accordingly, in reliance on Section 1032 and the rules of Subchapter K, the corporate partner could permanently avoid gain on appreciated property exchanged through the partnership for its own stock, thereby avoiding *General Utilities* repeal.

To prevent this result, in 1992 the Treasury Department ("**Treasury**") and the Internal Revenue Serve (the "**Service**" or the "**IRS**") published the Original Proposed Regulations.[11] The Original Proposed Regulations contained a deemed redemption rule and a distribution rule.[12] Subsequent versions of the regulations largely removed the distribution rule, as it had the potential of capturing transactions that did not implicate *General Utilities* repeal.[13] The deemed redemption rule, on the other hand, has remained (with some modifications). This rule generally applies to a transaction (or series of transactions) that has the effect of an exchange by an entity that is a corporation for federal income tax purposes and holds or acquires an interest in a

---

[8] In *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935), the Supreme Court held that corporations generally could distribute appreciated assets to their shareholders without recognizing corporate-level gain. This is often referred to as the "***General Utilities* doctrine**" or "***General Utilities***".

[9] May Company transactions are in reference to a prominent example of this type of transaction involving May Department Stores.

[10] A waiting period of at least seven years generally would be necessary under the current anti-mixing bowl rules. Sections 704(c)(1)(B) and 737.

[11] *See* Original Proposed Regulations, *supra* n.5. The Original Proposed Regulations followed the issuance of Notice 89-39 in 1989, which announced that future regulations under Section 337(d) would address the use of partnerships to avoid the repeal of the *General Utilities* doctrine and would require gain to be recognized at the time of the contribution. Notice 89-37, 1989-1 C.B. 679 (Mar. 9, 1989).

[12] Prop. Treas. Reg. §§ 1.337(d)-3(d) and (e) (1992 version).

[13] The distribution rule required a corporate partner to recognize gain upon a distribution by the partnership to the corporate partner of its own stock. This rule could have caused the corporate partner to recognize gain in an amount that exceeded the appreciation in the property effectively exchanged for the corporate partner's stock. *See* NYSBA TAX SEC., *Report on Notice 89-37 Regarding the Use of Partnerships to Avoid the Repeal of the General Utilities Doctrine*, Rep. No. 634 (Nov. 14, 1989) (the "**1989 Report**"); NYSBA TAX SEC., *Use of Partnerships to Circumvent Repeal of the General Utilities Doctrine: Report on Proposed Regulations Implementing Notice 89-37*, Rep. No. 752 (Mar. 3, 1993) (the "**1993 Report**"); NYSBA TAX SEC., *Report on Temporary and Proposed Regulations under Section 337(d) and Section 732(f)*, Rep. No. 1355 (Oct. 13, 2016) (the "**2015 Report**").

partnership (a "**Corporate Partner**")[14] for an interest in its stock that is owned, acquired or distributed by a partnership (a "**Section 337(d) Transaction**").[15] Upon such a transaction, the Corporate Partner generally must recognize gain at the time, and to the extent, that the Corporate Partner exchanges, as an economic matter, an interest in appreciated property for an interest in its own stock (the "**Deemed Redemption Rule**").[16]

Under the Original Proposed Regulations, stock of the corporate partner included the corporate partner's own stock and other equity interests such as options, warrants and similar interests, as well as stock and such other equity interests in affiliates of the corporate partner. For this purpose, an affiliate was defined by reference to membership in the same affiliated group as defined in Section 1504(a) (generally 80-percent ownership, by vote and value).[17] Subsequent to the issuance of the Original Proposed Regulations, Congress also made substantial changes to Subchapter K that made May Company transactions involving affiliate stock more difficult to undertake.[18]

In 2015, Treasury and the IRS published the Temporary Regulations.[19] The Temporary Regulations changed several aspects of the Original Proposed Regulations. In particular, the Temporary Regulations introduced the definition of "**Stock of the Corporate Partner**" broadening the prior definition that referred to Section 1504(a) affiliation to include stock and other equity interests of any corporation that controls the Corporate Partner within the meaning of Section 304(c) (a "**Controlling Corporation**"), thus lowering the relevant ownership threshold from 80 percent to 50 percent.[20] However, the Temporary Regulations also turned off Section 318(a)(1) (attribution among family members, or "**Family Attribution**") and Section 318(a)(3) (attribution to corporations or other entities, or "**Downward Attribution**") for purposes of determining Section 304(c) control, such that only a direct or indirect owner of the Corporate Partner could be a Controlling Corporation.[21] The Temporary Regulations also

---

[14] *See* Treas. Reg. § 1.337(d)-3(c)(1).

[15] Treas. Reg. § 1.337(d)-3(c)(3). *See also* Prop. Treas. Reg. § 1.337(d)-3(d)(1) (1992 version). Under the Current Regulations, a Section 337(d) Transaction may occur when (i) a Corporate Partner contributes appreciated property to a partnership that owns Stock of the Corporate Partner; (ii) a partnership acquires Stock of the Corporate Partner; (iii) a partnership that owns Stock of the Corporate Partner distributes appreciated property to a partner other than a Corporate Partner; (iv) a partnership distributes Stock of the Corporate Partner to the Corporate Partner; or (v) a partnership agreement is amended in a manner that increases a Corporate Partner's interest in Stock of the Corporate Partner (including in connection with a contribution to, or distribution from, a partnership). Treas. Reg. § 1.337(d)-3(c)(3).

[16] Treas. Reg. § 1.337(d)-3(d)(1). Under the Current Regulations, gain is recognized to the extent that the Corporate Partner's interest in appreciated assets (other than Stock of the Corporate Partner) is reduced in exchange for an increased interest in the Stock of the Corporate Partner.

[17] Prop. Treas. Reg. § 1.337(d)-3(c) (1992 version).

[18] *See* NYSBA TAX SEC., *Report on the Impact of Legislative Changes to Subchapter K on the Proposed "May Company" Regulations under Section 337(d) and Technical Recommendations Regarding Affiliate Stock*, Rep. No. 1270 (Aug. 15, 2012) (the "**2012 Report**" and, together with the 2015 Report, the "**Prior Reports**").

[19] *See* Temporary Regulations, *supra* n.6.

[20] Temp. Treas. Reg. § 1.337(d)-3T(c)(2)(i).

[21] *Id*. The Temporary Regulations initially did not exclude Family Attribution and Downward Attribution. However, the intention to do so was intimated in the 2015 Preamble and a correction was issued shortly after the

included an exception pursuant to which Stock of the Corporate Partner does not include any stock or equity interests held or acquired by a partnership all of the interests in which are held by members of an affiliated group (within the meaning of Section 1504(a)) that includes the Corporate Partner (the "**Affiliated Group Exception**").[22] Finally, the Temporary Regulations introduced the so-called "value rule," pursuant to which Stock of the Corporate Partner also includes interests in any entity to the extent that the value of the interest is attributable to Stock of the Corporate Partner (the "**Value Rule**").[23]

The Current Regulations were promulgated in 2018, generally adopting the Temporary Regulations as final without significant modification.[24] However, Treasury and the IRS noted that several aspects of the Current Regulations were under continuing study and that proposed regulations with more substantive changes were being considered that would (i) limit the application of the Value Rule to entities that are not Controlling Corporations but that own, directly or indirectly, five percent or more, by vote or value, of the Corporate Partner and clarify how taxpayers would determine what portion of the value of an interest in such an entity is attributable to Stock of the Corporate Partner; (ii) further modify the definition of Stock of the Corporate Partner to no longer exclude Family Attribution and Downward Attribution; and (iii) remove the Affiliated Group Exception.[25]

2. The Proposed Regulations

On March 25, 2019, the Treasury Department and the IRS published proposed amendments to the May Company Regulations that would generally implement the changes foreshadowed in 2018.[26]

First, the Proposed Regulations would again broaden the definition of Stock of the Corporate Partner by applying the ownership attribution rules of Section 304(c) in their entirety (including both Family Attribution and Downward Attribution) for purposes of determining

---

Temporary Regulations were first published clarifying that the Family Attribution and Downward Attribution rules would not apply for this purpose. *See* 2015 Preamble at 33,404 and 33,406; Correcting Amendments to T.D. 9722, 80 Fed. Reg. 38,940 (July 8, 2015).

[22] Temp. Treas. Reg. § 1.337(d)-3T(c)(2)(ii).

[23] Temp. Treas. Reg. § 1.337(d)-3T(c)(2)(i).

[24] *See* Current Regulations, *supra* n.4. The Current Regulations, which were adopted on the same day that the Temporary Regulations were set to expire, and the related preamble contained some clarifications, including that (i) options, warrants and other similar interests issued by third parties on stock of the Corporate Partner, a Controlling Corporation or any entity relevant under the Value Rule (to the extent of the value attributable to the Stock of the Corporate Partner) are treated as Stock of the Corporate Partner, (ii) stock in a Controlling Corporation will constitute Stock of the Corporate Partner in its entirety, irrespective of the proportion of the Controlling Corporation's interest in the Corporate Partner to the Controlling Corporation's other assets and (iii) there are circumstances in which a partnership's acquisition of Stock of the Corporate Partner does not have the effect of an exchange of appreciated property for such stock, including when a partnership uses operating cash flow to acquire Stock of the Corporate Partner. *See* 2018 Preamble at 26,582-83.

[25] *Id*. at 26,582-83.

[26] *See* Proposed Regulations, *supra* n.3.

whether a corporation is a Controlling Corporation.[27] However, the Proposed Regulations would also add a second prong to this definition that would require a corporation to own a direct or indirect interest in the Corporate Partner (not taking into account Family Attribution or Downward Attribution) before it could be deemed a Controlling Corporation.[28]

Second, the Value Rule would apply only with respect to an entity when either (i) the Corporate Partner is in control (within the meaning of Section 304(c)) of the entity or (ii) the entity owns at least five percent, by vote or value, of the Corporate Partner's stock.[29] The Proposed Regulations also introduce a formula to calculate the portion of an interest in an entity that is attributable to the Stock of the Corporate Partner. Pursuant to this formula, the value of an equity interest in an entity that is attributable to Stock of the Corporate Partner is obtained by multiplying the fair market value of the equity interest and the lesser of (i) the ratio of the fair market value of the Stock of the Corporate Partner owned by the entity to the fair market value of all the equity interests in the entity and (ii) one.[30]

Finally, the Proposed Regulations would eliminate the Affiliated Group Exception.[31]

IV. CONTROLLING CORPORATIONS AND ATTRIBUTION RULES

1. Downward Attribution—Effect of the Expanded Scope of the Definition of Stock of the Corporate Partner

The Current Regulations provide that Stock of the Corporate Partner includes stock or other equity interests in a corporation that controls the Corporate Partner within the meaning of Section 304(c), except that for this purpose Sections 318(a)(1) and (3) do not apply.[32] The Proposed Regulations would expand the scope of the Stock of the Corporate Partner to include stock or other equity interests in a corporation that (i) controls the Corporate Partner within the meaning of Section 304(c) without modification (*i.e.*, determined taking into account the Family Attribution and Downward Attribution rules of Section 318 as modified by Section 304(c)(3)) and (ii) has a direct or indirect interest in the Corporate Partner.[33] For purposes of the second prong of this definition, a direct or indirect ownership of an equity interest in the Corporate Partner includes ownership that would be attributed to a person under Section 318(a)(2) (attribution to shareholders and other owners, or "**Upward Attribution**"), except that the 50% limitation in Section 318(a)(2)(C) does not apply, and Section 318(a)(4) (attribution on account of options, or "**Option Attribution**"), but otherwise without regard to Section 318, including the Downward Attribution rules.[34]

---

[27] Prop. Treas. Reg. § 1.337(d)-3(c)(2)(i).

[28] *Id.*

[29] Prop. Treas. Reg. § 1.337(d)-3(c)(2)(ii).

[30] Prop. Treas. Reg. § 1.337(d)-3(c)(2)(iii).

[31] *See* 2019 Preamble at 11,006-07.

[32] Treas. Reg. § 1.337(d)-3(c)(2).

