Report 1292

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE ROLE OF THE STEP TRANSACTION DOCTRINE IN SECTION 355 STOCK DISTRIBUTIONS: CONTROL REQUIREMENT AND NORTH-SOUTH TRANSACTIONS

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I. INTRODUCTION

This report of the New York State Bar Association Tax Section discusses the appropriate role of the step transaction doctrine in determining the U.S. Federal income tax consequences of certain transactions involving stock distributions intended to qualify as tax-free under section 355[1] (this "**Report**").[2] The Treasury Department (the "**Treasury**") and Internal Revenue Service (the "**Service**") announced they are currently studying the transactions discussed in this Report.

Specifically, in January 2013, when the Treasury and the Service updated the annual revenue procedure listing the matters upon which the Service will not issue private letter rulings ("**PLRs**"),[3] they added three new "areas under study in which rulings . . . will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations or otherwise." These three areas (the "**No-Rules**") involve various requirements for qualification as a tax-free separation under section 355 and related provisions, and whether and how the step transaction doctrine should apply in determining if the requirements are satisfied. The Treasury's 2013-2014 Priority Guidance Plan includes items for each of the No-Rules.[4]

While the Code and regulations provide alternative methods for bringing corporations together for business reasons, section 355 is the sole remaining provision following the repeal of the

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[1] All "section" or "§" references are to the Internal Revenue Code of 1986, as amended (the "**Code**") or the regulations thereunder.

[2] The principal drafters of this Report were Karen Gilbreath Sowell and Shane Kiggen. Substantial contributions were made by Neil Barr, Kathleen Ferrell, Larry Garrett, Josh Holmes, Vadim Mahmoudov, Richard Nugent, Debbie Paul, Matthew Rosen, David Schizer, Michael Schler, David Schnabel, Jodi Schwartz, David Sicular, Eric Solomon, Linda Swartz, Davis Wang, and Gordon Warnke.

[3] Rev. Proc. 2013-3, 2013-1 I.R.B. 113.

[4] Office of Tax Policy and Internal Revenue Service, 2013-2014 Priority Guidance Plan (August 9, 2013), Corporations and Their Shareholders (items 6-8):

"Guidance regarding when a transfer by a person to a corporation and a transfer by that corporation to that person, ostensibly in two separate transactions, should be respected as two separate transactions for Federal income tax purposes.

Guidance regarding whether a corporation is a "controlled corporation" within the meaning of section 355 if, in anticipation of the distribution of its stock, the distributing corporation acquires or retains putative control of the controlled corporation through the use of classes of shares having different voting powers.

Guidance regarding the application of section 355 and 361 to a distributing corporation's use of its controlled corporation's stock or securities to retire its putative debt issued in anticipation of the distribution of the stock of the controlled corporation."

General Utilities doctrine[5] that allows a corporation to divide in a tax-free manner. In a typical divisive transaction, a corporation ("**Distributing**") distributes to its shareholders and/or security holders[6] the stock and securities of a corporation that it controls ("**Controlled**").[7] Controlled may be a pre-existing corporation or may be newly formed as part of the spin-off pursuant to section 368(a)(1)(D) (a "**D reorganization**"). If the many requirements for qualification under section 355 and its related provisions are satisfied, a spin-off will result in no taxable gain or income to Distributing or its shareholders. Therefore, section 355 plays an important role in the life cycle of corporate businesses. Section 355 transactions commonly have been executed only after receiving a PLR both, because they are complex and because the potential tax exposure from such a transaction that fails to qualify can be devastating, with tax to Distributing and its shareholders.

Historically, a PLR could address the entirety of the spin-off transaction, addressing all of the tax consequences. Pursuant to Rev. Proc. 2013-32,[8] however, the Service announced it would issue rulings only on "significant" issues associated with a spin-off, leaving all other issues to be addressed by taxpayers and their advisors.[9] Despite this change in ruling policy, PLRs are expected to continue to play an important role in addressing uncertain issues raised by complex spin-off transactions.[10] The No-Rule areas involve issues that generally would be considered "significant" and thus would be eligible for consideration for a PLR. Consequently, notwithstanding the issuance of Rev. Proc. 2013-32, we believe it is important to narrow the scope of the No-Rules and, where appropriate, issue guidance upon which taxpayers may rely without obtaining a PLR.

This Report focuses on two of the three No-Rules. The first No-Rule we focus on relates to the requirement that Distributing possesses section 368(c) control of Controlled (the "**Control Requirement**").[11] The second No-Rule we focus on relates to whether a transaction involving a

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5 *Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

6 Hereinafter, Distributing's shareholders and security holders will be referred to together as shareholders.

7 The distribution may take the form of a pro rata distribution to shareholders ("**spin-off**"), a distribution in redemption of shares ("**split-off**"), or a distribution in liquidation of Distributing ("**split-up**"). This Report generally refers to all forms of section 355 distributions as "spin-offs" for ease of reading.

8 2013-28 I.R.B. 55.

9 *See* Rev. Proc. 2013-3, section 3.01 A significant issue is an issue of law, the resolution of which is not essentially free from doubt and that is legally significant and germane to determining the tax consequences of the transaction.

10 We note that if a transaction that implicates certain of the No-Rules is involved, it is not clear whether it is possible to obtain a PLR on a significant issue outside of the No-Rules. We urge the Service to consider significant issues even where the transaction raises issues under the No-Rules.

11 "Whether a corporation is a 'controlled corporation' within the meaning of § 355(a)(1)(A) if, in anticipation of a distribution of the stock of the corporation, a distributing corporation acquires putative control of the controlled corporation (directly or through one or more corporations) in any transaction (including a recapitalization) in which stock or securities were exchanged for stock having a greater voting power than the stock or securities relinquished in the exchange, or if, in anticipation of a distribution of the stock of the putative controlled corporation, such corporation issues stock to another person having

contribution of property in connection with a distribution of property (a "**north-south transaction**") should be respected as separate transactions or collapsed and treated as an exchange.[12] The third No-Rule relates to whether an exchange of Controlled securities or stock for Distributing debt issued in anticipation of a spin-off should be respected as a tax-free exchange.[13] This Report does not address the Debt Exchange No-Rule because there has been significant public commentary regarding debt exchanges in the context of spin-offs.[14]

The Control Requirement No-Rule and the North-South No-Rule are drafted broadly and, consequently, cover a broad range of transactions. The Tax Section appreciates the complexity of the analysis involved in the study. The Report does not undertake to make recommendations for all of the transactional patterns that are covered by the No-Rules. Instead, the Report discusses a range of possible transactions and provides recommendations for certain transactions where it is clearest that the application of the step transaction doctrine is not necessary to give effect to the relevant section 355 policies. We also discuss the relevant historical background and policy arguments to assist Treasury and the Service in concluding on transactions that are not entirely clear, and recommend the adoption of certain safe harbors designed to confirm that the step transaction doctrine either is not applicable or not necessary to give effect to the underlying policies.

For the Control Requirement No-Rule, the Report makes recommendations to exclude certain transactions from the areas under study and, because of the uncertainty created by the inclusion in the Control Requirement No-Rule, to provide guidance confirming the results so that taxpayers will not need to seek confirmation in PLRs. Other transactions covered by the Control

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different voting power per share than the stock held by the distributing corporation" (the "**Control Requirement No-Rule**"). *See* Rev. Proc. 2013-3, section 5.01(9).

12 "Whether transfers of stock, money, or property by a person to a corporation and transfers of stock, money, or property by that corporation to that person (or a person related to such person) in what are ostensibly two separate transactions (so-called 'north-south' transactions), at least one of which is a distribution with respect to the corporation's stock, a contribution to the corporation's capital, or an acquisition of stock, are respected as separate transactions for Federal income tax purposes" (the "**North-South No-Rule**"). *See* Rev. Proc. 2013-3, section 5.02(1). The North-South No-Rule applies to all instances of the exchange question, regardless of whether it is presented in the context of a spin-off or otherwise. As discussed below, this Report limits the analysis of the North-South No-Rule to transactions in which the "north" transaction is a spin-off.

13 "Whether either § 355 or § 361 applies to a distributing corporation's distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if such distributing corporation debt is issued in anticipation of the distribution" (the "**Debt Exchange No-Rule**"). *See* Rev. Proc. 2013-3, section 5.01(10).

14 *See* Deborah L. Paul, *Spin-offs, Leverage and Value Extraction: A spin by another name*, Taxes – The Tax Magazine Volume 91 TAXES (2013). *See also* Jodi J. Schwartz, *What's Debt Got to Do with It?, Spin-offs, Morris Trust, and Indebtedness*, The Tax Club, April 16, 1997; Michael L. Schler, *Simplifying and Rationalizing the Spin-off Rules*, 56 S.M.U. L. Rev. 239 (2003); American Bar Association, Section of Taxation, *Comments on Section 355 Legislation Proposed by the Clinton Administration*, March 7, 1997.

The Tax Section would be happy to comment on the issues raised by the Debt Exchange No-Rule if requested by Treasury and the Service.

Requirement No-Rule raise questions that require analyzing various policies, which questions have not been resolved by existing guidance. This Report provides a comprehensive analysis of the relevant policies and considerations that we hope will aid Treasury and the Service in their formulation of guidance that will address these fact patterns. For certain of these transactions, the Report recommends safe harbors as an interim solution to address such cases while the broader study is undertaken.

For the North-South No-Rule, the Report makes recommendations only for transactions where the "north" transaction is a spin-off. The North-South No-Rule has created significant uncertainty for spin-offs and, thus, we respectfully urge Treasury and the Service to issue guidance in an expedited manner. While the North-South No-Rule encompasses many other types of transactions in its scope, we believe the resolution of cases that implicate other Code provisions should be decided upon the policies unique to those provisions.

Part II discusses the nature and role of the step transaction doctrine. Part III provides a brief overview of the history of the taxation of corporate divisions. Parts IV and V consider the proper application of the step transaction doctrine with respect to transactions subject to the Control Requirement No-Rule and the North-South No-Rule, respectively. In each instance, the examination begins by inquiring into the policies that underlie the provisions whose application is at stake, and then posits various case studies in order to tease out when and how the step transaction doctrine should apply.