[33] Prop. Treas. Reg. § 1.377(d)-3(c)(2)(i).

[34] *Id.*

We generally do not recommend that the proposed definition of the Stock of the Corporate Partner be adopted in its proposed form because this change could, in many circumstances, cause Corporate Partners to recognize gain in an amount that significantly exceeds the appreciation in the property effectively exchanged for Stock of the Corporate Partner.

To frame the discussion, it is helpful to begin by considering a partnership that owns affiliate stock to which the May Company Regulations generally would not apply.

> *Example 1*: P owns 100% of the stock of S1 and 90% of the stock of S2. A, an unrelated party, owns the remaining 10% of the stock of S2. A and S1 form a 50-50 partnership, PRS. S1 contributes Asset, worth $100 and with basis of $0, to PRS, and A contributes its S2 stock, with fair market value and basis of $100.

Under the Current Regulations, S2 stock is not Stock of the Corporate Partner because, without taking into account Downward Attribution, S2 does not have Section 304(c) control of S1. As is the case under the Current Regulations, the Proposed Regulations also would not treat the S2 stock as Stock of the Corporate Partner. While S2 controls S1 within the meaning of Section 304(c),[35] S2 does not own any direct or indirect interest in S1 (since for this purpose Downward Attribution does not apply), and thus the second prong of the Stock of the Corporate Partner definition is not satisfied.[36]

As discussed in detail in our 2012 Report, we believe that this is the appropriate result.[37] Section 337(d) authorizes the issuance of regulations that would preclude the circumvention of *General Utilities* repeal, which, at its core, is about protecting the Section 311(b) and Section 336(a) requirements that corporate-level gain be recognized upon a distribution of appreciated property by a corporation to its shareholders. In Example 1, no such distribution or exchange has occurred. Through PRS, S1 has economically exchanged a 50% interest in Asset for 50% of the stock of S2 contributed by A (representing 5% of the outstanding S2 stock). The transaction could become a classic partnership mixing bowl, but not one that implicates *General Utilities* repeal and thus not a transaction that should be covered by the May Company Regulations.[38]

The May Company Regulations have always involved difficult questions of balance and line-drawing, however. As discussed in our Prior Reports, partnership transactions involving stock of affiliates can often serve as a first step in a series of transactions that ultimately achieves results inconsistent with *General Utilities* repeal, and Section 337(d) is fundamentally an anti-

---

[35] All of P's S1 stock is attributed to S2 by virtue of Section 318(a)(3)(C).

[36] *See* Prop. Treas. Reg. § 1.377(d)-3(c)(2)(i).

[37] *See* 2012 Report at 36-45.

[38] A "partnership mixing bowl" refers to a transaction pursuant to which partners are able to exchange assets in a tax-free manner through a partnership, whereas such a tax-free exchange would not be possible if effectuated directly. *See* Sections 704(c)(1)(B) and 737. In the typical case, a partnership mixing bowl only achieves deferral. The May Company transaction takes the structure a step further by allowing a corporation to exchange appreciated assets for its own stock or the stock of an affiliate in a tax-free manner, resulting in a tax-free corporate contraction and potentially permanent gain elimination.

abuse provision.[39] As such, we believe that the May Company Regulations appropriately may, and do, impose tax in certain circumstances where the avoidance of *General Utilities* repeal has not yet been (and may never be) completed. At the same time, we believe that the reach of the May Company Regulations should not be so unrestrained as to preemptively impose tax in all situations where a possibility of *General Utilities* repeal avoidance in the future is merely conceivable, or to impose tax in respect of appreciated assets that have not been economically exchanged for stock of the Corporate Partner. As discussed at length in the 2012 Report, a principle that we believe is conceptually useful in guiding this balancing exercise is the fact that the classic *General Utilities* transaction—the distribution by a corporation of appreciated property with respect to its own stock—generally involves a corporate contraction.

> *Example 2*: P owns 100% of the stock of S1, which represents a *de minimis* portion of P's total assets. S1 contributes an appreciated Asset (value of $100 and basis of $0) to PRS, a 50-50 partnership with A, an unrelated party. A contributes stock of P (value and basis of $100).

In Example 2, S1 has economically exchanged a 50% interest in Asset for 50% of the P stock contributed by A. At this point, *General Utilities* repeal has not been (and may never be) avoided.[40] That said, avoidance of *General Utilities* repeal could be completed relatively easily by having both PRS and S1 liquidate in a tax-free liquidation. Moreover, in Example 2 (unlike Example 1) a corporate contraction actually occurs at the time of the partnership's formation, albeit indirectly.[41] Therefore, on balance, imposing tax at the time of the initial contributions in Example 2 seems appropriate.

---

[39] We have previously also observed that, in certain circumstances, *General Utilities* repeal could also be viewed as serving as a backstop to Section 1001. *See* 2012 Report at 31 & n.68.

[40] S1's gain in Asset is preserved in its partnership interest, as well as in the Asset held by the partnership. Sections 722 and 723. This gain would continue to be preserved if the partnership were to liquidate and distribute the P stock entirely to S1 because S1 would take a $0 basis in the P stock under Section 732, and Section 1032 would not protect S1 from recognizing gain upon a disposition of P stock.

[41] P has contracted because, before the transaction, P indirectly owned 100% of Asset through its subsidiary, S1, and, through the partnership transaction, economically exchanged 50% of that indirect interest for an indirect interest in its own stock. S1 has also contracted to some extent because S1 economically exchanged 50% of its interest in Asset for an indirect interest in its own stock due to the fact that P owns 100% of the stock of S1. Both P and S1 have economically repurchased a percentage of their outstanding stock equal to the percentage of the P stock contributed to PRS (*i.e.*, if 10% of the outstanding P stock is contributed to PRS, this contribution represents an indirect interest in 10% of S1, since P owns 100% of S1). The extent of the economic contraction of S1 in terms of value, however, generally depends on the composition of P's assets. If the S1 stock is P's only asset and P has no liabilities, then S1 has effectively exchanged 50% of Asset for an indirect interest in its stock. If the S1 stock represents 10% of the value of P's assets and P has no liabilities, then S1 has effectively exchanged 5% of Asset for an indirect interest in its own stock. It is also interesting to note that, assuming the S1 stock is P's only asset and A contributes 10% of P stock to PRS, A has acquired an economic interest in slightly more than 50% of Asset—specifically, if Asset were to be distributed all the way through the ownership chains to the P shareholders, A would ultimately receive approximately $52.63 of Asset (if PRS were to distribute Asset, each of S1 and A would receive $50 of Asset; however, if S1 then distributed this $50 interest in Asset to P and P then distributed it to its shareholders, including PRS, then PRS would receive another $5 interest in Asset (10% of $50), and each of S1 and A would end up with another $2.5 (50% of $5), and so on).

Example 1, on the other hand, which involves a partnership that holds stock of a corporate sibling, does not involve a corporate contraction. In that example, none of P, S1 or S2 exchanged an appreciated asset for its own stock, directly or indirectly. The same is true where P is a partner in a partnership that acquires or holds stock of P's subsidiary. In such cases, the absence of both any permanent built-in gain elimination and any corporate contraction at the time of the partnership "going in" transaction makes imposing tax up-front on account of protecting *General Utilities* repeal more difficult to justify.[42]

The Current Regulations are in many respects consistent with this analytical framework in that some corporate contraction generally must occur before the Deemed Redemption Rule will apply to impose tax in situations where avoidance of *General Utilities* repeal (and permanent gain elimination) has not yet occurred. For example, the Current Regulations generally do not apply to situations involving partnerships holding stock of subsidiaries or siblings of the Corporate Partner.[43] The relevance of a corporate contraction is also evident in the Value Rule.[44] However, the Current Regulations do not target corporate contractions with precision, and from this perspective can be both over- and under-inclusive, depending on the circumstances.

> *Example 3*: P directly owns 90% of the stock of S1 and 30% of the stock of S2. S1 directly owns the remaining 70% of the stock of S2. The stock of S2 represents a *de minimis* portion of S1's total assets.[45] S2 and A, an unrelated party, form a 50-50 partnership, PRS, to which S2 contributes appreciated Asset (value of \$100 and basis \$0) and A contributes 10% of S1 stock (value and basis of \$100).

[42] We set forth this analysis in detail in our 2012 Report and continue to believe that it provides a useful guide in evaluating the appropriate scope of the May Company Regulations. *See* 2012 Report at 29-46. Consistent with that analysis, we also suggested—notably against the backdrop of the then-current Original Proposed Regulations, which included stock of affiliates by reference to the 80-percent ownership thresholds contained in Section 1504(a)—that in situations in which a parent corporation holds less than all of the stock of a Corporate Partner, the Deemed Redemption Rule should apply only to the extent of the parent's direct or indirect percentage ownership. In the case of such a partial owner, the corporate owner contracts only to the extent of its indirect interest in the appreciated asset exchanged by the Corporate Partner through the partnership for the owner's stock. *See id.* at 45-46.

[43] *See* Treas. Reg. § 1.337(d)-3(c)(2). In promulgating the Temporary Regulations, the Treasury and the IRS also observed that Sections 732(f) and 755(c) generally serve to prevent basis shifting transactions involving partnerships that own stock of lower-tier affiliates of the Corporate Partner. 2015 Preamble at 33,404.

[44] Where stock is Stock of the Corporate Partner because it is stock of a Controlling Corporation, the May Company Regulations focus on the contraction of the Controlling Corporation that is effected through its exchange of an indirect interest in an asset for an indirect interest in its stock that is, in each case, held by the Controlling Corporation through the Corporate Partner. Where stock is Stock of the Corporate Partner as a result of the Value Rule, the focus is on the Corporate Partner itself (effected through its exchange of a direct interest in an asset for an indirect interest in its stock).

[45] For illustrative purposes, Examples 3 through 5 posit that the stock of the Corporate Partner represents a *de minimis* portion of the assets of the relevant upper-tier entities so as not to implicate the Value Rule. However, we would expect the Value Rule to apply in most fact patterns as discussed in Part IV.3.a.

Under the Current Regulations (as well as the Proposed Regulations), S1 stock is Stock of the Corporate Partner because, even without Downward Attribution, S1 has Section 304(c) control of S2. As a result of the partnership transaction, S2 has economically exchanged a 50% interest in Asset for 5% of the stock of S1. Therefore S2 has not contracted, but S1 has.[46] However, the extent of S1's contraction is less than the value of a 50% interest in Asset. Because S1 owned, indirectly, only 70% of Asset, it exchanged only an indirectly held interest in 35% of Asset for an indirect interest in 3.5% of its stock.[47] Nevertheless, because under the Current Regulations stock of a Controlling Corporation is wholly treated as Stock of the Corporate Partner (regardless of the Controlling Corporation's percentage ownership), $50 of S1 stock is taken into account,[48] and S2 must recognize gain in the amount of $50 under the Deemed Redemption Rule.[49] Thus, from the perspective of the contraction of the Controlling Corporation, the Current Regulations are over-inclusive in situations involving stock of a direct or indirect owner that owns 50% or more, but less than 100%, of the Corporate.

In other cases, the Current Regulations are under-inclusive. In particular (putting aside the Value Rule), the Deemed Redemption Rule does not apply at all where a corporation the stock of which is acquired by a partnership owns a less than 50% direct or indirect interest in the Corporate Partner, even though such situations involve a contraction of the owner to the extent of its ownership in the Corporate Partner.[50] The Proposed Regulations would change this result where the partial owner has Section 304(c) control of the Corporate Partner (taking Downward Attribution into account).

> *Example 4*: P owns 90% of the stock of S1 and 70% of the stock of S2. S1 directly owns the remaining 30% of S2. The stock of S2 represents a *de minimis* portion of S1's total assets. S2 and A form a 50-50 partnership, PRS, to which S2 contributes appreciated Asset (value of $100 and basis of $0), and A contributes 10% of S1 stock (value and basis of $100).

Under the Current Regulations, the S1 stock is not Stock of the Corporate Partner because, without Downward Attribution, S1 does not have Section 304(c) control of S2. Accordingly, the Deemed Redemption Rule does not apply.[51] Under the Proposed Regulations, however, all of the S1 stock is Stock of the Corporate Partner because S1 has both an indirect

[46] More precisely, S2 has contracted by a *de minimis* amount to the extent the value of the S1 stock reflects the value of S2. P also has not contracted.

[47] As noted above, however, A has ultimately acquired more than 65% of Asset. *See supra* n.41.

[48] Treas. Reg. § 1.377(d)-3(c)(2)(i).

[49] S2's Gain Percentage of 50% ($50/$100), multiplied by S2's built-in gain in Asset of $100.

[50] However, as discussed in Part IV.1.b.(i) below, the Value Rule operates as a backstop in such situations and often will result in gain recognition.

[51] This disregards, for ease of discussion, the *de minimis* consequences under the Value Rule. If, however, the stock of S2 were S1's sole asset (and S1 had no liabilities), the Value Rule would cause the Deemed Redemption Rule to apply, and S2 would recognize $50 of gain.

interest as well as Section 304(c) control in the Corporate Partner.[52] As a result, the Deemed Redemption Rule applies, and S2 recognizes $50 of gain.[53]

But the corporate contraction that occurs in Example 4 is much smaller than the $50 of value that is deemed to be exchanged for Stock of the Corporate Partner under the Proposed Regulations. As in Example 3, only S1 has contracted, but in this case to an even smaller extent, specifically, its indirect ownership of a portion of Asset worth $15.[54] Thus, a $35 interest in Asset that has not been exchanged, directly or indirectly, by any corporation for its stock would nevertheless be subject to tax under the Proposed Regulations. Contrast this with Example 3, where, because S1 has a greater ownership interest in S2, the asset value that was not exchanged for stock but that was nevertheless subject to tax is far less at $15.

As Examples 3 and 4 illustrate, the proposed broadening of the Controlling Corporation definition would allow the May Company Regulations to catch some indirect exchanges of appreciated property by a Controlling Corporation for its own stock that are not covered by the Current Regulations. But, in every such case, the Proposed Regulations would also necessarily result in tax being imposed with respect to gain in the *larger* portion of such property that has not been so exchanged by the Controlling Corporation (*i.e*., in Example 4, 70% ($35/$50) of the Asset deemed exchanged). While the potential for taxing gain that is not attributable to property that is effectively exchanged for the property's indirect owner's stock is already present in the Current Regulations where a Controlling Corporation, directly or indirectly, owns at least 50% but less than 100% of the Corporate Partner, we find the expansion of that construct to situations where a Controlling Corporation owns less than 50% of the Corporate Partner more troubling. In those cases, not only would the Proposed Regulations always result in the taxation of gain in appreciated assets that have not economically left the relevant corporate solution, the amount of such gain will always exceed the amount of gain that is, in our view, appropriately within the purview of the May Company Regulations. Even in the anti-abuse context and in circumstances where there is constructive Section 304(c) control, we believe that such an extension goes too far, especially in light of the fact that the application of the Deemed Redemption Rule in these cases is already prophylactic because it taxes gain that has not yet been permanently eliminated.

In addition to the issues discussed above, we believe that the expanded definition of Controlling Corporation could cause the Deemed Redemption Rule to apply to non-abusive transactions and would also result in drastically different tax consequences based on relatively minor variations in facts. Consider the following examples:

---

[52] P's entire 70% interest in S2 would be attributed to S1 under Section 318(a)(3)(C) (as modified by Section 304(c)(3)).

[53] S2's Gain Percentage of 50% ($50/$100), multiplied by S2's built-in gain in Asset of $100.

[54] S1 has only indirectly exchanged 50% of its indirect 30% interest in Asset (*i.e.*, a 15% indirect interest in Asset, valued at $15) for an indirect interest in S1 stock worth $15. S2 has not contracted at all because it exchanged $50 of Asset for $50 of stock of its owner (and the S2 stock represents a *de minimis* portion of S1's total assets). P also has not contracted because P indirectly exchanged an indirect interest of $48.50 in Asset for additional stock of its subsidiary previously held by an unrelated party. P had a 97% indirect interest in Asset (90%*30% + 70%), 50% of which was exchanged for S1 stock through the partnership transaction. The partnership transaction also resulted in a minor indirect increase in P's interest in Asset by virtue of its increased indirect interest in S1.

> *Example 5*: S1 and S2 own 51% and 49%, respectively, of the stock of another corporation, CP, which represents a *de minimis* portion of each of S1's and S2's total assets. P owns 51% of S2. CP contributes appreciated assets (value of $100 and basis of $0) to a partnership in exchange for a 50% interest. The partnership owns or acquires S2 stock.
>
> *Example 5A*: Same facts as Example 5, except that P also owns 5% of S1.

Under the Current Regulations, the Deemed Redemption Rule would not apply in either Example 5 or Example 5A because S2 does not have Section 304(c) control of CP without taking Downward Attribution into account. Under the Proposed Regulations, the Deemed Redemption Rule would not apply to Example 5[55] because, even taking Downward Attribution into account, S2 does not have Section 304(c) control of CP. However, the Deemed Redemption Rule would apply to Example 5A under the Proposed Regulations because P's 5% ownership interest in S1 causes 5% of S1's CP stock to be attributed upward to P and then downward to S2, providing S2 with Section 304(c) control of CP. Moreover, the Deemed Redemption Rule applies with respect to 100% of the partnership's S2 stock. Accordingly, under the Proposed Regulations, CP would not recognize any gain in Example 5, but would recognize $50 of gain in Example 5A. It is not clear that such relatively small factual differences should drive such drastically different results, and we do not see a compelling reason for treating Example 5 and Example 5A differently. We believe that similar issues could arise in a host of other contexts if the proposed changes to the scope of the Controlling Corporation definition are adopted.[56]

2. Modifications to the Proposed Application of Downward Attribution

For the reasons discussed in Part IV.1, we generally would not recommend that the final regulations adopt the proposed revisions to the definition of Stock of the Corporate Partner in their proposed form. However, we believe that a number of the issues discussed in Part IV.1 could be alleviated with certain modifications to the Proposed Regulations. In particular, we recommend that the final regulations provide for an ownership threshold below which the definition would not be satisfied. We also recommend that the final regulations limit the portion of the relevant equity interest that is treated as Stock of the Corporate Partner by reference to the Controlling Corporation's direct or indirect interest in the Corporate Partner. If this latter recommendation is adopted, further consideration should be given to the interaction of these rules with the Value Rule, as discussed in Part V.5.

---

[55] Ignoring, for illustrative purposes, the *de minimis* consequences under the Value Rule.

[56] For example, contrast (i) a situation where P owns 100% of S1 and 90% of S2, and S1 contributes an appreciated asset (value of $100 and basis of $0) to a partnership that owns or acquires S2 stock with (ii) the same fact pattern, but with P and S2 owning 99% and 1% of S1, respectively. Under the Proposed Regulations, in situation (i) the Deemed Redemption Rule would not apply (putting aside the Value Rule) because S2 does not have a direct or indirect interest in S1 and thus S2 is not a Controlling Corporation. Accordingly, S1 would not recognize any gain. In situation (ii), on the other hand, S2 is a Controlling Corporation because it owns a 1% direct interest in S1. As a result, the Deemed Redemption Rule applies and S1 recognizes $50 of gain. We note that P could presumably cause S2 to distribute or otherwise transfer its S1 stock to P to avoid the application of the Deemed Redemption Rule, but it is not apparent why encouraging such restructuring transactions would be desirable.

a. Direct or Indirect Ownership Threshold

If Downward Attribution is to apply for purposes of establishing Section 304(c) control, the definition of Controlling Corporation should include an ownership threshold (similar to the threshold contained in the proposed modifications to the Value Rule), such that an entity could not be a Controlling Corporation unless the entity owns, directly or indirectly (determined without Downward Attribution), at least a threshold percentage (*e.g.*, five percent) of the stock of the Corporate Partner. As the rule is currently drafted, ownership of a single share of stock of the Corporate Partner could cause the Deemed Redemption Rule to apply. We believe that an ownership threshold would be appropriate to preclude the application of the Deemed Redemption Rule in situations in which the corporate contraction that occurs is relatively small, as well as situations that are unlikely to be abusive and may present a trap for the unwary.

For example, the addition of an ownership threshold would prevent the May Company Regulations from having a draconian effect in unrelated party transactions that do not involve the avoidance of *General Utilities* repeal.

> *Example 6*: P, a publicly traded corporation, owns 100% of the stock of S1 and 80% of the stock of S2. The remaining 20% of S2 is publicly traded. S1 and S2 form PRS, with S1 contributing cash and S2 contributing appreciated assets. PRS acquires 100% of the stock of T, a publicly traded corporation. T owns 1 share of S2, which represents a *de minimis* portion of T's assets.

Under the Current Regulations, the T stock is not Stock of the Corporate Partner. Under the Proposed Regulations, however, T stock is Stock of the Corporate Partner, S2.[57] As a result, all of the T stock acquired by PRS, which could have significant value, is treated as Stock of the Corporate Partner, and S2 may be required to recognize a large gain.[58] We do not believe that this result is appropriate. Moreover, the Proposed Regulations could create a significant trap for the unwary.

Not only is ownership of a single share sufficient to trigger the application of the Deemed Redemption Rule and a significant tax liability as illustrated in Example 6, but because the Proposed Regulations define direct or indirect ownership (here to determine whether T owns stock in S2) by reference to the Upward Attribution rules of Section 318(a)(2) but eliminating the 50% ownership limitation in Section 318(a)(2)(C) entirely (without replacing the 50% limit with a smaller percentage), the rule operates as a pure look-through rule that could apply through a chain of minor ownership interests in multiple, unrelated entities.[59] To illustrate, the result in Example 6 would be the same even if T owned a small interest in another publicly traded corporation or an investment fund which in turn happened to own a small interest in S2. Thus, the Proposed Regulations could trigger significant tax consequences in a host of unexpected

[57] T has a direct or indirect interest in S2 (albeit a single share) and under the Downward Attribution rules, P's S2 stock is attributed to T through S1 and PRS, such that T has Section 304(c) control of S2.

[58] Prop. Treas. Reg. § 1.377(d)-3(c)(2)(ii).

[59] Prop. Treas. Reg. § 1.377(d)-3(c)(2)(i).

situations, and taxpayers may not become aware of the issue until it is too late. Indeed, in many cases taxpayers may not even have a way of ascertaining whether any relevant direct or indirect ownership exists. This echoes the administrability and compliance concerns identified by Treasury and the IRS in the 2019 Preamble with regard to the application of the Value Rule where public entities are involved,[60] and we believe that including a minimum ownership threshold (*e.g.*, five percent) for direct or indirect ownership in the definition of Controlling Corporation would make sense as a parallel solution.

An ownership threshold would also prevent the application of the Deemed Redemption Rule in cases where the corporate contraction is *de minimis*.

> *Example 7*: P owns 90% of S1 and 100% of S2. S2 owns 49% of CP, a corporation. S1 is a large corporation, and any interest in CP would represent a *de minimis* portion of its assets. CP contributes appreciated assets to PRS, and A, an unrelated party, contributes S1 stock.