II. THE NATURE AND ROLE OF THE STEP TRANSACTION DOCTRINE

The No-Rules raise questions about the role of the step transaction doctrine in policing certain of the requirements for tax-free treatment under section 355. Part II.A provides a brief overview of the doctrine, its uses, the various tests for its applicability, and the difficulties associated with determining when and how these tests should apply to a particular situation. Part II.B discusses the role of substantive considerations in determining the proper scope of the step transaction doctrine, with a view towards developing a framework for analyzing the step transaction issues implicated by the No-Rules.

A. Overview of the Step Transaction Doctrine

The step transaction doctrine is a judicially created doctrine that permits a series of separate transactional steps to be integrated or recharacterized for federal income tax purposes if the steps are closely related and undertaken with a view to a common objective.[15] While it has been invoked most often by the Service against the taxpayer, the courts have allowed taxpayers to

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15 *See* Marvin A. Chirelstein and Benjamin B. Lopata, *Recent Developments in the Step Transaction Doctrine*, 60 Taxes 970, 970 (1982). *See also* Mintz & Plumb, *Step-Transactions in Corporate Reorganizations*, 12 N.Y.U. ANN. INST. OF FED. TAX'N 247 (1954).

apply the doctrine to their advantage in appropriate situations.[16] Moreover, the Service has published revenue rulings that apply the doctrine to specific fact patterns,[17] and taxpayers may rely on these rulings when faced with substantially similar facts.[18]

The step transaction doctrine has two basic uses.[19] First, the doctrine can apply to integrate, or link together, a series of formally separate transactional steps.[20] In this capacity, the doctrine operates to prevent the division of a single transaction into its parts in a manner that frustrates the purposes of a given Code provision. Second, the doctrine can apply to recharacterize a transaction as a different, but economically equivalent, transaction. This use is common where the taxpayer has chosen a needlessly circuitous path to a particular destination.[21] Thus, if the taxpayer wants to get from point A to point D and does so by stopping at points B and C in the

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16 *See, e.g., McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520 (7th Cir. 1982); *King Enterprises. Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

17 *See, e.g.,* Rev. Rul. 67-274, 1967-2 C.B. 141 (treating a stock acquisition qualifying as a reorganization described in section 368(a)(1)(B) ("**B reorganization**") followed by a liquidation of the target corporation into the acquiring corporation as an asset acquisition qualifying as a section 368(a)(1)(C) reorganization ("**C reorganization**") by the acquiring corporation).

18 Treas. Reg. § 1.6662-4(d)(3)(iii).

19 *See* Borris I. Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 Howard L.J. 693, 717 (1978) ("Although step transaction cases often, perhaps even usually, are concerned with whether a particular step with significant legal or business consequences should be treated as part of a larger single transaction, there are also many cases in which particular steps in an integrated transaction are disregarded as transitory or even empty formalities").

20 As one common example, the courts and the Service have applied the step transaction doctrine to determine whether a post-transfer event results in a failure to satisfy the control requirement of section 351(a). *See, e.g.,* Rev. Rul. 79-70, 1979-1 C.B. 144 (control did not exist when a pre-existing binding contract required the transferor to later sell 40 percent of the stock of the transferee corporation); *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976) (control did not exist where an incorporator irrevocably agreed to transfer 50 percent of the stock he received in exchange for his transfer to an unrelated third party); *S. Klein on Square, Inc. v. Commissioner*, 188 F.2d 127 (2d Cir. 1951), *cert. denied*, 342 U.S. 824 (1951) (affirming the Tax Court's finding that "the series of agreements involved here [were] substantially a single transaction resulting in a new corporation not controlled by the persons making the transfer of the property to the corporation," and thus concluding that the transaction did not qualify for non-recognition treatment). In addition, in cases where there is a binding obligation at the time of the purported section 351 exchange requiring the transferee corporation to issue additional shares, the courts have found that the control requirement is not satisfied. *See, e.g., National Bellas Hess, Inc. v. Commissioner*, 20 T.C. 636 (1953), *aff'd*, 220 F.2d 415 (8th Cir. 1955) (subsequent issuance of stock one year after initial section 351 exchange was a separate transaction from the initial transfer because no binding obligation to issue additional stock existed).

21 *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938), is an early illustration of this use of the step transaction doctrine. In that case, the target corporation in a transaction qualifying as a C reorganization distributed boot to its shareholders, subject to an agreement by the shareholders that they would use the boot so distributed to pay off T creditors. Under the law at the time, a boot received by a target corporation in an asset reorganization was taxable to it, unless distributed by the target to its shareholders pursuant to the plan of reorganization. Viewing the transaction at issue as outside the scope of the boot purging rule, the court applied the step transaction doctrine to recharacterize the transaction as though the target had distributed the boot to the creditors directly.

middle, the intervening stops may be ignored under the step transaction doctrine.[22] While these so-called "devious path"[23] cases represent the clearest case for applying the step transaction doctrine, the doctrine can also apply to recharacterize a multi-step transaction into a different multi-step transaction with an equal number of steps.[24]

Although it has long been one of the cornerstones of corporate income tax law, there is no generally accepted test as to when and how the doctrine should be applied.[25] Rather, the courts and the Service have generally applied three alternative tests.[26] The first, and broadest, alternative is the "end result" test. Under the end result test, a series of transactions may be stepped together or collapsed if they are "really prearranged parts of a single transaction intended from the outset to reach the ultimate result."[27] The second alternative, the "mutual interdependence" test, asks whether the steps in a series of transactions "are so interdependent that the legal relations created by one transaction would be fruitless without the completion of the series."[28] The third, and narrowest, alternative is the "binding commitment" test. Under this test, a series of transactions may be stepped together or collapsed only if, at the time the first step was entered into, there was a binding commitment to undertake the later steps.[29]

Neither the courts nor the Service have clear guidelines for determining which test should apply in a particular situation. Moreover, the boundaries between the tests themselves are not clear, and as a result, they have been applied inconsistently.[30] Consider, for example, *McDonald's of*

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22 *See Smith v. Commissioner*, 78 T.C. 350 (1982).

23 *See Minnesota Tea* at 611 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

24 A classic example of this application of the step transaction doctrine is *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (Jan. 27, 1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951), discussed *infra* in the text surrounding note 39.

25 *See Penrod v. Commissioner*, 88 T.C. 1415 (1987).

26 *See, e.g., Andantech L.L.C. v. Commissioner*, 83 T.C. Memo 1476 (2002); *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520 (7th Cir. 1982); *Cal-Maine Foods, Inc. v. Commissioner*, 93 T.C. 181 (1989).

27 *See Penrod*, 88 T.C. at 1429. *See also King Enterprises, supra* note 16; *South Bay Corp. v. Commissioner*, 345 F2d 698 (2nd Cir. 1965); *Redding v. Commissioner*, 630 F2d 1169 (CA-7); *True v. United States*, 190 F.3d 1165, 1175 (10th Cir. 1999) (holding that the key question is whether the parties intended "to reach a particular result by structuring a series of transactions in a certain way").

28 *See American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1947), *aff'd* 177 F.2d 1235 (5th Cir. 1949).

29 *See Commissioner v. Gordon*, 391 U.S. 83 (1968). Subsequent decisions have confined *Gordon* to its facts. *See Security Indus. Ins. Co. v. Commissioner*, 702 F.2d 1234 (5th Cir. 1983), *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520 (7th Cir. 1982); *King Enterprises, supra* note 16.

30 *See* Stephen Bowen, *The End Result Test*, 72 Taxes 722, 722-23 ("The existence of three step transaction tests implies greater conceptual clarity and distinctiveness than, in fact, exists."); Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions under Section 351*, 11 Va. Tax Rev. 349, 366 (1991-1992) ("Even after selecting the appropriate test for application of the doctrine, the result is not clear. The tests are imprecise, amorphous and susceptible of widely varying application.").

Zion.[31] In that case, McDonald's wanted to acquire various corporations (collectively, the "**target**") owned by a group of individuals (collectively, the "**GS group**"). McDonald's preferred to use its own stock as consideration in order to treat the transaction as a "pooling of interests" for financial accounting purposes. However, the GS group preferred to receive cash. After protracted negotiations, the parties reached a mutually acceptable compromise: the target merged into McDonald's, with the GS group receiving McDonald's unregistered common stock, subject to piggyback and demand registration rights. Six months after the merger, the GS group exercised their piggyback registration rights, and sold nearly all the shares of McDonald's stock received in the merger pursuant to a public offering of McDonald's stock.

McDonald's reported the merger as a taxable asset acquisition and claimed a cost basis for the target's assets, on the theory that the sale deprived the GS group of the continuity of interest necessary for the merger to qualify as a reorganization. The Service, however, determined that the merger qualified as a reorganization, notwithstanding the stock sale. Accordingly, the Service determined that McDonald's was allowed only a carryover basis for the target's assets.

The Tax Court held for the Service. The court acknowledged that, when it was called upon to decide the very same issue nearly thirty years earlier in *Heintz*,[32] it applied the end result test to find a violation of the continuity of interest requirement on account of a post-merger stock sale. This precedent notwithstanding, the Tax Court in *McDonald's of Zion* looked to the purpose and policy underlying the continuity of interest requirement, and concluded that the mutual interdependence test was best suited for determining whether the merger and stock sale should be stepped together. Applying this test, the Tax Court determined that the merger and stock sale were independent transactions for three reasons. First, although the members of the GS group had plainly intended to sell nearly all of the shares of McDonald's stock they received in the merger, they were not under any obligation to do so. Second, the merger was not contingent on the stock sale. Third, during the period between the merger and stock sale, the GS group possessed all of the benefits and burdens of ownership of the McDonald's stock — most significantly, risk of loss and opportunity for gain. Therefore, the court concluded that the step transaction doctrine was inapplicable, and that the merger qualified as a reorganization.