Under the Current Regulations, S1 stock is not Stock of the Corporate Partner because S1 does not have Section 304(c) control without the application of Downward Attribution. The Proposed Regulations do not change this result because S1 does not own a direct or indirect interest in CP. However, assume instead that S1 owns a single share of CP. Under the Current Regulations, the result is the same. Under the Proposed Regulations, however, S1 stock is Stock of the Corporate Partner, and not only that, but 100% of the S1 stock owned by PRS is taken into account for purposes of the Deemed Redemption Rule even though S1 owns only one share of the Corporate Partner and the Corporate Partner stock represents a negligible portion of S1's assets. This cliff effect of the Proposed Regulations potentially on account of a single share strikes us as unnecessarily punitive.

b. Percentage Ownership Limitation

As discussed in Part IV.1 above, an aspect of the proposed application of Downward Attribution that we find particularly troubling is the expanded potential for recognition of gain in appreciated assets that have not been effectively exchanged, directly or indirectly, by a corporation for its stock. However, most of these issues could be avoided if, in cases involving partnerships holding stock of a Controlling Corporation that owns less than 100% of the Corporate Partner, only the portion of such stock corresponding to the Controlling Corporation's direct or indirect ownership interest in the Corporate Partner were treated as Stock of the Corporate Partner. To illustrate, again consider the situation in Example 4, where S1 has Section 304(c) control (taking into account Downward Attribution), but only a 30% direct or indirect interest in S2 (which represents a *de minimis* portion of S1's assets), and S2 enters into a partnership that acquires S1 stock worth $100. Under a proportional approach, 30% of the S1 stock in PRS would be treated as Stock of the Corporate Partner, and thus only a portion of Asset worth $15 (50% of $30) would be treated as having been exchanged under the Deemed Redemption Rule. This result corresponds to the corporate contraction of S1 that economically actually takes place through the partnership transaction and is, thus, in our view, more

[60] *See* 2019 Preamble at 11,007.

appropriately tailored to the goal of protecting *General Utilities* repeal. A proportional approach would also alleviate many of the other issues discussed in Part IV.1 relating to the differential treatment of transactions with similar fact patterns.

At the same time, the introduction of a proportional rule could give rise to new questions. First, further consideration should be given to the interaction of the Controlling Corporation rules and the Value Rule, as discussed in Part V.5 below. Second, it should be considered whether such a rule would apply solely to those cases that are newly brought into the scope of the May Company Regulations through the introduction of Downward Attribution (*i.e.*, cases involving less than 50% direct or indirect owners that have constructive Section 304(c) control), or whether it would also be applicable in cases involving Controlling Corporations that own, directly or indirectly, 50% or more but less than 100% of the Corporate Partner. The two categories of situations are not easily distinguishable on principle. However, as discussed in Part IV.1, in cases involving 50% or greater owners, the quantum of gain that is taxed but that is not attributable to assets exchanged for corporate stock is relatively less (as compared to situations involving less-than-50% owners), and thus the existing rules may in fact strike the appropriate balance between accuracy and preventing abuse in cases involving entities that are Controlling Corporations without regard to Downward Attribution. Moreover, these rules have now been in place for some time. Therefore, on balance, we do not believe that changes to the existing regulatory regime in cases involving 50% or greater direct or indirect owners are necessary (even though they may arguably be warranted).

3. Value Rule and Subsequent Transactions

As discussed, we do not believe that the arguably over-inclusive approach of the Current Regulations should be extended to situations involving Controlling Corporations that are less than 50% owners of the Corporate Partner. While a proportional rule, discussed above, would address a number of our concerns with the proposed application of Downward Attribution, we are also concerned about the complexity that Downward Attribution would introduce into an already complex regime. We believe that Treasury and the IRS should consider whether extending Downward Attribution as contemplated by the Proposed Regulations is in fact necessary to effectively police abusive transactions. We recognize that Treasury and the IRS are concerned that the continued exclusion of these rules could leave opportunities for taxpayers to structure transactions in order to avoid the repeal of the *General Utilities* doctrine. However, we believe that such situations could be appropriately addressed through anti-abuse rules applied at the time corporate gain is permanently eliminated, or earlier, upon certain subsequent transactions. We believe that this may be a more appropriately tailored approach as compared to the up-front application of the Deemed Redemption Rule, which, while at its core an anti-abuse provision, is a set of largely mechanical rules that often can be overbroad in application. Most importantly, we note that there are other rules already in place that would seem to apply to many troubling fact patterns even if the definition of Controlling Corporation were not expanded as proposed.

a. Value Rule

One such rule is the Value Rule. Under the Value Rule, equity interests in an entity that is not a Controlling Corporation but that owns a direct or indirect interest in the Corporate

Partner is treated as Stock of the Corporate Partner to the extent that the value of the equity interests in such entity reflect the value of the Stock of the Corporate Partner.[61]

> *Example 8*: P owns 90% of the stock of each of S1 and S2. S1 and S2 each own 49% of the stock of CP. CP contributes appreciated Asset (value $100 and basis $0) to PRS, a 50-50 partnership with A, who contributes S1 stock (value and basis of $100). S1 does not have any liabilities, and its only asset is the stock of CP (such that the value of the S1 stock is entirely attributable to the value of the stock of CP). The fair market value of all of CP's stock is $10,000, and, thus, the fair market value of 100% of S1's stock is $4,900.[62]

While S1 has economically exchanged a 49% interest in Asset for an indirect 49% interest in its stock, S1 would not be treated as a Controlling Corporation under the Current Regulations because, without Downward Attribution, S1 does not have Section 304(c) control of CP. Nor would S1 be treated as a Controlling Corporation under the Proposed Regulations if S1and S2 were owned by unrelated parties because S1 would not have Section 304(c) control of CP. We appreciate, though, that, where, as in Example 8, S1 and S2 are almost entirely owned by the same corporate parent, there is a heightened concern that the transaction is effected for purposes of avoiding *General Utilities* repeal. Indeed, such transactions are not left completely unchecked by the Current Regulations because the Value Rule would generally apply. In Example 8, because 100% of the value of S1's stock is attributable to its interest in CP stock, under the Value Rule, the full $100 of S1 stock acquired by PRS is treated as Stock of the Corporate Partner.[63] Accordingly, CP recognizes 50% of its built-in gain in Asset, or $50. Thus, the result under the Current Regulations is the same as it would be under the Proposed Regulations. The Proposed Regulations would treat all of the S1 stock as Stock of the Corporate Partner on account of S1 being a Controlling Corporation, while the Current Regulations would do so under the Value Rule. The same result would obtain in Example 4 if S1 in that example did not hold any assets (or liabilities) other than its S2 stock. That is, in Example 4, the Proposed Regulations would treat all the S1 stock as Stock of the Corporate Partner as a result of Downward Attribution, while the Current Regulations would reach that result under the Value Rule.

> *Example 8A*: Same facts as Example 8, except that S1 has other assets (in addition to the CP stock), with the same value as its stake in CP, such that S1's total assets (and equity) are worth $9,800. Accordingly, the value of S1's CP stake is $4,900, which represents 50% of the value of S1's total assets.

---

[61] The portion of the value that is attributable to the value of the stock of the Corporate Partner itself is relevant because it measures the extent to which, by indirectly acquiring an equity interest in its owner, a Corporate Partner acquired an indirect interest in its own stock.

[62] The S1 stock contributed by A to PRS represents approximately 2.04% of the S1 stock outstanding ($100/$4,900).

[63] CP has exchanged a 50% interest in Asset for 1.02% of S1 stock, worth $50. As S1's only asset is its CP stock (and S1 has no liabilities), an acquisition of S1 stock represents an indirect acquisition of CP stock. Thus, as a result of the transaction, CP has exchanged a 50% interest in Asset for an indirect interest in 0.5% of its own stock.

In Example 8A, the acquisition of an interest in S1 is the equivalent of an acquisition of both an indirect interest in the stock of CP and in a different asset of equal value. Thus, 50% of the S1 stock acquired by PRS is treated as Stock of the Corporate Partner under the Value Rule. Accordingly, CP is treated as having exchanged a portion of Asset worth $25 for Stock of the Corporate Partner and the remainder of the exchanged portion of Asset ($25) for other assets. As a result, CP recognizes only 25% of its $100 of built-in gain in Asset. Similarly, if, in Example 4, the S2 stock represented 50% of S1's assets (and S1 had no liabilities), S2 would be required to recognize only $25 of gain as a result of the Value Rule.

Of course, the portion of the built-in gain in the appreciated asset that a Corporate Partner would be required to recognize under the Value Rule will decrease as the size of the entity's stake in the Corporate Partner relative to its other assets decreases (and the result will therefore move further away from that which would obtain under the Proposed Regulations). However, the Value Rule should still provide a deterrent effect without resulting in the imposition of tax with respect to appreciation not economically exchanged by a corporation for its stock.

b. Subsequent Transactions

Where the initial partnership transaction is not subject to the Deemed Redemption Rule because of the limited definition of Controlling Corporation, it is possible that certain subsequent transactions could achieve results similar to the classic May Company transaction. In our view, it would be appropriate for tax to be imposed at the time of any such subsequent transaction. In fact, we believe that in such cases the Deemed Redemption Rule is already intended to apply under the Current Regulations. However, it would be helpful if the regulations further clarified the application of the Deemed Redemption Rule upon certain subsequent transactions.[64]

> *Example 9*: The facts are the same as in Example 8, except that the stock of CP represents a *de minimis* amount of S1's total assets. Subsequent to the formation of PRS, CP merges into S1 in a

[64] The examples in this Part IV.3.b. relate to subsequent transactions that occur while the partnership structure is still in place and before any partnership distributions. These are the types of transactions we believe may be within the intended scope of the Current Regulations. Where the subsequent transaction is a current or liquidating distribution of property by the partnership, we note that in many cases Section 732(f) or Section 755(c) would apply. These provisions generally operate to prevent the use of partnerships to facilitate basis shifting to assets other than stock of a corporation that is related to a corporate partner, and therefore also guard against a number of the potentially concerning results targeted by the Proposed Regulations. For instance, if, in Example 4, PRS were to ultimately (after seven years) distribute all of the S1 stock to S2, the basis in S1's assets would generally be decreased by $100 under Section 732(f)(1), provided that P, S1, S2 and CP are members of the same consolidated group and the limitations in Section 732(f)(3) do not apply. If, alternatively, PRS were to distribute Asset to A (and PRS did not liquidate as a result), PRS would be required to allocate the $100 downward basis adjustment required under Section 734(b) to assets other than the S1 stock, and/or recognize gain up to that amount. However, Sections 732(f) and 755(c) are not a complete backstop. For example, the basis reduction required under Section 732(f) cannot exceed the amount by which the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds the corporate partner's adjusted basis in the stock of the distributed corporation. Section 732(f)(3)(A). Section 732(f) would also not apply to situations involving less-than-50% direct or indirect owners of the Corporate Partner outside of the consolidated group context. However, Section 732(f) generally would be triggered upon a subsequent acquisition of Section 1504(a)(2) control of the distributed corporation by the corporate partner, as well as upon a subsequent transaction that results in the elimination of any gain in the stock of the distributed corporation. *See* Section 732(f)(1)(B) and Treas. Reg. § 1.732-3(c).

reorganization qualifying under Section 368(a), with S2 receiving S1 stock in exchange for its CP stock.

If the subsequent merger in Example 9 (or, for that matter, any other transaction the end result of which would have been subject to the Deemed Redemption Rule had the steps been effected in a different order) occurs as part of the same plan as the initial partnership transaction, we believe that, under general principles of tax law as well as the express reference to a "transaction (or series of transactions)" in the definition of a Section 337(d) Transaction,[65] the Deemed Redemption Rule would apply to the exchange of 50% of Asset for S1 stock under the Current Regulations.[66]

Even if the subsequent merger were a separate transaction, it appears that the Deemed Redemption Rule is intended to apply at the time of the merger. In the Preamble to the Current Regulations, Treasury and the IRS clarified that the Current Regulations apply to "certain transactions involving related parties in which the first transaction does not constitute a Section 337(d) Transaction because the partnership does not own stock in either a Corporate Partner or a Controlling Corporation, but the Corporate Partner in a later, separate transaction transfers its partnership interest to a related corporation whose stock the partnership owns."[67] This language would seem to cover Example 9. If that is the case, then consistent with the 2018 Preamble, upon the subsequent merger, the initial "going-in" transaction would become a Section 337(d) Transaction, with S1 stepping into the shoes of CP to recognize CP's remaining built-in gain in Asset as of immediately prior to the merger.[68]

However, it is not entirely clear how (or if) this result is achieved under the Current Regulations. The Current Regulations do not contain any special rules that apply to subsequent transactions involving related parties. As for the general rules, while the subsequent merger in Example 9 is a transaction of a type that could qualify as a Section 337(d) Transaction (since S1 directly acquires an interest in a partnership that owns S1 stock), it is not clear to what extent, if any, S1 has exchanged any interest in appreciated property for Stock of the Corporate Partner at

[65] Treas. Reg. § 1.337(d)-3(c)(3).

[66] We assume that, because the transactions are part of an overall plan or the same series of transactions, 50% of Asset would be deemed to be subject to the exchange even if S1 owned a relatively small interest in CP prior to the transactions.

[67] 2018 Preamble at 26,584.

[68] We assume that the gain subject to the deemed redemption rule in these circumstances would be any remaining built-in gain in the relevant assets that existed at the time of the initial partnership transaction (as opposed to all of the built-in gain in the relevant assets as of the time of the subsequent transaction), but we would appreciate clarification as the 2018 Preamble is not entirely clear on this point. *See id*. ("… [T]hese final regulations apply to certain transactions involving related parties in which the first transaction does not constitute a Section 337(d) Transaction because the partnership does not own stock in either a Corporate Partner or in a Controlling Corporation, but the Corporate Partner, in a later, separate transaction transfers its partnership interest to a related corporation whose stock the partnership owns. In these transactions, the deemed redemption rule will trigger gain as if the first transaction was a Section 337(d) Transaction with the result that the transferee corporation who is now itself a Corporate Partner will 'step into the shoes' of the first Corporate Partner and will be subject to the deemed redemption rule to the extent of the first Corporate Partner's remaining built-in gain in the appreciated asset immediately prior to the transfer.")

the time of the subsequent merger given that the economic exchange through the partnership has already occurred.

The notion that a previously completed exchange of assets (not involving Stock of the Corporate Partner) through a partnership can nevertheless be treated as part of a subsequent, unrelated transaction involving Stock of the Corporate Partner and thus trigger the application of the Deemed Redemption Rule seems to be reflected in example 5 of the Current Regulations. That example involves a corporate partner that contributes an appreciated asset and an unrelated party that contributes cash, which cash is used in a later year to purchase stock of the corporate partner. The example concludes that a Section 337(d) Transaction occurs when the partnership purchases the stock and the Deemed Redemption rule therefore applies.[69] Although we agree with the result, example 5 leaves a number of open questions regarding the impact of subsequent transactions and could be interpreted to suggest that the Deemed Redemption Rule applies in a number of situations where its application may not actually be intended. For example, consider a partnership to which the partners only ever contributed cash. The partnership uses the cash to buy assets, which appreciate over time. Many years later, the partnership uses cash on hand generated from non-operating activities to acquire stock of one of its partners.[70] We do not believe that the Deemed Redemption Rule should (or is intended to) apply in this situation. However, example 5 introduces some ambiguity unless it can be interpreted as the illustration of a rule limited to scenarios involving a prior "going in" transaction in which a Corporate Partner contributed appreciated assets (or a new partner contributed cash to a preexisting partnership in which the Corporate Partner is a partner and that holds appreciated assets). We recommend that this be clarified.

Additional examples (and/or regulations) addressing subsequent transactions are also needed to ensure that the Deemed Redemption Rule will apply in appropriate cases.

> *Example 10*: The facts are the same as in Example 8, except that stock of CP represents a *de minimis* portion of S1's total assets and S1 and S2 are the same size. Subsequent to the formation of PRS, S1 and S2 merge in a reorganization qualifying under Section 368(a).[71] As a result, P owns 90% of the combined entity and the combined entity owns 98% of CP. PRS continues to hold an interest in the combined entity by virtue of its preexisting ownership of S1 stock.

The end result in Example 10 is not meaningfully different from that in Example 9. But the application of the Deemed Redemption Rule is arguably even less clear in this case because

[69] Treas. Reg. § 1.337(d)-3(h), ex. 5.

[70] The 2018 Preamble clarified that one circumstance in which a partnership's acquisition of Stock of the Corporate Partner does not have the effect of an exchange of appreciated property for such stock is where a partnership uses operating cash flow to acquire Stock of the Corporate Partner. *See* 2018 Preamble at 26,583. Thus, we assume that the Deemed Redemption Rule would not apply in this situation if the cash used to acquire a corporate partner's stock were generated in operations. However, we believe the same result should obtain if the cash were generated in non-operating activities.

[71] Alternatively, P contributes its S2 stock to S1 in a contribution qualifying under Section 351.

the subsequent merger is not described as a potential Section 337(d) Transaction in the Current Regulations. Indeed, the transaction in Example 10 may not even be described in the language of the 2018 Preamble, which seems to be limited to transactions involving a transfer of the partnership interest by the Corporate Partner to a related corporation. In Example 10, no such transfer has taken place. We believe that the transactions in Example 9 and Example 10 should be treated similarly. Accordingly, we recommend that the regulations clarify that the Deemed Redemption Rule would apply to transactions involving related parties (but not unrelated parties) in which a first transaction does not constitute a Section 337(d) Transaction because the partnership does not own stock in a Controlling Corporation, but in a later, separate transaction, ownership of the Corporate Partner among related parties is consolidated such that one of the related parties becomes a Controlling Corporation.[72]

4. Limited Application of Section 318 for Purposes of Determining Direct or Indirect Ownership

The Proposed Regulations state that "a direct or indirect ownership of an equity interest in the Corporate Partner includes ownership of Stock of the Corporate Partner that would be attributed to a person under section 318(a)(2) (except that the 50-percent ownership limitation in section 318(a)(2)(C) does not apply) and under section 318(a)(4) (but otherwise without regard to section 318)."[73] This language could be interpreted to mean that the operating rules of Section 318(a)(5) do not apply. It is not clear if this result was intended, but we believe that the operating rules of Section 318(a)(5) should apply to the extent that they are relevant to ensure the proper operation of Upward Attribution and Option Attribution. For example, without the mandate of Section 318(a)(5) that stock deemed to be owned by a person through Option Attribution is deemed to be actually owned by such person for purposes of applying Upward Attribution, it is not clear that ownership attributable to an option held by a subsidiary would be attributed upwards to its corporate parent. We believe that applying the Section 318(a)(5) operating rules to the extent relevant to the Section 318 rules that otherwise apply for this purpose is consistent with the intent of the regulations and the Preamble.

Finally, given the unique way in which the rules of Section 318 apply in the context of the May Company Regulations, we would welcome the addition of examples in the final regulations illustrating the application of Section 318 in a limited fashion for purposes of determining whether a direct or indirect ownership interest exists, as contrasted with their application for purposes of determining the existence of Section 304(c) control by a Controlling Corporation.

[72] Such a rule would be analogous to the so-called "gain elimination rule" set forth in Treasury Regulations Section 1.732-3(c). This rule generally will be implicated if a partnership distributes stock of a corporation to a corporate partner in a distribution to which Section 732(f) does not apply because the corporate partner did not have Section 1504(a)(2) control of the distributed corporation (and the corporate partner never acquires such control), but the corporate partner's gain in the distributed stock is subsequently eliminated (for example, if the distributed corporation merges with the corporate partner in a reorganization under Section 368(a)). If such a subsequent "gain elimination transaction" occurs, for purposes of Section 732(f), the corporate partner is deemed to acquire Section 1504(a)(2) control of the distributed corporation immediately before the gain elimination transaction. Treas. Reg. § 1.732-3(c)(1).

[73] Prop. Treas. Reg. § 1.337(d)-3(c)(2)(i).

V. VALUE RULE

Interests in an entity that is neither the Corporate Partner nor a Controlling Corporation can also be treated as Stock of the Corporate Partner under the Value Rule.[74] Specifically, under the Current Regulations, Stock of the Corporate Partner includes interests in any entity to the extent that the value of the interest is attributable to the Stock of the Corporate Partner.[75]

The Proposed Regulations would modify and clarify the Value Rule. We appreciate the focus of Treasury and the Service on this aspect of the Current Regulations, as the Current Regulations do not provide significant guidance.

1. The Ownership Threshold

The Proposed Regulations would narrow the scope of the Value Rule in that the Value Rule would not apply to interests in any entity unless the entity owns, taking into account the Upward Attribution rules of Section 318(a)(2) (except that the 50-percent ownership limitation in Section 318(a)(2)(C) would not apply) and the Option Attribution rules of Section 318(a)(4), five percent or more, by vote or value, of the Corporate Partner's stock.[76]

We agree with the observations made by Treasury and the Service in the Preamble to the Proposed Regulations to the effect that the Value Rule could be overbroad in certain circumstances, and we welcome the proposal to narrow the scope of the rule.[77] However, we observe that even with the proposed limitation, the Value Rule could apply in many circumstances that, while involving a corporate contraction, may not present a realistic potential for the avoidance of *General Utilities* repeal.

> *Example 11*: Corporation A owns 20% of the stock of Corporation B. The value of Corporation A's stock in Corporation B is $200. The stock of Corporation B represents 10% of Corporation A's total assets. Neither Corporation A nor Corporation B has any liabilities. The value of all of the outstanding stock of Corporation A is $2,000, and thus 10% of the value of such stock is attributable to Corporation A's stake in Corporation B. Corporation B contributes Asset, with value of $100 and basis of $0, to a 50-50 partnership, PRS, with OP, an unrelated party. OP contributes stock of Corporation A, with a value and basis of $100. The Corporation A stock contributed to PRS represents a 5% interest in Corporation A.

Under the Value Rule, 10% of the Corporation A stock acquired by PRS (with value of $10) is treated as Stock of the Corporate Partner because 10% of the value of the Corporation A

[74] *See* Treas. Reg. § 1.337(d)-3(c)(2)(i); Prop. Reg. § 1.337(d)-3(c)(2)(ii).

[75] Treas. Reg. § 1.337(d)-(3)(c)(2)(i).

[76] Prop. Treas. Reg. § 1.337(d)-3(c)(2)(ii).

[77] 2019 Preamble at 11,007.

stock is attributable to Corporation A's interest in Corporation B.[78] Accordingly, Corporation B is treated as having exchanged $5 of Asset for Stock of the Corporate Partner and recognizes gain in the same amount.

We recognize that this fact pattern involves a contraction of Corporation B insofar as Corporation B has economically acquired, through its indirect interest in Corporation A, an indirect interest in itself. But it is difficult to see a realistic potential for abuse in this example. Even if PRS is ultimately liquidated and all of the Corporation A stock is distributed to Corporation B, Corporation B will still only hold a five percent interest in Corporation A. Corporation B cannot obtain its stock held by Corporation A or eliminate its built-in gain in the stock of Corporation A through a tax-free liquidation of Corporation A. Similarly, while Corporation A owns a relatively larger stake in Corporation B, it does not have control over Corporation B and cannot effect a tax-free liquidation of Corporation B to obtain its own stock. Finally, while a tax-free combination of Corporation A and Corporation B could obtain a result that more closely resembles the classic May Company transaction, in the absence of a control relationship and where the stock of either corporation does not present a significant portion of the assets of the other, that result seems far from inevitable. Indeed, the lack of ability on the part of any of the corporations involved to ensure a successful end-run around *General Utilities* repeal makes it unlikely that the initial transaction was (or any subsequent transaction will be) abusive or entered into for the purpose of avoiding corporate-level gain.

For these and other reasons, we suggested in our 2015 Report that the Value Rule should not apply to an interest in an entity unless at least 20 percent of the assets of the entity were attributable to the Stock of the Corporate Partner.[79] Such a threshold (which would have echoed existing rules in Section 731(c)) could have served to preclude the Value Rule from applying in non-abusive situations.[80] We understand that Treasury and the IRS were concerned that such an approach could permit taxpayers to structure transactions that would contravene the purpose of Section 337(d) but, as illustrated above, the approach in the Proposed Regulations still seems overbroad. Accordingly, we recommend that Treasury and the IRS consider further narrowing the scope of the Value Rule by, for example, increasing the relevant ownership threshold to a higher percentage (*e.g.*, 10 percent). Should Treasury and the Service take this suggestion under consideration, it should be noted that our observations regarding the limited opportunities for abuse in certain circumstances where the Value Rule applies are primarily applicable with respect to entities that own Corporate Partner stock that are themselves corporations. The same barriers to completing a May Company transaction may not exist if the entity is a partnership or a special type of corporation that provides for pass-through treatment, such as a regulated investment company. In those circumstances, retaining the currently proposed five percent threshold may be appropriate.