On appeal, the Seventh Circuit reversed the Tax Court. The Seventh Circuit concluded that the merger and the stock sale should be stepped together no matter which test is applied. The end result test was satisfied because the GS group intended to sell their McDonald's stock at the outset of the transactions. And the mutual interdependence test was satisfied because the merger

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31 76 T.C. 972 (1981), *rev'd sub. nom.*, *McDonald's of Illinois, Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982). Other commentators have used this case to illustrate the confused state of the step transaction doctrine. *See* Ginsberg, Levin & Rocap, *Mergers, Acquisitions & Buyouts* ¶608.1 (2012); Jensen at 367-368; Bowen *at* 728-731.

32 25 T.C. 133, 143 (1955) (Although the Tax Court in *Heintz* did not expressly invoke the end result test, the following passage indicates that it relied on an intent-based standard differing markedly from the narrow version of the mutual interdependence test applied in *McDonald's of Zion*: "[t]he parties themselves, in their . . . agreements, characterized the . . . transaction as a sale; and we think this of some help in establishing their intent to divest themselves of their proprietary interest in [the target corporation] and [the acquiring corporation].").

would not have taken place without the "guarantee of salability" afforded by the registration rights. Finally, the spirit, if the not the letter, of the binding commitment test was satisfied because the registration rights made it highly likely that the GS group would promptly sell their McDonald's stock. Accordingly, because continuity of interest was lacking, the Seventh Circuit held that the merger failed to qualify as a reorganization.

McDonald's of Zion points up the confusion that plagues the step transaction doctrine. To begin with, there are three alternative tests for applying the doctrine, but no clear guidelines for determining which test should apply in a particular situation. In *Heintz*, the Tax Court applied the end result test, but when faced with an essentially identical scenario in *McDonald's of Zion*, it applied the mutual interdependence test to reach a different result.

Furthermore, the tests are ambiguous, and therefore can come out differently depending on how broadly or narrowly they are interpreted. For example, the Tax Court tested for mutual interdependence by asking whether the merger would have had economic significance had the GS group been unable to sell their shares of McDonald's stock. Finding that the answer to that question was "yes", it concluded that the merger and stock sale were independent transactions. By contrast, the Seventh Circuit tested for mutual interdependence by asking "whether the merger would have taken place without the guarantees of salability."[33] Finding that the answer to that question was "no", it concluded that the mutual interdependence test was satisfied, and stepped the transactions together. Thus, on the Tax Court's interpretation,[34] the mutual interdependence test focuses on objective facts about the economic consequences of the steps, whereas the Seventh Circuit's interpretation also takes into account subjective considerations.[35]

The Tax Court and the Seventh Circuit interpreted the binding commitment test differently, too. The Tax Court tested for a binding commitment by asking whether there was, at the time of the merger, a legally binding instrument obligating the selling shareholders to sell the stock they received in the mergers. However, the Seventh Circuit concluded that the "spirit" of the binding commitment test was satisfied on the theory that the registration rights received by the GS group effectively rendered a prompt sale of the GS group's McDonald's stock a *fait accompli*.

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33 *McDonald's of Zion*, 688 F.2d at 524.

34 *See also* Rev. Rul. 79-250, 1972-2 C.B. 156 (stating that transactions will be respected as separate if each has independent economic significance, is not subject to attack as a sham, and was undertaken for valid business purposes and not mere tax-avoidance).

35 *See Penrod*, 88 T.C. at 1430 (1987) (characterizing the mutual interdependence test as "a variation of the end result test"). *See also* Ginsberg, Levin & Rocap, *Mergers, Acquisitions & Buyouts* ¶608.1 (2012) (same).

B. The Importance of Substantive Considerations in Determining the Applicability of the Step Transaction Doctrine

The determination of when and how the step transaction doctrine should apply in a particular situation depends not just on the formal relationship between the steps, but also on substantive considerations.[36]

Although this position is rarely expressly stated by the courts or the Service, it is implicit in many cases and rulings. For example, the courts have declined to apply the step transaction doctrine where doing so would be inconsistent with the language and structure of the statutory or regulatory scheme whose application is at issue. A leading example of this principle is *Granite Trust Co. v. United States.*[37] There, the parent owned all of the stock of a subsidiary, whose stock had depreciated. Seeking to recognize its loss, the parent disposed of more than 20 percent of the subsidiary's stock to friendly parties, and then liquidated the subsidiary in a transaction reported as a taxable liquidation. The taxpayer's position was that the dispositions were effective to deprive it of the 80-percent ownership requisite to tax-free treatment under the predecessor to section 332. The Commissioner determined that the transfers should be ignored under the end result test, and thus, that the liquidation was tax-free under the predecessor to section 332.

The First Circuit held for the taxpayer on the basis that the statutory language of the predecessor to section 332 foreclosed application of the end result test. The statute sets forth specific conditions for its application: if the conditions are met, the provision applies; otherwise, not. Moreover, the court found support for this position in the Senate Finance Committee Report, which stated that section 332 had "elective features."[38] Inferring that Congress must have intended for corporations to avoid the predecessor to section 332 by structuring a transaction so as to fail the statutory 80-percent ownership requirement, the court determined that application of the step transaction doctrine to find a tax-free liquidation would frustrate this intention.

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36 *See* Chirelstein and Lopata at 974 (The step transaction doctrine is "dependent for its application on underlying considerations of substantive tax policy or Code structure . . . . [I]t is necessary to go beyond the formal factors that on their face invite the doctrine's application and analyze the substantive considerations at issue in each transaction."); Jensen at 372 (1991-1992) ("Courts have viewed the doctrine as an instrument for perceiving reality, that is, for determining what really took place. The courts typically employ the doctrine to ascertain 'what really happened,' and then apply the relevant legal principles to the facts thus determined. This approach misses the true nature of the step transaction doctrine. Legal doctrines are not, and by their nature cannot be, devices for determining reality. They do not add to our ability to discern the facts. Rather, legal doctrines, including the step transaction doctrine, are means of determining legal consequences. A necessary corollary of this observation is that the proper scope and limits of the doctrine must ultimately be grounded in the policy the law seeks to implement.")

37 238 F.2d 670 (1st Cir. 1956). *See also Falconwood Corp. v. United States*, 422 F.3d 1339 (Fed. Cir. 2005) (finding application of the step transaction doctrine inconsistent with the regulatory scheme of Treas. Reg. § 1.1502-75(d)(2)(ii), which addresses the circumstances under which a consolidated group continues in existence following a downstream reorganization of the common parent into a subsidiary member).

38 H.R. 8300, 83d Cong., 2d Sess. 255 (1954).

The Service has also foregone application of the step transaction doctrine where doing so would violate a clearly articulated tax policy. In this regard, the evolution of the so-called *Kimbell-Diamond* doctrine following the enactment of section 338 is instructive. In *Kimbell-Diamond Milling Co. v. Commissioner*,[39] a purchasing corporation acquired a target corporation for cash. Immediately thereafter and pursuant to a pre-existing plan, the purchasing corporation liquidated the target corporation to obtain its assets. Solely for purposes of determining the purchasing corporation's basis in the assets of the target corporation, the Tax Court stepped together the parent corporation's stock acquisition and liquidation of the target corporation as a direct asset acquisition by the purchasing corporation. The *Kimbell-Diamond* case has become synonymous with the doctrine that an acquisition of stock of a target corporation followed by the pre-planned liquidation of the target corporation should be collapsed and treated as the purchasing corporation's direct acquisition of the target corporation's assets.

In 1982, Congress enacted section 338 "to replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine."[40] The Service has applied the step transaction doctrine in a manner consistent with this policy. For instance, in Rev. Rul. 90-95,[41] situation 2, P, a domestic corporation, formed a wholly owned domestic subsidiary corporation, S, for the sole purpose of acquiring all of the stock of an unrelated domestic target corporation, T, by means of a reverse subsidiary cash merger. Following the merger of S into T, and pursuant to the same plan, T merged upstream into P. The Service ruled that the step transaction doctrine applies to disregard the existence of S because S had no significance apart from P's acquisition of T stock. However, the step transaction doctrine does not apply to treat the upstream merger in situation 2 as an asset purchase. Rather, the transaction will be treated as a qualified stock purchase of T followed by a section 332 liquidation of T into P. As a result, P's basis in T's assets will be the same as the basis of the assets in T's hands. The ruling explains that, even though "the step-transaction doctrine is properly applied to disregard the existence of the [merged subsidiary]," so that the first step is treated as a stock purchase, the acquisition of T's stock is accorded independent significance from the subsequent liquidation of T and, therefore, is treated as a qualified stock purchase regardless of whether a section 338 election is made. The rationale is that treating P as though it directly acquired T's assets would have resulted in treating a stock purchase as an asset purchase, which would be inconsistent with the replacement of the *Kimbell-Diamond* doctrine by section 338.

However, the *Kimbell-Diamond* doctrine continues to have vitality in the corporate reorganization context.[42] The Service has justified the continued application of the *Kimbell-*

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39 14 T.C. 74 (Jan. 27, 1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951).

40 H.R. Conf. Rep. No. 97-760, at 536 (1982), reprinted in 1982 U.S.C.C.A.N. 781, 1310.

41 1990-2 C.B. 67. *See also* Rev. Rul. 2008-25, 2008-1 C.B. 986. *See also* Treas. Reg. § 1.338-3(d) (overturning the result in *Yoc Heating Corp.*, 61 T.C. 168 (1975)). For other examples in which the Service has abstained from applying the step transaction doctrine in order to effectuate a clearly defined tax policy, see Rev. Rul. 98-27 and Rev. Rul. 2003-79, *infra*.

42 *See, e.g.,* Rev. Rul. 2001-46, 2001-2 C.B. 321 (ruling that a reverse subsidiary merger of an acquiring subsidiary into the target corporation followed by the target corporation's upstream merger into the

Diamond doctrine in the context of tax-free transactions on the grounds that "the policy underlying section 338 is not violated" where the acquiring corporation "acquires the assets of [the target] with a carryover basis under section 362, and does not result in a cost basis for those assets under section 1012."[43] As this example illustrates, if the applicability of the step transaction doctrine turns on policy considerations, the same basic transactional formats can be treated differently depending on the Code provisions whose application are at stake.

The authorities discussed above involved situations in which the courts or the Service respected the taxpayer's chosen transactional form because the application of the step transaction doctrine would either contravene policy considerations or do violence to the language and logic of the statutory or regulatory scheme whose application was at stake. The Service has also "called off" the step transaction doctrine in some situations simply on account of the absence of any compelling substantive reason to apply it. In Rev. Rul. 2003-51,[44] W and X were unrelated corporations that wanted to combine their business A operations within a new corporation beneath Y, a holding company wholly owned by X. W and X entered into a legally binding agreement whereby (1) W formed Z by exchanging its business assets for all of the Z stock, (2) W contributed all of the stock of Z to Y, and X contributed cash to Y both in exchange for Y stock; and (3) immediately afterwards, Y contributed the X cash and certain of its assets to Z. The Service ruled that W's initial transfer to Z satisfied the control requirement of section 351(a) even though W subsequently transferred the stock of Z (the transferee corporation) to Y (and W did not end up owning 80 percent of the Y stock). The Service rejected the notion that W's binding commitment to transfer the stock of Z to Y caused W to lose control of Z. The Service acknowledged the existence of authorities holding that the control requirement is not satisfied where, pursuant to a binding agreement entered into by the transferor prior to the transfer of property to the corporation in exchange for stock, the transferor loses control of the corporation by a taxable sale of all or part of that stock to a party who is not a co-transferor. However, these cases, the Service observed, involve transactions that are inconsistent with the purpose of section 351: to facilitate the rearrangement of the transferor's interest in its property. Treating a transfer of property that is followed by a tax-free disposition of the stock received as a section 351 exchange, however, is "not necessarily inconsistent" with the purposes of section 351.

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acquiring corporation should be treated as a merger of the target directly into the acquiring corporation qualifying under section 368(a)(1)(A)); Rev. Rul. 2004-83, 2004-2 C.B. 157 (parent's contribution of target stock to a subsidiary in exchange for the subsidiary's stock followed by the liquidation of the target qualifies as a D reorganization; Rev. Rul. 87-27, 1987-1 C.B. 134 (parent's contribution of target stock to newly formed corporation in exchange for the corporation's stock followed by liquidation of the target qualifies as a reorganization under section 368(a)(1)(F)). Cf. Rev. Rul. 2008-25, 2008-21 C.B. 986 (ruling that if the step transaction doctrine would convert a stock acquisition into a taxable asset acquisition, section 338 requires that the first step (*i.e.*, the qualified stock purchase) be respected for purposes of section 338).

[43] Rev. Rul. 2001-46, 2001-2 C.B. 321.

[44] 2003-1 C.B. 938.

As support for this proposition, the Service pointed to the fact that there was an alternative form of transaction that would have qualified for tax-free treatment.[45] Specifically, if W had transferred its business A assets directly to Y, in exchange for Y stock, as part of a plan that included X's transfer of cash to Y and Y's transfer of the same assets to Z, the successive transfers would have been tax-free.[46] Thus, the Service concluded that the taxpayer's chosen transactional form was consistent with the purpose of section 351 on the ground that there was an economically equivalent transactional form that clearly would have qualified for tax-free treatment. While the Service's emphasis on the role of substantive considerations in determining the applicability of the step transaction doctrine is uncontroversial, its "alternative form of transaction" theory is a novel take on the step transaction doctrine.

III. A BRIEF HISTORY OF THE TAXATION OF CORPORATE SEPARATIONS

The tax law has provided for the tax-free treatment of certain forms of corporate separations since the enactment of the first corporate reorganization provisions in the Revenue Act of 1918 (the "**1918 Act**"). However, the requirements for tax-free treatment have changed markedly during this period. A brief overview of the development of the central statutory provisions illuminates the policies that underlie the various requirements for tax-free treatment.

For much of its early history, the Code taxed the various forms of corporate separations differently. Section 202(b) of the 1918 Act provided for nonrecognition of gain or loss "when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater face or par value." The Revenue Act of 1921 introduced the first definition of the term "reorganization", and accordingly restated this provision to provide for nonrecognition "when in the reorganization of one or more corporations a person receives in place of the any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization." It was generally understood that the foregoing provisions applied to split-ups,[47] but not to spin-offs. The status of split-offs, being a hybrid of the two, was uncertain.[48]

The Revenue Act of 1924 (the "**1924 Act**") brought about two significant changes to the divisive reorganization provisions. First, Congress amended the definition of the term reorganization to include "a transfer by a corporation of all or part of its assets to another corporation if

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45 In this regard, the Service distinguished Rev. Rul. 70-140, 1970-1 C.B. 73 (transfer of assets to the transferor's wholly owned subsidiary followed by an exchange of stock of the wholly owned subsidiary for stock of another corporation was recast as a direct transfer of assets to the unrelated, widely held corporation in a taxable transaction).

46 *See* Rev. Rul. 77-449, 1977-2 C.B. 101.

47 The House report on the Revenue Bill of 1924 gives an example of a split-up as a non-taxable transaction "under the existing law", although there is no case law or administrative guidance to that effect. H.R. Rep. No. 179, 68th Cong. 1st Sess. 14 (1924).

48 *See* Seymour M. Mintz, *Divisive Corporate Reorganizations: Split-Ups and Split-Offs*, 6 Tax. L. Rev. 365 (1950-51) (positing that section 202(b) could have applied to non-pro rata split-offs).

immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred."[49] Second, desiring to place the various forms of corporate separation on equal footing, Congress extended tax-free treatment to spin-offs (and by implication, split-offs) in section 203(c) of the 1924 Act. This provision provided (emphasis added):

> If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to a reorganization, stock or securities in such a corporation or in another corporation a party to the reorganization, *without the surrender by such shareholder of stock or securities in such a corporation*, no gain to the distributee from the receipt of such stock or securities shall be recognized."

The legislative history to the 1924 Act explained that the "spin-off was a common type of reorganization and clearly should be included within the reorganization provision of the statute as long as the exemption under present law is continued."[50]

This provision quickly proved liable to abuse by taxpayers seeking to distribute assets from a corporate solution without incurring a shareholder-level dividend tax. In *Gregory v. Helvering*,[51] the taxpayer, Mrs. Gregory, owned all of the stock of United Mortgage, which, in turn, owned certain securities that she wished to sell. Rather than causing United Mortgage to distribute these securities to her as a taxable dividend, Mrs. Gregory caused United Mortgage to transfer the securities to Averill, a newly formed corporation, in exchange for all of the Averill stock, and then to distribute such stock to her. Mrs. Gregory asserted that the transfer of the securities to Averill, followed by the distribution of the Averill stock, qualified as a divisive reorganization. Three days after receiving the Averill stock, Mrs. Gregory liquidated Averill to get hold of the securities. She reported a capital gain on the liquidation of Averill equal to the difference between the value of the securities and her basis in the Averill stock.

The Board of Tax Appeals held for Mrs. Gregory, based on the fact that the transaction fully complied with the literal language of the reorganization provisions. The Second Circuit[52] and the Supreme Court[53] both reversed the Board of Tax Appeals. The latter based its decision on the theory that the transaction – its compliance with the statutory requirements notwithstanding – was a "mere device" for bailing out Distributing's earnings and profits at capital gains rates, not a genuine business-motivated restructuring as contemplated by the reorganization provisions.

However, these decisions came too late to save the spin-off provisions: in the Revenue Act of 1934, in response to the Board of Tax Appeals' decision, Congress rescinded the tax-free

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49 Section 203(h)(1)(B) (1924).

50 H.R. Rep. No. 179, 68th Cong. 1st. Sess. 14 (1924). *See also* S. Rep. No. 398, 68th Cong., 1st Sess. 15 (1924).

51 27 B.T.A. 223 (1932), *rev'd*, 69 F.2d 809 (1934), *aff'd*, 293 U.S. 465 (1935).

52 *Helvering v. Gregory*, 69 F.2d 809 (2d. Cir. 1934).

53 *Gregory v. Helvering*, 293 U.S. 465 (1935).

treatment formerly accorded spin-offs. Split-offs and split-ups, however, continued to be a viable form of tax-free division, even though both could be used to the same effect as spin-offs.

After a 17-year hiatus, the Revenue Act of 1951 (the "**1951 Act**") reinstated the spin-off form of reorganization. However, to cure the infirmities revealed by *Gregory*, tax-free treatment was made subject to two provisos. First, section 112(b)(11)(A) required that there be an intention for Distributing and Controlled to engage in the active conduct of a trade or business after the spin-off (the "**ATB Requirement**"). Second, section 112(b)(11)(B) required that the spin-off of Controlled must not be "used principally as a device for the distribution of the earnings and profits" (the "**Device Requirement**").

Three years later, Congress enacted the Revenue Act of 1954 (the "**1954 Act**"), which introduced section 355 in substantially its current form. The statute made a number of significant changes to the prior law:

- The 1954 Act eliminated the requirement that the distribution be part of a reorganization. The purpose for this change was to eliminate the need to form a holding company solely to effect a tax-free division of a pre-existing subsidiary.[54]

- The 1954 Act restated the ATB Requirement to require that each of Distributing and Controlled be engaged *immediately after* the distribution in the active conduct of a trade or business.[55] A corporation was treated as engaged in the active conduct of a trade or business if it was so engaged in its own right or, under the so-called holding company test, if substantially all of its assets consisted of stock and securities of a controlled corporation which was so engaged.[56] Furthermore, the 1954 Act added the requirements that the businesses (1) have been actively conducted by Distributing and Controlled for the five-year period preceding the spin-off;[57] (2) not have been acquired in a taxable transaction during the five-year period preceding the spin-off;[58] and (3) not have been held by a corporation that was acquired by Distributing or Controlled in a taxable transaction during the five-year period preceding the spin-off.[59] These provisions were intended to prevent a corporation from bailing out its earnings and profits ("E&P") at capital gains rates.

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54 *See* H. Rep. No. 1337, 83d Cong., 2d Sess. 267 (1954).

55 Prior law did not require that each of Distributing and Controlled be engaged in the active conduct of a trade or business immediately after the reorganization, and regulations issued under Section 112(b)(11) (1939) provided that a transaction could qualify as a divisive reorganization even where Controlled's assets consisted entirely of cash, provided that a "plan" existed whereby Controlled would purchase and conduct an active trade or business. *See* Treas. Reg. 118, § 39.112(b)(11)-2, example (2) (1953).