[78] *See* Prop. Treas. Reg. § 1.337(d)-3(c)(2)(ii).

[79] 2015 Report, at 7.

[80] If the majority or a significant portion of the assets of the entity are represented by the corporate partner's stock, it may be more likely that the entity was organized to facilitate a tax-motivated transaction. In addition, the greater the portion of the entity's assets that are represented by the stock of the corporate partner, the more likely perhaps is a subsequent combination transaction.

2. Determining Direct or Indirect Ownership Under the Value Rule

The Proposed Regulations provide that an equity interest in an entity will be treated as Stock of the Corporate Partner if the entity "owns directly or indirectly five percent or more, by vote or value, of the stock in the Corporate Partner."[81]

First, it appears that the Proposed Regulations mandate a pure look-through approach in that Upward Attribution would apply without regard to any ownership threshold. Thus, for example, if an entity (an "owner entity") owns an interest in another entity (a "downstream entity"), stock held by the downstream entity would be proportionately attributed upward to the owner entity even if the owner entity owns less than five percent of the stock of the downstream entity. We note that this mechanic differs from the approach in Section 304(c), which modifies the Section 318(a)(2)(C) Upward Attribution rules to substitute the 50% ownership threshold with a five percent threshold, not eliminate it entirely.[82]

We believe this approach could present compliance difficulties. For example, taxpayers may not be able to determine that an entity that owns slightly less than five percent of the taxpayer's stock directly in fact owns five percent or more of the taxpayer's stock directly or indirectly on account of the entity's minor interest in yet another entity.[83] Therefore, we recommend that for purposes of determining direct or indirect percentage ownership by an entity under the Value Rule, the Upward Attribution rules as modified by Section 304(c) should apply, as opposed to the proposed pure look-through approach.

Second, the Proposed Regulations do not refer to Option Attribution for purposes of determining direct or indirect ownership under the Value Rule.[84] Based on the Preamble, we understand that this was intentional.[85] We agree with this approach given that the Value Rule could be difficult to administer otherwise.

> *Example 12*: Corporation A, a publicly traded corporation, owns convertible debt issued by CP, another publicly traded corporation. If all of the CP convertible debt held by Corporation A were to be

---

[81] Prop. Treas. Reg. § 1.337(d)-3(c)(2)(ii)(B).

[82] *See* Section 304(c)(3)(B)(i) ("For purposes of Subparagraph (A)… paragraph (2)(C) of section 318(a) [Upward Attribution] shall be applied substituting '5 percent' for '50 percent'."). Section 318(a)(2)(C) provides that "[i]f 50% percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation."

[83] We note that a similar pure look-through approach applies for purposes of determining whether a corporation owns a direct or indirect interest in the Corporate Partner in the context of the definition of Controlling Corporation. For that purpose, the Proposed Regulations rely on the Upward Attribution rules of Section 318(a)(2), but modified to eliminate any ownership threshold limitation. *See* Prop. Treas. Reg. § 1.337(d)-3(c)(2)(i). While the administrative difficulties associated with a pure look-through approach may be generally less severe in that context given that the Controlling Corporation test also requires the existence of Section 304(c) control, this may not be the case in all circumstances as discussed in Part IV.2.a.

[84] *See* Prop. Treas. Reg. § 1.337(d)-3(c)(2)(ii)(B).

[85] *See* 2019 Preamble at 11,007.

> converted into stock, Corporation A would own 4% of CP. The conversion window for CP's convertible debt does not begin for at least 12 months. Corporation A also owns 1.5% of CP's stock. CP enters into a partnership, PRS, to which CP contributes appreciated assets and OP, an unrelated party, contributes stock of Corporation A.

Because CP's convertible debt is not convertible for more than 60 days, it would generally not be taken into account and aggregated with the CP stock for purposes of the SEC ownership reporting rules.[86] Accordingly, because Corporation A owns only 1.5% of the CP stock, it would generally not be required to file a Schedule 13-D or Schedule 13-G, and CP may not be able to conclude that stock of Corporation A is required to be treated as Stock of the Corporate Partner to any extent.

Third, to facilitate compliance, we recommend that, absent actual knowledge to the contrary, taxpayers be entitled to rely on the absence of a Schedule 13-D, Schedule 13-G or a similar filing to conclude that a relevant entity does not own the requisite five percent interest in the stock of the Corporate Partner.

3. Calculating the Value of the Equity Interest Attributable to Corporate Partner Stock

The Proposed Regulations provide specific rules for determining the extent to which the value of an equity interest is attributable to the Stock of the Corporate Partner.[87] Specifically, the portion of the value of an equity interest that is so attributable would be determined by multiplying the value of the equity interest by a ratio, the numerator of which is the fair market value of the Stock of the Corporate Partner owned directly or indirectly by the entity and the denominator of which is the fair market value of all of the equity interests in the entity, provided that this ratio cannot be greater than one.[88] We believe that this approach works properly in the case of entities that do not have any liabilities. In situations in which the entity has liabilities, the formula in the Proposed Regulations would overstate the extent to which the value of the equity interests in the entity reflects the value of Corporate Partner stock.

> *Example 13*: Corporation A owns 10% of the stock of Corporation B. Corporation B is worth $1,000, and accordingly A's 10% stake is worth $100. Corporation A also owns Asset, which is worth $100, and has $100 of debt outstanding. Accordingly, the value of all the stock in Corporation A is $100. Corporation B contributes an appreciated asset to partnership PRS, and unrelated OP contributes stock of Corporation A. The contributed Corporation A stock and the asset contributed by Corporation B are each worth $10.

---

[86] 17 C.F.R. § 240.13d-3(d)(1)(i).

[87] *See* Prop. Treas. Reg. § 1.337(d)-3(c)(2)(iii).

[88] *Id.*

Under the Proposed Regulations, all of the contributed Corporation A stock is treated as Stock of the Corporate Partner because the relevant ratio is one (the value of Corporation A's stake in Corporation B, or $100, divided by the fair market value of all of the stock of Corporation A, also $100).[89] We believe that this approach overstates the portion of the value of the equity in Corporation A that is attributable to Corporation B stock. That is, Corporation A has two assets of equal value, and ownership of Corporation A stock represents an indirect ownership interest in both. The formula in the Proposed Regulations effectively ignores the value of Asset. Unless the $100 liability is non-recourse and secured solely by Asset, there seems to be no particular reason to attribute the liability entirely to Asset and thus to treat 100% of the stock in Corporation A as Stock of the Corporate Partner. That is the result that would obtain if Corporation A owned only stock in Corporation B and had no liabilities. Where Corporation A also owns Asset and has a liability, it does not seem appropriate, in general, to treat the liability as wholly related to Asset.

Indeed, even if the liability were non-recourse and secured solely by Asset, it is not necessarily the case that the liability should be treated for this purpose as wholly related to Asset. Asset might not ultimately be used to satisfy the liability. Moreover, given the numerous situations in which the Value Rule could apply (including, in particular, situations involving portfolio investments by unrelated parties), we do not believe that taxpayers should be required to determine the nature of an entity's liabilities as recourse or non-recourse in order to perform the analysis or that the regulations should mandate the most taxpayer-unfavorable assumption.

The effect of the formula in the Proposed Regulations is best illustrated through an example.

> *Example 14*: Corporation A has assets of $100, consisting of CP stock worth $40 and Asset 1, which is worth $60. Corporation A also has $75 of debt. Thus, the equity value of Corporation A is $25. CP has one asset, Asset 2, worth $100, and no liabilities. Accordingly, Corporation A owns 40% of CP. CP and OP form a 50-50 partnership to which CP contributes a portion of Asset 2 worth $20 and OP contributes Corporation A stock of the same value.

Assume that sometime in the future, when none of the relevant values have changed, PRS liquidates, and, thereafter, Corporation A also liquidates. Each of the liquidations is accomplished through a pro rata liquidating distribution, with the relevant equity owners also assuming their pro rata share of any liabilities of the liquidating entity. Immediately after the liquidation of PRS, CP's assets would consist of an interest in Asset 2 worth $90 (original $100 interest, less the $10 portion of the $20 interest in Asset 2 that was contributed to PRS and then distributed to OP in the PRS liquidation) and $10 of Corporation A stock, representing a 40% interest in Corporation A. In the liquidation of Corporation A, CP receives 40% of each of Corporation A's assets and assumes 40% of its liabilities. Thus, immediately after the liquidation of Corporation A, CP's assets and liabilities (treating the newly acquired CP stock as an asset for purposes of this analysis) are as follows:

---

[89] *Id.*

Asset 2	$90
CP Stock	$16 ($40 x 40%)
Asset 1	$24 ($60 x 40%)
Total Assets	$130
Debt	$30 ($75 x 40%)
Equity	$100

As a result of these transactions, CP has effectively acquired CP stock worth $16 and Asset 1 worth $24 in exchange for a $10 interest in Asset 2 and the assumption of a $30 liability. Out of the total consideration "paid" by CP, 25% was in the form of Asset 2 and 75% was in the form of liability assumption. Allocating this consideration pro rata among the two assets acquired, $12 of the CP stock ($16 x 75%) was acquired in exchange for the assumption of Corporation A's liability and only $4 of the CP stock ($16 x 25%) was acquired in exchange for Asset 2. The remaining $6 of Asset 2 was exchanged for a portion of Asset 1 of the same value.

Returning to the initial partnership transaction, if, for purposes of the May Company Regulations, the portion of the value of Corporation A stock that is attributable to CP stock were measured by reference to the portion of the total assets of Corporation A represented by its stake in CP, the results are consistent with the above analysis. The relevant ratio is 0.4 ($40 value of Corporation A's CP stake / $100 total assets), and thus the value of the Corporation A stock contributed to PRS that should be treated as Stock of the Corporate Partner is $8 ($20 x 0.4). Under the Deemed Redemption Rule, as a 50% partner, CP should be deemed to have exchanged a portion of Asset 2 worth $4 for Stock of the Corporate Partner.

Of course, the CP stock is not really an asset in the hands of CP, and CP's equity value has been reduced by $16. However, only a portion of that contraction (specifically, $4) is attributable to the "repurchase" of stock in exchange for an appreciated asset. The remainder is attributable to a redemption of stock in exchange for the assumption of a shareholder's liability. This, in turn, is effectively a redemption of stock for cash, and therefore not a transaction that implicates *General Utilities* repeal.

But the Proposed Regulations reach a different result. Following the formula in the Proposed Regulations, the relevant multiplier is one, which is the lesser of (i) one and (ii) the ratio obtained by dividing the value of Corporation A's stake in CP ($40) by the fair market value of all of Corporation A's equity ($25), or 1.6.[90] As a result, all of the Corporation A stock that is contributed to the partnership is treated as Stock of the Corporate Partner, and CP is deemed to have exchanged a $10 interest in Asset 2 for Stock of the Corporate Partner.[91] The formula in the Proposed Regulations effectively attributes the equity contraction of the Corporate

[90] *Id.*

[91] *See* Prop. Treas. Reg. § 1.337(d)-3(c)(2)(ii).

Partner (here $16) first to the appreciated assets exchanged through the partnership (up to the greatest extent possible, namely the portion of the asset economically exchanged), with only the remaining contraction in excess of the value of the exchanged appreciated asset, if any, being attributable to the indirect liability assumption. There does not seem to be any compelling reason for applying the formula in this manner, particularly as pro rata allocation is generally the rule in other areas of the tax law absent special facts that would allow for different forms of consideration to be allocated among assets acquired in a different manner.

As noted above with respect to non-recourse liabilities, there may be circumstances where a different allocation could make sense, but in most cases such a fact-specific approach is unlikely to be administrable. We do, however, believe that allocating liabilities first against the cash balances of the relevant entity would be appropriate and could be easily achieved by taking liabilities into account net of cash for purposes of this calculation.