56 Section 355(b)(3).

57 Section 355(b)(2)(B).

58 Section 355(b)(2)(C).

59 Section 355(b)(2)(D).

- The 1954 Act also added additional safeguards to the Device Requirement. To begin with, the 1954 Act modified the Device Requirement to provide that the entire transaction — and not merely the spin-off itself — would be tested as a device. Furthermore, to backstop the Device Requirement, the 1954 Act added the separate requirement that Distributing distribute either all of the stock of Controlled or an amount of stock constituting control (within the meaning of section 368(c)) (the "**Distribution-of-Control Requirement**").[60]

- Finally, the 1954 Act added the requirement that Distributing be in "control" of Controlled immediately before the spin-off (*i.e*., the Control Requirement).

The object of the foregoing requirements was to prevent the use of spin-offs as a means of converting shareholder-level dividend income into capital gain. However, with the repeal of the *General Utilities* doctrine in the Tax Reform of 1986, the concern became that spin-offs could be improperly used to avoid corporate-level tax on the distribution of appreciated property. In the Revenue Act of 1987, Congress amended section 355(b)(2)(D) to provide that the ATB Requirement will not be satisfied where a corporation acquires control of Distributing in a taxable transaction during the five-year period preceding the spin-off.

Two years later, Congress added section 355(d), which renders certain distributions taxable to Distributing (but not to Distributing's shareholders). In general, section 355(d) applies where a person purchases Distributing stock within five years preceding the distribution, and such stock either (1) represents 50 percent or more of the outstanding Distributing stock after the spin-off, or (2) results in the purchaser receiving 50 percent or more of the outstanding Controlled stock in the spin-off.

The next major development was the enactment of section 355(e) in the Taxpayer Relief Act of 1997 (the "**1997 Act**"). Section 355(e) generally applies to any distribution that is part of a plan (or series of related transactions) pursuant to which one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest, measured by vote *or* value, in either the distributing corporation or any controlled corporation.[61] In enacting section 355(e), Congress believed that section 355 was intended to permit the tax-free division of existing business arrangements among existing shareholders. In Congress's view, a transaction that is part of a plan for new shareholders to acquire ownership of a business in connection with a spin-off "more closely resembles a corporation-level disposition of the business that is sold", and should be taxed accordingly.[62] Thus, section 355(e) is aimed at the type of transaction in which those who

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60 Section 355(a)(1)(D).

61 Section 355(e)(2)(A); see section 355(e)(4), referring to the definition of 50-percent or greater interest in section 355(d)(4).

62 *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (large type edition December 17, 1997) at 198.

were not historic shareholders of a business prior to a corporate separation come to own a sufficiently large portion of the business in connection with the corporate separation.[63]

The most recent significant change to section 355 came with the addition of section 355(b)(3) by the Tax Increase Prevention and Reconciliation Act of 2005, as amended by the Tax Technical Corrections Act of 2007. Section 355(b)(3) generally provides that, in the case of any distribution made after May 17, 2006, a corporation will be treated as being engaged in the conduct of an active trade or business if all members of that corporation's "separate affiliated group" ("**SAG**"), viewed as a single corporation, are engaged in the active conduct of a trade or business.[64] A corporation's SAG means the affiliated group determined under section 1504(a) as if that corporation was the common parent and section 1504(b) was inapplicable. The Service has issued proposed regulations under section 355(b)(3), which interpret section 355(b)(3)(A) as effectively repealing the holding company test of section 355(b).[65]

IV. THE ROLE OF THE STEP TRANSACTION DOCTRINE IN POLICING THE CONTROL REQUIREMENT

A. Background

As discussed in Part II, to determine whether the step transaction doctrine is properly applicable in a given case, it is necessary to examine the policies underlying the Code provision whose application is at stake. Accordingly, Part IV.B reviews the relevant law concerning the Control Requirement with a view to discerning its purpose. With this background in place, Part IV.C posits various case studies based on transactions currently subject to the Control Requirement No-Rule and analyzes whether application of the step transaction doctrine would be appropriate.

B. The Rationale for the Control Requirement

Although the presence of a control requirement is presumably designed to limit tax-free spinoffs (and the like) to divisions of a single corporate enterprise, there is a dearth of authority explaining why control for this purpose is determined under section 368(c), given the anomalies that can arise in measuring section 368(c) control. However, as discussed below, the use of section 368(c) as the measure for control seems attributable to the fact today's tax-free spin-off rules trace their origins to (and are somewhat integrated with) the general reorganization provisions now found in section 368.

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63 In a typical transaction, pursuant to a single plan that includes a spin-off, either Distributing (in a "**Morris Trust transaction**") or Controlled (in a "**Reverse Morris Trust transaction**") would combine with another corporation in a reorganization qualifying under section 368, thereby diluting the historic shareholders' ownership in Distributing or Controlled.

64 Section 355(b)(3).

65 *See* New York State Bar Association, Tax Section, *Report on Proposed Regulations Regarding the Active Trade or Business Requirement under Section 355(b)* (January 11, 2008).

1. Origins of the Control Requirement

Under the provisions of the 1951 Act, it was not possible to accomplish a tax-free spin-off without complying with the requirements of a divisive reorganization. Therefore, where Distributing wished to spin-off a business that was conducted by a pre-existing subsidiary, Distributing would typically transfer the stock of that subsidiary to a holding company, and then spin-off the holding company to its shareholders.[66] This practice did not run afoul of the ATB Requirement, as then in effect, because regulations under section 112(b)(11) permitted Controlled to rely on the business of a subsidiary so long as it owned enough stock to give it effective control over the subsidiary's affairs.[67] Specifically, under the regulations, a corporation could satisfy the ATB Requirement if it:

> . . . indirectly conducts the business through ownership of stock in another corporation actively conducting the business, which other corporation is a subsidiary (whether or not majority-owned) of the corporation, a party to the reorganization. For the purpose of the preceding sentence, a corporation is considered a subsidiary of another corporation if a majority of its voting stock is owned by the other corporation or if a part of its stock (whether or not a majority of its voting stock) is owned by the other corporation under such circumstances that the policies of the first corporation are directed by the second corporation.[68]

Accordingly, under appropriate circumstances, a pre-existing subsidiary — whether or not majority-owned — could be spun off tax-free through the holding company method described above.

The 1954 Act eliminated the need to form a holding company solely to effect a tax-free division by providing Distributing the ability to spin off a pre-existing subsidiary directly. At the same time, Congress added the Control Requirement. Congress also revised the ATB Requirement so that Controlled could satisfy the ATB Requirement indirectly, through ownership of stock in a subsidiary engaged in an active business, only if Controlled owned stock representing section 368(c) control of that subsidiary.[69] This change ensured that Distributing could not spin off a less-than-80-percent owned subsidiary through the holding company method described above. Even after these changes, however, it remained possible to spin off stock of a subsidiary that did not represent section 368(c) control of that subsidiary by contributing the stock to a controlled corporation with a small active business.

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66 *See* Rev. Rul. 54-499, 1954 C.B. 150 (ruling that the spin-off of a 60-percent owned subsidiary qualified under section 112(b)(11)).

67 The regulation is consistent with the legislative history to section 112(b)(11). *See* S. Rep. No. 781, 82d Cong., 1st Sess., Part 1, pp. 57-58 (1951).

68 Reg. 118, 39.112(b)(11)-2(b) (1953).

69 As mentioned in Part III, the old section 355(b)(1) was effectively repealed by the Tax Increase Prevention and Reconciliation Act of 2005, which added section 355(b)(3). Under this provision, a corporation is treated as engaged in an active trade or business if such corporation and its "separate affiliated group", viewed as a single corporation, are engaged in an active trade or business.

2. The Control Test of Section 368(c)

The legislative history to the 1954 Act sheds little light on Congress' reasons for defining control by reference to section 368(c). However, the section 368(c) control test was used in the Code for testing acquisitive reorganizations, which may suggest that Congress believed the standard used to determine whether two corporations should be permitted to combine on a tax-free basis should also be used to determine whether two corporations should be permitted to divide on a tax-free basis.[70]

Congress has moved away from the control test of section 368(c) in other contexts. For example, prior to 1984, the affiliation test of section 1504(a) required ownership of 80 percent of the voting power and 80 percent of each class of nonvoting stock of each includible corporation. In the Deficit Reduction Act of 1984, Congress amended section 1504(a) to require ownership of both 80 percent of the voting power and 80 percent of the value. This amendment was made in response to concerns that, through the use of "creative capital structures," corporations were filing consolidated returns in circumstances in which a parent had little or no interest in the underlying equity value of a subsidiary."[71] However, Congress did not amend section 368(c).

Two years later, in the Tax Reform Act of 1986, Congress amended the ownership requirements to qualify as a tax-free section 332 liquidation and to be eligible to make a section 338 election so that in both cases what was required was the ownership of stock meeting the section 1504(a) tests; before these amendments, both sections had required the ownership of stock meeting the section 368(c) test. Congress again did not amend the section 368(c) definition used for reorganizations and spin-offs.[72]

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70 In 1954, Congress also adopted the section 368(c) standard for consolidation. P.L. 591, 83d Cong., 2d Sess., Amendment No. 263 (1954). In general, under the 1939 Code, two or more corporations were affiliated if one corporation owned at least 95 percent of the voting stock of the others, or if at least 95 percent of the voting stock of two or more corporations were owned by a third corporation. The Report of the Committee on Ways and Means states "[y]our committee has lowered this stock ownership affiliation test to 80 percent. This change will make it possible for a substantially greater number of multicorporate businesses, which in effect operate as economic units, to report their income for tax purposes as a single taxpayer." H.R. No. 1337, 83d Congress, 2d Session, p. 87 (1954).

71 *See* Senate floor amendment to H.R. 2163, 130 Cong. Rec. 8654 (Apr. 11, 1984) ("The law is generally intended to permit two corporations to file a consolidated return if one corporation owns and controls at least 80 percent of the other. Unfortunately, the law, as written, is more generous than that. Taxpayers have been using creative capital structures so as to be eligible for consolidation in situations not appropriate for consolidation and to avoid consolidation in situations when it should not be avoided. Taxpayers have been filing consolidated returns in situations where one owns less than 30 percent in value of the other. As a result, corporations with substantial taxable incomes have been taking advantage of the consolidated return rules to use tax losses of the other corporation. In essence, the former are buying tax losses of the latter.").

72 The Clinton Administration in its Fiscal Year 2000 Budget proposed to conform the definition of "control" contained in section 368(c) to the section 1504(a)(2) ownership test (*i.e.*, ownership of at least 80 percent of the total voting power and at least 80 percent of the value of a corporation's stock). That proposal was not introduced into legislation and has not been made again by the Treasury. General Explanations of the

C. Pre-Spin-off Acquisitions of "Control"

1. Authorities

The Control Requirement (as stated in section 355(a)(1)(A)) requires that Distributing have section 368(c) control of Controlled "immediately before" the spin-off. The Service has generally interpreted this phrase literally, but not without considering the overall context. Thus, the Service has issued several revenue rulings holding that the Control Requirement was satisfied where, in anticipation of a spin-off, Distributing obtained control of Controlled in a tax-free transaction.

An early example is Rev. Rul. 56-117.[73] In that ruling, Distributing owned 100 percent of the common stock and 12 percent of the nonvoting preferred stock of Controlled. Distributing wanted to distribute its Controlled stock to certain of its shareholders in a non-pro rata split-off. In anticipation of the split-off, Controlled recapitalized, issuing new shares of common stock for all of the shares of its nonvoting preferred stock held by shareholders other than Distributing, and thereby Distributing obtained control of Controlled. Distributing then split off Controlled. The ruling concluded that the split-off was tax-free under section 355. The ruling provides no analysis of the Control Requirement, suggesting that the recapitalization was sufficient to bring the split-off into technical compliance with the strictures of the Control Requirement. However, the ruling devotes considerable attention to the question whether the split-off satisfies the ATB Requirement of section 355(b), which, as mentioned, generally requires that immediately after the spin-off, both Distributing and Controlled be engaged in the active conduct of a trade or business that was not acquired in a taxable transaction during that period. Here, the ruling concluded that Controlled satisfies the ATB Requirement. Although Distributing had acquired control of Controlled during the five-year period ending on the date of the split-off, it had done so in a tax-free recapitalization, and thus in a manner permitted by section 355(b).

The Service has disregarded Distributing's acquisition of control where Distributing acquired stock of Controlled from an existing shareholder of Controlled and returned the stock to the shareholder as part of the same overall transaction. In Rev. Rul. 63-260,[74] shareholder *A* and his wholly owned subsidiary, Distributing, directly owned 30 percent and 70 percent, respectively, of the stock Controlled. To facilitate a spin-off of Controlled, *A* contributed 10 percent of its Controlled stock to Distributing such that, in form, Distributing was in control of Controlled. Distributing then distributed to *A* all of its shares of Controlled stock, including the shares it received upon the contribution from *A*. The ruling concludes that the distribution does not qualify under section 355 because "[Distributing] did not have control of [Controlled]

Administration's Revenue Proposals 130 (Feb. 1999). *See* New York State Bar Association, Tax Section, *Report on the Control Test of Section 368(c)*, July 19, 1999.

[73] 1956-1 C.B. 180.

[74] 1963-2 C.B. 147.

immediately before the distribution except in a transitory or illusory sense."[75] The ruling further announces that, "[s]ection 355 cannot be made to apply to a transaction in which an immediately preceding contribution to capital by the distributor corporation's shareholder is made solely to attempt to qualify the transaction as a nontaxable distribution under that section."

By contrast, where Distributing obtains control of Controlled through a transaction that works a meaningful alteration of the pre-existing relationships among Controlled's shareholders, the Service has concluded that the Control Requirement is satisfied. In Rev. Rul. 69-407,[76] Distributing owned 70 percent of the stock of Controlled. In order to facilitate the spin-off of Controlled and to create a class of stock available to Controlled's key employees, Controlled recapitalized its existing stock into two new classes of stock — Class A and Class B — having identical economic rights but different voting rights. In the recapitalization, Distributing exchanged its Controlled stock for Class B stock possessing 80 percent total combined voting power of Controlled's voting stock. Following the recapitalization, Distributing distributed all of the Class B stock to its shareholders on a pro rata basis. The Service concluded that Distributing was in control of Controlled immediately before the spin-off. Although the Service noted that Distributing owned only 70 percent of the stock of Controlled for the greater part of the five-year period before the spin-off, it acquired, by way of the recapitalization, sufficient stock to give it control of Controlled immediately before the spin-off. The Service distinguished Rev. Rul. 63-260 on the ground that the recapitalization "resulted in a permanent realignment of voting control" — that is, after the spin-off, Distributing and the other shareholders of Controlled continued to own 80 percent and 20 percent, respectively, of the total combined voting power of Controlled's voting stock.

In GCM 34122,[77] which sets forth the basis for the Service's conclusion in Rev. Rul. 69-407, the Service acknowledged that Distributing maintained control of Controlled for only a brief period following the recapitalization before such control was divested by the distribution of Controlled stock to *A*. Regardless, the Service found that the proximity of the recapitalization and the subsequent distribution was consistent with Congressional intent:

> The recapitalization of [Controlled] resulted in a bona fide realignment of voting power of [Controlled] sufficient to vest all of the actual ownership of 80 percent of the [Controlled] stock in [Distributing] which is all that section 368(c) requires. The reference to the necessity for control 'immediately before' the distribution coupled with

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[75] In this regard, Rev. Rul. 63-260 is consistent with other rulings in which the legal relations created through a series of steps were transitory and thus without substance. *See, e.g.,* Rev. Rul. 68-602, 1968-2 C.B. 135 (disregarding cancellation of debt owing from a subsidiary to its parent where such cancellation was an integral part of a subsequent liquidation of the subsidiary and had no independent significance other than to secure the tax benefits of the subsidiary's net operating loss carryover); Rev. Rul. 71-364, 1971-2, C.B 181 (disregarding a circular flow of cash).

[76] 1969-2 C.B. 50. The Service has applied a similar standard in the context of acquisitive reorganizations. *See* Rev. Rul. 77-226, 1976-1 C.B. 104 (respecting the target corporation's recapitalization of its nonvoting preferred stock into voting preferred stock so that a subsequent acquisition of the target corporation's common stock could qualify as a B reorganization).

[77] (May 8, 1969).

> the permission granted by sections 355(b)(2)(C) and (D) to acquire in a nontaxable acquisition an active trade or business at any time within the five-year period ending on the date of the distribution indicate that where control is acquired in a nonrecognition transaction Congress was not concerned with the proximity of such an acquisition to the date of the distribution.[78]

In addition, the Service has distinguished Rev. Rul. 63-260 where the transaction by which Distributing obtained control of Controlled was meaningful in its own right, aside from its role in facilitating a subsequent tax-free spin-off of Controlled. For instance, in Rev. Rul. 71-593,[79] Shareholders *A* and *B* each owned 50 percent of the stock of Distributing, and *A* and Distributing owned 25 percent and 75 percent, respectively, of the stock of Controlled. For valid business reasons, *A* and *B* sought to separate the ownership of Distributing and Controlled, with *A* to own all of the stock of Controlled and B to own all of the stock of Distributing. In order to equalize the value of Distributing and Controlled, Distributing transferred assets to Controlled in exchange for additional Controlled stock of equal value, thereby acquiring control of Controlled. Distributing then distributed its entire interest in Controlled to *A* in a non-pro rata split-off. The ruling concluded that Distributing was in control of Controlled immediately before the split-off, and that the split-off qualifies under section 355. The ruling distinguished Rev. Rul. 63-260 on the ground that the transfer of assets was necessary to equalize the value of Distributing and Controlled to facilitate the split-off, and thus "must be viewed as a meaningful exchange and not as an exchange made solely to attempt to qualify the distribution of [Controlled] to *A* as a non-taxable distribution under section 355."

2. Case Studies

Case 1

Facts

Distributing is a widely held, publicly traded corporation and the common parent of an affiliated group of corporations filing a consolidated federal income tax return (the "**Distributing Group**"). Distributing owns 100 percent of the sole class of outstanding stock of Controlled, which is a member of the Distributing Group. The following transactions occur pursuant to a single, integrated plan.

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78 *Id.*

79 1971-2 C.B. 181. *See also*, Rev. Rul. 70-18, 1970-1 C.B. 74 (ruling that Distributing was in control of Controlled immediately before the distribution where Distributing acquired such control upon the tax-free merger, undertaken for valid business purposes, of another commonly controlled corporation into Distributing). *Cf.* Rev. Rul. 57-114, 1957-1 C.B. 122 (reaching a contrary result where Distributing's acquisition of control was transitory).

Step 1: Controlled amends its corporate charter to provide for two authorized classes of stock: Class A and Class B. Each share of Controlled Class A stock is identical to each share of Controlled Class B stock, except that with respect to the election of members of the Controlled Board of Directors, each share of Controlled Class A stock entitles its holder to one vote and each share of Controlled Class B stock entitles its holder to multiple votes. Pursuant to the recapitalization, Distributing surrenders its existing Controlled stock for Controlled Class B stock.

Step 2: Controlled completes an IPO of Controlled Class A stock representing 20 percent of the voting power of all classes of Controlled stock entitled to vote and 45 percent of the value of all classes of Controlled stock. Controlled retains the IPO proceeds.

Step 3: Distributing distributes its Controlled Class B stock to its shareholders in a spin-off intended to qualify as tax-free under section 355.

As of the date of the spin-off, there is no plan or intention to change the capital structure of Controlled following the spin-off.

Analysis

As discussed in Part IV.C.1, a recapitalization that shifts voting power among the shares of a corporation so as to enable a subsequent transaction to qualify for favorable tax treatment generally will be respected if it has some degree of permanence.[80] In general, a shift in voting power will be considered permanent for this purpose if there is no plan to undo the effects of that shift.[81] In Case 1, there is no plan or intention to change the capital structure of Controlled following the spin-off, so the recapitalization should be respected as vesting Distributing with ownership of stock representing 80 percent of the voting power of all classes of Controlled stock entitled to vote. Furthermore, Controlled had no non-voting stock outstanding. Accordingly, Distributing should be in control of Controlled, within the meaning of section 368(c), immediately before the spin-off. Therefore, the spin-off should satisfy the Control Requirement.