In sum, we recommend that the formula for calculating the value of the equity interest in an entity that is attributable to the Stock of the Corporate Partner be modified so that the determination is made by reference to the portion of the total value of the entity's assets that are attributable to the stock of the Corporate Partner. For this purpose, we believe that taxpayers should be permitted to determine the value of an entity's assets by adding back the entity's net debt (identifiable liabilities less cash) to the value of all of the equity interests in the entity. Where the taxpayer does not have access to actual information, taxpayers should be able to rely on publicly filed financial statements of the relevant entity as of the closest point in time to the transaction in question.

We acknowledge that there could be situations in which the taxpayer will not have access to information regarding the entity's liabilities or the value of its assets (*e.g.*, where the relevant entity is not publicly traded). At the same time, in most cases the parties presumably will, as part of the partnership deal, have a view as to the value of the equity interest in the entity being contributed. If the Value Rule is to apply in such circumstances, the rule as set forth in the Proposed Regulations may be the only administrable alternative.[92] However, because the rule as currently proposed would, in any case where liabilities are present, overstate the portion of the equity interests in the entity that is attributable to the value of the Stock of the Corporate Partner, we do not believe that this formula should be mandated in cases where the taxpayer can obtain the relevant information.

4. Applying the Value Rule Formula to Non-Stock Equity Interests

While non-stock equity interests are ignored for purposes of determining an entity's direct or indirect ownership interest in the Corporate Partner, such interests are taken into account for purposes of determining the value of an equity interest in an entity that is attributable to Stock of the Corporate Partner, both with respect to the entity, as well as the issuer of the Stock of the Corporate Partner.[93] It would be helpful if the final regulations included examples

[92] Alleviating such administrative difficulties may be another reason for increasing the ownership threshold from the currently proposed five percent.

[93] Prop. Treas. Reg. § 1.337(d)-3(c)(iii)(B) (referring to (i) all of the "equity interests" in the entity (which includes non-stock interests pursuant to Prop. Treas. Reg. § 1.337(d)-3(c)(2)(i)) and (ii) the "Stock of the Corporate Partner" (which similarly includes non-stock equity interests pursuant to Prop. Treas. Reg. § 1.337(d)-3(c)(2)(1)) owned by

as to how non-stock equity interests should be taken into account in the formula under various scenarios.

> *Example 15*: Publicly traded Corporation A has 10 shares of stock outstanding, each worth $10. The total equity value of Corporation A is thus $100, and Corporation A has no liabilities. Corporation A owns stock of CP worth $40 (representing a greater than 5% ownership interest in CP), and its CP stake represents 40% of Corporation A's total assets. CP and unrelated OP form a 50-50 partnership PRS to which CP contributes an appreciated asset and OP contributes an option to acquire 1 share of Corporation A stock from Corporation A, for an exercise price of $5. The option is currently exercisable.

The Proposed Regulations would provide that the value of the equity interest in Corporation A that is attributable to Stock of the Corporate Partner is equal to (A) the fair market value of the option, multiplied by (B) the ratio, not to exceed one, of (1) the fair market value of the Stock of the Corporate Partner owned by Corporation A and (2) the fair market value of all of the equity interests in Corporation A.[94] With respect to the value in clause (A), on the simplified facts of this example, the value of the option could be thought of as approximately $5. Turning to the ratio in (B), and the denominator in particular, the required approach is not clear. The Proposed Regulations refer to the value of "all of the equity interests" in the relevant entity, which definitionally includes options.[95] However, on the facts of Example 15, it seems that the more appropriate (and administrable) approach would be for the denominator to take into account only the value of the outstanding equity of Corporation A (without any adjustment for the option). If it can be assumed that the option would be net settled and that the price of Corporation A stock already takes into account the dilutive effect of the option, then exercise of the option should not have an appreciable effect on the total equity value of Corporation A. Rather, the aggregate equity value would stay the same (*i.e.*, the size of the pie would not change, but the pieces of the pie would be distributed differently, with PRS owning a percentage interest valued at approximately $5).[96] Similarly, we do not believe that the value of options written by persons other than the issuer of the underlying stock should be taken into account.

Additional questions may arise in more complex fact patterns. For example, how should the calculation be performed where the option is not currently exercisable, not in-the-money or otherwise valued using more complicated methods such as Black-Scholes? In all of those cases, the value of the option may not correspond to the holder's ultimate claim on the equity of the

---

the entity directly or indirectly within the meaning of Prop. Treas. Reg. § 1.337(d)-3(c)(2)(i) (which includes Option Attribution)).

[94] *See* Prop. Treas. Reg. §§ 1.337(d)-3(c)(2)(i) and (iii)(B)(1).

[95] *Id.*

[96] A net-settlement-based approach would also avoid complications that could arise by assuming cash exercise if our recommendation in Part V.3 above (to the effect that the portion of the value of an entity's equity interests that is attributable to the Stock of the Corporate Partner should be determined by reference to the value of the entity's assets as opposed to the value of its equity) is adopted.

corporation in any meaningful way. We appreciate that it is not realistic for these issues to be resolved in the final regulations. However, to the extent Treasury and the IRS determine that any simplifying assumptions or other guidance would be appropriate (*e.g.*, ability to ignore out-of-the money options until a subsequent date), they would be welcome. Finally, it may be helpful if the regulations could clarify how taxpayers should take convertible debt into account for purposes of these rules. We believe that the principal amount of convertible debt should be treated as debt, and therefore not as an equity interest, and that only the value attributable to the embedded option should be taken into account, but we would appreciate confirmation.

5. Coordination with the Controlling Corporation Rules; Other Matters

The Proposed Regulations clarify that where an equity interest is stock of the Corporate Partner because it is an interest in a Controlling Corporation, the Value Rule does not apply.[97] We welcome this clarification as a general matter because, without it, many situations would involve overlap, resulting in uncertainty as to which rule, or even whether both rules, apply.

However, further consideration should be given to the coordination of the Controlling Corporation rules and the Value Rule if our recommendation that only such portion of the stock of a Controlling Corporation that is equal to its direct or indirect ownership percentage in the Corporate Partner should be treated as Stock of the Corporate Partner. Consider again the facts of Example 4, where (i) S1 has Section 304(c) control of the Corporate Partner, S2, taking into account Downward Attribution, but only a 30% direct or indirect interest in S2, (ii) S2 represents a *de minimis* portion of S1's total assets, and (iii) S2 enters into a 50-50 partnership, contributing Asset worth \$100, while the other partner contributes S1 stock worth \$100. As illustrated above, in this example S2 has not contracted (by more than a *de minimis* amount), while S1 has contracted to the extent of its 30% interest in Asset. Thus, for purposes of applying the Controlling Corporation rule, which as discussed above, largely focuses on the contraction of the Controlling Corporation as opposed to the contraction of the Corporate Partner itself, we suggested that only 30% of the portion of the Asset exchanged for S1 stock should be subject to the Deemed Redemption Rule and that, accordingly, only 30% of the S1 stock should be treated as Stock of the Corporate Partner. The Value Rule, which more directly focuses on the contraction of the Corporate Partner, was not implicated on these facts.

If we assume instead that S1's only asset is the S2 stock, however, S2's contraction is larger (in terms of value), and the Value Rule becomes relevant. Specifically, under the Value Rule, 100% of the S1 stock would be treated as Stock of the Corporate Partner because all of the value of the S1 stock is attributable to the value of its S2 stock. While the contraction of the Controlling Corporation is the same as in the original example, the result under the Value Rule is consistent with the economic contraction of the Corporate Partner, S2, because under these modified facts, an interest in S1 entirely represents an indirect interest in S2.

Given that S2 is the Corporate Partner in this example, we believe that its contraction is more relevant than that of S1. Accordingly, should Treasury and the IRS adopt our recommendation to, in situations involving a Controlling Corporation that has Section 304(c) control but directly or indirectly owns less than 50 percent of the Corporate Partner, limit the

[97] Prop. Treas. Reg. § 1.337(d)-3(c)(2)(ii).

portion of the stock of such Controlling Corporation that is treated as Stock of the Corporate Partner by reference to the Controlling Corporation's direct or indirect ownership in the Corporate Partner, we recommend that the Value Rule take precedence in such situations if its application would result in a greater portion of the Controlling Corporation's stock being treated as Stock of the Corporate Partner.

If, however, Treasury and the IRS determine that the Downward Attribution rules should not apply for purposes of determining whether a corporation is a Controlling Corporation, it may be appropriate to provide that any threshold ownership limitations included in the Value Rule do not apply with respect to entities that have Section 304(c) control (taking Downward Attribution into account) of the Corporate Partner. Such an exception would enhance the role of the Value Rule as a backstop with respect to transactions involving related parties where the relevant partnership is not deemed to own stock of a Controlling Corporation because the Downward Attribution rules do not apply. To illustrate:

> *Example 16*: P owns 90% of the stock of S1 and 96% of the stock of S2. S1 directly owns the remaining 4% of S2. The stock of S2 is S1's only asset (and S1 has no liabilities). S2 and A form a 50-50 partnership, PRS, to which S2 contributes appreciated Asset (value of $100 and basis of $0), and A contributes 10% of S1 stock (value and basis of $100).

If the Downward Attribution rules do not apply for purposes of determining whether a corporation is a Controlling Corporation, S1 would not be treated as such because, absent Downward Attribution, S1 does not have Section 304(c) control of S2. Moreover, if the Value Rule were adopted as currently proposed, the Value Rule would also not apply because S1 owns, directly and indirectly, less than 5% of S2. As a result, the Deemed Redemption Rule would not apply. However, if the Value Rule were modified such that its ownership threshold were not applicable in circumstances where the entity the stock of which is acquired by the partnership would have Section 304(c) control of the Corporate Partner taking into account Downward Attribution, then the Value Rule would apply in Example 16 and S2 would recognize $50 of gain.

VI. AFFILIATED GROUP EXCEPTION

The Proposed Regulations would remove the Affiliate Group Exception.[98] This exception provides that Stock of the Corporate Partner does not include any stock or other equity interests held or acquired by a partnership all of the interests in which are held by members of an affiliated group (as defined in Section 1504(a)) that includes the Corporate Partner.[99] Thus, the May Company Regulations currently do not apply to internal partnerships among domestic affiliated group members. If there are any outside partners that are not members of the affiliated group (or that are affiliated entities that are not domestic corporations), regardless of the size of their interest in the partnership, the Affiliated Group Exception does not apply.

---

[98] *See* 2019 Preamble at 11,006-7.

[99] Treas. Reg. § 1.337(d)-3(c)(2)(ii).

We agree with the elimination of the Affiliated Group Exception. The *General Utilities* repeal avoidance concerns that arise in the context of partnerships among unrelated parties arise in a substantially similar manner in the context of internal group partnerships. While there are some differences and additional considerations, we do not believe that they justify a full exemption. Moreover, we agree that transactions among related parties warrant heightened scrutiny, and we are not aware of many ordinary business transactions that would be impacted by this rule.

> *Example 16*: P owns 100% of S. S and P form a partnership to which S contributes P stock and P contributes an appreciated asset.

Example 16 looks like the classic May Company transaction. It is worth noting, however, that this example does not involve a corporate contraction. S has economically exchanged an interest in one asset (its P stock) for an interest in another asset. While at first blush it may appear that P has economically exchanged an interest in the appreciated asset for an interest in the P stock, P already owned such stock indirectly through its ownership of S. Nevertheless, through the partnership, P has exchanged a direct interest in an appreciated asset for a "direct" interest (through the partnership) in its own stock, which is the quintessential transaction to which Section 311(b) is meant to apply. In these circumstances,[100] the absence of a corporate contraction is in our view not relevant.

> *Example 17*: P owns 100% of S. S and P form a 50-50 partnership, PRS, to which S contributes Asset and P contributes S stock.