This conclusion is unaffected by the fact that, immediately before the spin-off, Distributing owns only 55 percent of the total value of all outstanding Controlled stock. Congress chose the control test of section 368(c) for purposes of section 355, which test has no value component.

Recommendation

For the reasons discussed above, the spin-off in Case 1 complies with the Control Requirement. Accordingly, we recommend that Treasury and the Service remove Case 1 from the No-Rule. Furthermore, because the inclusion of Case 1 in the No-Rule suggests Treasury and the Service

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80 *See* Rev. Rul. 69-407; Rev. Rul. 76-223. *But cf.* Rev. Rul. 63-260.

81 Rev. Rul. 76-223.

have questions regarding the operation of section 368(c) in Case 1, we recommend that guidance be issued confirming its result.

Case 2

Facts

The facts are the same as in Case 1, except that Controlled distributes the IPO proceeds to Distributing immediately after the IPO (the "**Cash Distribution**").

Analysis

For the reasons discussed in Case 1, the spin-off in Case 2 complies with the Control Requirement. Thus, because section 368(c) does not have a value requirement, Distributing is able to shift the voting power among the shares of Controlled stock in a manner that permits it to retain control of Controlled, while effectively monetizing a significant portion of its value.

Note that, together, the IPO and the Cash Distribution leave Distributing in the same economic position as it would have been in had it recapitalized its existing Controlled stock into Controlled Class A stock and Controlled Class B stock, and then sold the Class A stock in a secondary public offering ("**Case 2A**") prior to a spin-off. Yet the federal income tax consequences of Case 2 and Case 2A are materially different. In Case 2, Distributing recognizes no gain (or loss) on its receipt of cash in the Cash Distribution, subject to a basis limitation;[82] in Case 2A, it recognizes gain (or loss) equal to the difference between the amount received and its basis in the Controlled Class A stock. However, the fact that Distributing is able to extract cash from Controlled in a tax-free manner to the extent of Distributing's basis in the Controlled stock is not an issue specific to section 355. For example, such a monetization of Controlled stock may occur even if Distributing does not distribute the Controlled stock to its shareholders. Thus, the fact that the basis recovery transaction occurs in connection with a spin-off does not seem to raise special policy concerns.

Recommendation

As in Case 1, the spin-off in Case 2 complies with the Control Requirement. Accordingly, we recommend that Treasury and the Service remove Case 2 from the No-Rule. Furthermore, because the inclusion of Case 2 in the No-Rule suggests Treasury and the Service have questions

[82] *See* Treas. Reg. § 1.1502-19. This conclusion assumes that the transactions in Case 2A are respected in accordance with their form. *See* Rev. Rul. 68-55; Rev. Rul. 75-447.

regarding the operation of section 368(c) in Case 2, we recommend that guidance be issued confirming its result.

Case 3

Facts

Distributing and unrelated person *X* own 70 percent and 30 percent, respectively, of the sole class of outstanding stock of Controlled. The following transactions are executed pursuant to a single, integrated plan:

<u>Step 1:</u> Controlled amends its corporate charter to provide for two authorized classes of stock: Class A and Class B. Each share of Controlled Class A stock is identical to each share of Controlled Class B stock, except that with respect to the election of members of the Controlled Board of Directors, each share of Controlled Class A stock entitles its holder to one vote and each share of Controlled Class B stock entitles its holder to multiple votes. Pursuant to the recapitalization, Distributing surrenders its existing Controlled stock for Controlled Class B stock representing 80 percent of the voting power of all classes of Controlled stock entitled to vote and 70 percent of the value of all classes of Controlled stock, and *X* surrenders its existing Controlled stock for Controlled Class A stock representing 20 percent of the voting power of all classes of Controlled stock entitled to vote and 30 percent of the value of all classes of Controlled stock.

<u>Step 2:</u> Distributing distributes its Controlled Class B stock to its shareholders in a spin-off intended to qualify for tax-free treatment under section 355.

As of the date of the spin-off, there is no plan or intention to change the capital structure of Controlled following the spin-off.

Analysis

Case 3 raises the question of whether the Control Requirement can be satisfied where Distributing obtains control of Controlled in anticipation of the spin-off. While the capital structure of Controlled resulting from the recapitalization is intended to be permanent, Case 3 raises the question of whether it should be respected for purposes of satisfying the Control Requirement.

On the one hand, Distributing is in control of Controlled “immediately before” spin-off, and thus the spin-off complies with the letter of the Control Requirement. On the other hand, it could be argued that step transaction principles should apply so that, in the case of a series of prearranged transactions undertaken pursuant to a plan to spin off Controlled, the determination of whether the Control Requirement is satisfied would be made immediately before the first step in the series, rather than immediately before the spin-off itself. So viewed, the spin-off in Case 3 would not qualify as tax-free under section 355, because Distributing did not have control of Controlled immediately before the first step in the plan (*i.e.*, the recapitalization) pursuant to which it spun off Controlled. These competing views are discussed below. In order to focus on the relevant substantive considerations, Case 3 presumes that there is an appropriate factual basis for integrating the recapitalization and the spin-off under the step transaction doctrine.

While the "immediately before" language is not, by itself, decisive, the courts have interpreted similar language literally for purposes of other provisions of section 355. For instance, in *Morris Trust v. Commissioner*,[83] the court rejected the Service's contention that Distributing was not engaged in an active trade or business "immediately after" the spin-off as required by the ATB Requirement, because Distributing merged into another corporation in a reorganization following the spin-off. Observing that "the 1954 Code was the product of a careful attempt to codify the judicial limiting principles in a more particularized form," the court noted the contrast between the vague ATB Requirement of the 1951 Act, which required that Distributing and Controlled intend to continue the active conduct of a trade or business, with "section 355(b)'s highly particularized requirements respecting the duration of the active business prior to the reorganization and the methods by which it was acquired."[84] Based on this observation, the court concluded that the phrase "immediately after" should be given its ordinary meaning.

Furthermore, it is clear that Congress intended to allow Distributing and/or Controlled to acquire its active trade or business regardless of the timing of such acquisition, as long as the acquisition is made in a tax-free manner. Sections 355(b)(2)(C) and (D) prohibit taxable acquisitions within five years of the spin-off, but there is no such timing prohibition for tax-free acquisitions. Thus, the permission granted by section 355(b)(2)(D) to acquire, in a tax-free transaction, control of a corporation engaged in an active business at any time during the pre-distribution period belies the notion that the Control Requirement implies a temporal element.

Moreover, suppose that Distributing and *X* own 70 percent and 30 percent, respectively, of the sole class of outstanding stock of Subsidiary. Instead of consummating the transactions described in Case 3, (1) Distributing transfers its Subsidiary stock to newly formed Controlled in exchange for all of the Controlled stock, (2) Subsidiary recapitalizes to give Controlled control, and finally (3) Distributing spins off Controlled. Refer to this as Case 3A. Until the holding company test was effectively repealed in 2007, the spin-off would have satisfied the ATB

83 367 F.2d 794 (4th Cir. 1966). *See also* Rev. Rul. 68-603, 1968-2 C.B. 148 (agreeing to follow *Morris Trust* to the extent it holds that the ATB Requirement is satisfied where Distributing merged into another corporation following the spin-off).

84 *Id.* at 798.

Requirement, and thus would have been tax-free under section 355. In fact, the Service had issued several rulings to this effect.[85]

Case 3A is similar in many respects to Case 3. Therefore, if the Control Requirement and the holding company test of the ATB Requirement serve the same purpose and Controlled's acquisition of control of S is consistent with the policy that underlies the holding company test of the ATB Requirement, then Distributing's acquisition of control in Case 3 is consistent with the policy that underlies the Control Requirement. As GCM 34122 reveals, this is the theory underlying the Service's long-standing position that the Control Requirement can be satisfied where Distributing obtains control of Controlled in anticipation of the spin-off by way of a recapitalization, provided that effects of the recapitalization are real and permanent.

Nonetheless, it is possible that the Service's long-standing position in Rev. Rul. 69-407 is incorrect (and the long-standing Congressional acquiescence of that position is misplaced). In this event, the policy should be reconsidered. One could argue that the reason that Congress originally allowed a spin-off to be tax-free both to Distributing and to Distributing shareholders is that a single *pre-existing* economic unit was being divided, evidenced by the requirement to distribute a controlled subsidiary in the original D reorganization method for doing a spin-off. Although the actual language of the statute directs that the time for testing for control is "immediately before" the spin-off, the use of similar language has not stopped the courts from applying the step transaction doctrine in other contexts. For example, section 351(a) provides that no gain or loss is recognized if one or more persons transfer property to a corporation in exchange for stock, and "immediately after" the exchange the transferor or transferors are in control of the transferee corporation. Yet the courts and the Service have applied step transaction principles to determine whether a post-transfer event results in a failure to satisfy the control requirement.[86]

Moreover, if step transaction principles are not applied in this situation, in an extreme case, the Control Requirement could be viewed as a mere formal requirement and the concept of dividing up a single pre-existing economic unit into two groups becomes irrelevant. At least in theory, no matter how low the initial ownership interest that Distributing has in Controlled, Distributing could acquire control of Controlled, whether by way of a recapitalization or other tax-free transaction, and immediately spin off Controlled without running afoul of the Control Requirement. The Code does not distinguish between a lack of control because of ownership of 79 percent of Controlled stock and a lack of control because of ownership of 10 percent or even

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85 *See* Rev. Rul. 71-593, 1971-2 C.B. 181 (ruling that the ATB Requirement was satisfied where Distributing obtained control of Controlled, by way of a section 351 exchange, in connection with spin-off of Controlled); Rev. Rul. 70-18, 1970-1 C.B. 74 (same, where Distributing obtained control of Controlled by way of a merger).

86 *See* authorities at *note* 20.

1 percent of Controlled stock.[87] This may suggest that Congress was not contemplating a recapitalization undertaken to satisfy the Control Requirement.