While the P group has not contracted, S clearly has (by exchanging a 50% interest in the appreciated asset for its stock), and from the perspective of S, this is the quintessential May Company scenario. We do not see any compelling reason the Deemed Redemption Rule should not apply to this situation.[101] We believe the same result should obtain to any other internal partnership where the May Company Regulations would otherwise apply (*e.g.*, if S owned 100% of S2 and P formed PRS with S2).[102]

We are not aware of many routine business transactions that would be impacted by the elimination of the Affiliated Group Exception even though stock of a parent corporation (or its

[100] Situations where the exchange of an appreciated asset for its owner's stock is directly and finally accomplished through the partnership, as opposed to a partnership transaction involving subsidiary or brother-sister stock or stock of an entity holding the stock of the asset owner in which latter cases the end-run around *General Utilities* repeal is not inevitable.

[101] We note that if S had actually distributed 50% of the Asset to P and P and S were members of the same consolidated group, any related Section 311(b) gain would be deferred under the consolidated return regulations. Treas. Reg. § 1.1502-13(f)(2)(iii). However, we acknowledge that introducing additional complexity through special rules that would allow consolidated groups to defer gain recognized under the May Company Regulations may not be warranted given the anti-abuse context.

[102] The elimination of the Affiliated Group Exception would have the added benefit of removing a cliff effect inherent in the Current Regulations pursuant to which the existence of a minor external partner interest (for example, a service provider receiving equity-based compensation from the partnership) can lead to vastly different tax consequences under the May Company Regulations.

subsidiaries) may in some circumstances be contributed to an internal partnership in legitimate and ordinary course transactions. For example, where a corporate group conducts all or a portion of its business through an internal partnership, the employees of that partnership often will be compensated in part with equity of the parent corporation, which is first contributed by the parent to the partnership. However, we believe that the May Company Regulations generally would not apply in such cases under the exception for certain dispositions set forth in Treasury Regulations Section 1.337(d)-3(f)(2). Another situation in which stock of a member of an affiliated group may be contributed to an internal partnership is in connection with financing transactions. For example, where the partnership is a borrower, a contribution of stock of an affiliate not already owned by the partnership could increase the asset base against which the partnership can borrow and potentially secure better borrowing terms due to increased collateral. However, to our knowledge, contributing stock of a direct or indirect owner of the partnership in such circumstances is not a particularly common approach in non-structured transactions, and the result can often be achieved through other means.

VII. EFFECTIVE DATE AND IMPLEMENTATION

To the extent that the definition of Stock of the Corporate Partner is expanded in the final regulations (whether on account of the application of Family Attribution or Downward Attribution, or the elimination of the Affiliated Group Exception), it is not entirely clear how (or when), the May Company Regulations would apply to preexisting structures that were not previously subject to the May Company Regulations but that will be so subject once the Proposed Regulations are finalized. We do not believe that preexisting structures that relied on the Current Regulations should be penalized by the implementation of the final regulations (or at least not immediately). Therefore, we recommend that the final regulations clarify that any economic exchange of appreciated assets for stock that was not Stock of the Corporate Partner at the time of the exchange under the Current Regulations will not be subject to the Deemed Redemption Rule either upon the effectiveness of the final regulations or later upon a subsequent Section 337(d) Transaction. Alternatively, the final regulations could provide taxpayers with some period of time to unwind current structures without triggering any consequences under the May Company Regulations.

As an initial matter, we assume that the mere effectiveness of the final regulations would not in itself result in the occurrence of a Section 337(d) Transaction or the imposition of tax under the Deemed Redemption Rule.

> *Example 18*: Same as Example 17, except that the transaction occurred in 2017. In addition, assume that, at the time of the contribution, Asset had a value of $100 and a basis of $0, and that the contributed S stock had a value and basis of $100. Asset is non-depreciable and there has been no change in asset values since the partnership was formed.

As noted above, as a result of the transaction, S has exchanged a $50 interest in Asset for $50 of its own stock. However, at that time, S stock was not Stock of the Corporate Partner and accordingly the transaction was not subject to the Deemed Redemption Rule. We assume that the "springing" classification of the S stock in PRS as Stock of the Corporate Partner will not be treated as a Section 337(d) Transaction (*i.e.*, the partnership will not be deemed to have newly "acquired" Stock of the Corporate Partner as a result of the final regulations). We also assume that there will be no Section 337(d) Transaction, and that the Deemed Redemption Rule will not apply if, in 2025, PRS is liquidated with S receiving a 50% interest in both Asset and the S stock held by PRS. At the time of the liquidation, S already owns a 50% interest in the S stock. We believe this would be the result under the Proposed Regulations, but would appreciate confirmation.

The impact of intervening transactions (also occurring prior to finalization of the Proposed Regulations) is less clear.

> *Example 19*: Same as Example 18, and in addition, in 2018, S1, an affiliated group member 100% owned by P, contributes $100 of cash for a 1/3 interest in PRS. Then, in 2026, PRS redeems S1's interest for $50 in cash and a $50 interest in Asset.

As a result of the 2018 transaction, S's indirect interest in PRS's S stock is reduced from $50 to $33.33. Then, upon the 2026 redemption, S's indirect interest in the S stock goes back up to $50. The question is whether the redemption of S1 is a Section 337(d) Transaction. Under Treasury Regulations Section 1.337(d)-3(d)(2), a Corporate Partner's interest in an identified share of Stock of the Corporate Partner will never be less than the Corporate Partner's largest interest (by value) in that share of Stock of the Corporate Partner that was taken into account when the partnership previously determined whether there had been a Section 337(d) Transaction. Because the S stock in PRS was not Stock of the Corporate Partner in either 2017 or 2018 on account of the Affiliated Group Exception, it is not clear that any interest in the S stock "was taken into account" when the partnership previously determined whether there had been a Section 337(d) Transaction (or whether the partnership ever necessarily made such a determination). We believe that the rules under Treasury Regulations Section 1.337(d)-3(d)(2) should apply in this situation as if the S stock had always been Stock of the Corporate Partner and as if the relevant partnership determinations had been made in both in the 2017 and the 2018 transactions. Otherwise, S could be required to recognize gain upon the 2026 transaction. This result may not be appropriate given that the economic exchange took place at a time when the May Company Regulations did not apply.

We recognize that there may be additional complexity inherent in such a rule and that, given that the May Company Regulations were not previously relevant, taxpayers may not have the relevant information or records to make the necessary determinations. As an alternative, Treasury and the IRS could consider allowing taxpayers some period of time to unwind existing structures where stock held by the relevant partnership previously was not, but under the final regulations would be, Stock of the Corporate Partner. Under such a transition rule, the final regulations would generally not apply until the grace period elapses, provided that taxpayers do not, during such period, engage in any transactions (including amendments of the partnership agreement or non-pro rata distributions) that have the effect of increasing the Corporate Partner's interest in the Corporate Stock or that are otherwise part of a plan or arrangement to circumvent the purpose of the May Company Regulations and the transition rule.

Finally, we would not in any case recommend that preexisting structures be fully grandfathered. Given that preexisting partnerships can be used to further circumvent *General Utilities* repeal going forward, we believe that transactions undertaken by preexisting partnerships after the final regulations are promulgated should be subject to the generally applicable rules.

VIII. TECHNICAL ISSUES IN OTHER AREAS OF THE CURRENT REGULATIONS

1. Treasury Regulations Section 1.337(d)-3(e)(3)

Treasury Regulations Section 1.337(d)-3(e)(3) states that the "Corporate Partner will recognize gain on a distribution of Stock of the Corporate Partner to the extent that the partnership's adjusted basis in the distributed Stock of the Corporate Partner . . . exceeds the Corporate Partner's adjusted basis in its partnership interest . . . immediately *after* the distribution" (emphasis added). We believe that the reference to "after" is a drafting error and that the regulation is meant to refer to the Corporate Partner's adjusted basis in its partnership interest immediately *before* the distribution. Indeed, this is how the rule is applied in example 3 of the Current Regulations.[103] Given that the Regulations are otherwise being amended, we recommend that Treasury and the IRS take the opportunity to make this correction.

2. Treasury Regulations Section 1.337(d)-3(e)(1)

The first sentence of Treasury Regulations Section 1.337(d)-3(e)(1) states that the rules of paragraph (e) apply only to "distributions to the Corporate Partner of Stock of the Corporate Partner to which section 732(f) does not apply and that have previously been the subject of a Section 337(d) Transaction or become the subject of a Section 337(d) Transaction as a result of the distribution." Nevertheless, it is not clear that these conditions must in fact be satisfied before the second sentence of Treasury Regulations Section 1.337(d)-3(e)(1) can apply. This second sentence sets forth the methodology for the application of the Deemed Redemption Rule to non-pro rata distributions of Stock of the Corporate Partner to the Corporate Partner and could be interpreted as applying to all such distributions (regardless of whether the conditions in the first sentence of paragraph (e)(1) are satisfied).[104] Indeed, example 4 in the Current Regulations seems to operate in this manner.[105] In that example, the fact that Section 732(f) does not apply to the non-pro rata distribution in question is stated as a relevant fact in illustrating the application of the rules set forth in Treasury Regulations Sections 1.337(d)-3(e)(2) and (e)(3), but it is not considered in illustrating the application of the Deemed Redemption Rule to such distribution.[106] As a result, it appears that the conditions set forth in the first sentence of Treasury Regulations Section 1.337(d)-3(e)(1) may only be relevant to Treasury Regulations Sections 1.337(d)-3(e)(2)

---

[103] Treas. Reg. § 1.337(d)-3(h), ex. 3.

[104] There may be an element of circularity in the regulation as drafted insofar as the condition in the first sentence refers to a distribution that becomes the subject of a Section 337(d) Transaction as a result of the distribution itself, but the rule in the May Company Regulations that would generally apply to such distributions is contained in the second sentence, which is conditioned on the first.

[105] Treas. Reg. § 1.337(d)-3(h), ex. 4.

[106] *Id*.

and (3), but not to the second sentence of Treasury Regulations Section 1.337(d)-3(e)(1). We recommend that this be clarified.

Relatedly, Treasury Regulations Section 1.337(d)-3(e)(2)(iii) provides that, for purposes of determining the amount of the decrease to the basis of property held by a distributed corporation required under Section 732(f), the required decrease is to be reduced by the amount of gain that a Corporate Partner has recognized under the May Company Regulations "in the same Section 337(d) Transaction or in a prior Section 337(d) Transaction." The import of the reference to the "same Section 337(d) Transaction" is unclear. If, as set forth in Treasury Regulations Section 1.337(d)-3(e)(1), paragraph (e) of the regulations only applies to distributions to which Section 732(f) does not apply, it is not clear how both rules could apply as suggested in Treasury Regulations Section 1.337(d)-3(e)(2)(iii). We recommend that the final regulations clarify what is meant by this reference.

3. Treasury Regulations Section 1.337(d)-3(f)(2)

Treasury Regulations Section 1.337(d)-3(f)(2) contains an exception for Stock of the Corporate Partner that is "disposed of (by sale or distribution) by the partnership before the due date of the partnership's federal income tax return for the year of the relevant transaction." We believe that the exception should also apply if the stock that causes the stock held by the relevant partnership to be treated as Stock of the Corporate Partner is disposed of. Consider the following example (which for illustrative purposes assumes that the Proposed Regulations are adopted in their current form):

> *Example 20:* P owns 90% of the stock of each of S1 and S2. S1 owns one share of S2. S2 and an unrelated party form a partnership, to which S2 contributes appreciated assets and the other party contributes stock of S1.

Under the Proposed Regulations, S1 is a Controlling Corporation. If S1 were to dispose of its share of S2 stock after the partnership is formed but before the due date for the partnership's tax return for year of formation, the exception in Treasury Regulations Section 1.337(d)-3(f)(2) would technically not seem to apply because the partnership has not disposed of its S1 stock. However, we believe that the exception should apply because the disposition of the S2 stock by S1 also results in the partnership no longer holding Stock of the Corporate Partner. We recommend that this concept be included in the final regulations.

Finally, we assume that a disposition "by sale" would include the delivery of stock or other equity interests as compensation, but would appreciate confirmation.