Recommendation

The history of the relevant provisions supports the view that the proper time for testing the requisite ownership is immediately before the spin-off. The Treasury and the Service have consistently adhered to this same view for more than four decades and there has been no intervening change in the law that would suggest this view was incorrect or should be reconsidered. Accordingly, we believe Case 3 should satisfy the Control Requirement and should be removed from the No-Rule. Furthermore, because the inclusion of Case 3 in the No-Rule suggests Treasury and the Service have questions regarding the operation of section 368(c) in Case 3, we recommend that guidance be issued confirming its result.

D. Post-Spin-off Transactions Potentially Implicating Control

1. Authorities

Prior to the 1997 Act, the tax consequences of a spin-off which was followed by an acquisition or restructuring of one of the parties thereto depended on whether Distributing or Controlled was the entity involved in the post-spin-off acquisition or restructuring. For example, there was risk that the Service would apply the step transaction doctrine to find a violation of the Control Requirement on an account of a post-spin-off acquisition or restructuring of Controlled;[88] however, this issue did not arise in the case of a post-spin-off acquisition or restructuring of Distributing.

In Rev. Rul. 70-225,[89] Distributing transferred assets to newly formed Controlled in exchange for all of the stock of Controlled, and distributed all of that stock to its shareholders in a transaction which, viewed in isolation, qualified as a divisive D reorganization. Shortly thereafter, and pursuant to the same plan, an unrelated third party acquired all of the Controlled stock in a putative B reorganization. Applying *Court Holding* principles, the Service recharacterized the transaction as a transfer by Distributing of the spun-off assets to the acquiror in exchange for acquiror stock, followed by a distribution by Distributing of the acquiror stock to its shareholders. Neither the deemed transfer of assets to the acquiror nor the deemed distribution of the acquirer stock qualified as tax-free.

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[87] We are not aware of transactions in which such a small amount of stock was recapitalized to satisfy the Control Requirement. Presumably Treasury and the Service could adopt an administrative safe harbor position for an acceptable vote-to-value ratio that would distinguish one case from another.

[88] Rev. Rul. 96-30.

[89] 1970-1 C.B. 80.

By contrast, in Rev. Rul. 75-406,[90] the Service reached a different result where the post-spin-off disposition of Controlled was contingent upon a public shareholder vote. In that ruling, Distributing, whose stock was widely held and actively traded, owned all of the stock of Controlled. In order to comply with a governmental divestiture order, Distributing distributed the stock of Controlled to its shareholders on a pro rata basis. Shortly after the distribution, Controlled's management submitted a plan of reorganization to its shareholders in which Controlled was to be merged into a third corporation, *X*. The shareholders voted to approve the merger, and thereafter, Controlled merged into *X* with Controlled's shareholders receiving 25 percent of the stock of *X*. The ruling concludes that the spin-off qualifies under section 355. The Service indicated that *Court Holding* doctrine (and, more broadly, the step transaction doctrine) was inapplicable because the shareholder's ownership of the Controlled stock, though brief, was nonetheless meaningful, as evidenced by their ability to vote for or against the merger.

More than twenty years later, the Service modified Rev. Rul. 75-406 in Rev. Rul. 96-30.[91] The transactions at issue in the two rulings were essentially identical, except that Rev. Rul. 96-30 provides that no negotiations had occurred between Distributing, Controlled, or *X* regarding the merger prior to the spin-off. It was on this basis that the ruling concluded that the order of the steps should be respected, and thus that the spin-off qualifies under section 355.

i. Section 355(e)

One of the objectives of enacting section 355(e) was to create parity among spin-offs, providing that there should not be additional restrictions on post-distribution acquisitions or restructurings of Controlled if the same restrictions would not apply to post-distribution acquisitions or restructurings of Distributing. In the legislative history to the 1997 Act and the Technical Corrections Act of 1998 (the "**1998 Act**"), Congress indicated that it intended for the Service to administer the Control Requirement in a manner consistent with this objective. Specifically, the Conference Report accompanying the 1997 Act states, in part:

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

90 1975-2 C.B. 125. Cf. Rev. Rul. 70-225, 1970-1 C.B. 80 (applying *Court Holding* principles where Distributing spun off newly formed Controlled, and Controlled was acquired by a third corporation pursuant to a pre-arranged plan).

91 1996-1 C.B. 36.

> impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.[92]

The 1998 Act provided various revisions to the 1997 Act. Among these changes, the 1998 Act amended section 368(a)(2)(H)(ii) to clarify that, as long as the requirements of section 355 are satisfied, for purposes of measuring "control immediately after" a transfer of property to a controlled corporation in a divisive reorganization, the fact that the shareholders of Distributing lose control of Controlled will not be taken into account. Thus, the 1998 Act essentially eliminated the "control-immediately-after-requirement" for divisive D reorganizations.

ii. Post-355(e) Authorities

Based on this legislative history, the Service announced in Rev. Rul. 98-27[93] that it "will not apply Court Holding [*sic*] (or any formulation of the step transaction doctrine) to determine whether the distributed corporation was a controlled corporation immediately before the distribution under section 355(a) solely because of any post-distribution acquisition or restructuring of the distributed corporation, whether prearranged or not." In other words, section 355(e) will police whether the Control Requirement was not met *because of* a post-distribution transaction involving controlled or distributing. However, Rev. Rul. 98-27 then provides, "[i]n otherwise applying the step transaction doctrine, the Service will continue to consider all facts and circumstances. *See, e.g.,* Rev. Rul. 63-260, 1963-2 C.B. 147." In this regard, whether the post-spin-off acquisition or restructuring is subject to an "independent shareholder vote is only one factor to consider."

In Rev. Rul. 2003-79,[94] the Service extended the principles of Rev. Rul. 98-27. In that ruling, Distributing transferred an active business (which comprised less than substantially all of its assets) to newly formed Controlled, and then spun-off Controlled to its shareholders. Then, pursuant to the same plan, an unrelated acquiring corporation acquired all of the assets of Controlled solely in exchange for its voting stock in a transaction that, viewed in isolation, qualified as a C reorganization. The ruling concluded that the acquisition of Controlled qualified as a C reorganization, notwithstanding that the assets acquired comprised less than substantially all of Distributing's historic assets, and thus those assets could not have been acquired by the acquiring corporation directly from Distributing in a C reorganization. To reach this conclusion, the Service respected the transitory existence of Controlled, even though it was, in effect, "born to die."

2. Case Studies

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92 H.R. Rep. No. 105-220, at 529-30 (1997); 1997-4 C.B. 1457, at 1999-2000.

93 1998-1 C.B. 1159.

94 2003-2 C.B. 80.

Cases 4 & 5

Facts for Case 4

The facts are the same as in Case 1 (or Case 2) (that is, Distributing owns 100 percent of Controlled, Controlled then issues stock in an IPO representing 45 percent of the value but 20 percent of the vote and Distributing then spins-off its stock of Controlled), except that shortly after the spin-off, and pursuant to the same plan, the Controlled Board of Directors presents to the Controlled shareholders a proposal to convert the Controlled Class B stock to Controlled Class A stock. This proposal is approved pursuant to a shareholder vote requiring the vote of a majority of both the Controlled Class A stock and the Controlled Class B shareholders. This proposal is the sole matter on which the Controlled Class B Stock actually votes.

Facts for Case 5

The facts are the same as in Case 3 (that is, Distributing owns 70 percent of the single class of Controlled stock, Distributing exchanges its stock for Controlled stock representing 70 percent of the value and 80 percent of the vote and distributes that stock to the public), except that shortly after the spin-off, and pursuant to the same plan, the Controlled Board of Directors presents to the Controlled shareholders a proposal to convert the Controlled Class B stock to Controlled Class A stock. This proposal is approved pursuant to a shareholder vote requiring the vote of a majority of both the Controlled Class A stock and the Controlled Class B shareholders. This proposal is the sole matter on which the Controlled Class B Stock votes.

Analysis of Case 4

Control Requirement Policy

In Case 4, as in Cases 1 and 2, Controlled implements a dual-class voting structure that permits Distributing to retain control of Controlled following the IPO. The policy underlying the Control Requirement is to limit tax-free treatment under section 355 to transactions that result in the separation of what are, in effect, divisions of a single corporation. Does Case 4 offend this policy?

On the one hand, Distributing owned all of the issued and outstanding Controlled stock before the plan to undertake the transactions in Case 4 arose. Further, while the IPO reduced Distributing's ownership of Controlled, Distributing continued to own stock possessing more than 80 percent of the voting power of all classes of Controlled stock entitled to vote until the spin-off. Thus, if one approaches the matter from the perspective that Distributing and Controlled historically comprised a single corporate enterprise for purposes of the Control Requirement, the relevant question to ask in determining whether Case 4 offends the policy underlying the Control Requirement is whether the post-spin-off recapitalization, in effect, nullified the historic relationship immediately prior to the spin-off in a manner that should render section 355 unavailable. Clearly, if Controlled's dual-class voting structure was "old and cold," a post-spin-off recapitalization would not cause the spin-off to flunk the Control Requirement.

On the other hand, framing the question in this manner arguably assumes the very point under debate — namely, whether Distributing should be treated as owning a controlling interest in Controlled immediately before the spin-off. The issue arises because the control test is only satisfied by respecting the high-vote nature of the stock held by Distributing that became high-vote as part of the plan for the spin-off and that, assuming the shareholder vote is successful, will become low-vote stock (and not represent an 80 percent controlling interest) after the spin-off as part of the same plan.

Section 355(e) Policy

As discussed above, one of the reasons for enacting section 355(e) was to ensure that a spin-off which is followed by an acquisition or disposition of Controlled is treated in the same manner as a spin-off which is followed by an acquisition or disposition of Distributing. In the legislative history to the 1997 Act, Congress indicated that it intended for the Control Requirement to be applied in a manner consistent with this objective. Specifically, the Conference Report accompanying the 1997 Act states, in part, that the Control Requirement "is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80-percent controlled subsidiary, but would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation."[95]

This legislative history indicates that there are circumstances in which Congress intended to allow Controlled to undergo a post-spin-off acquisition or restructuring without disqualifying the prior spin-off as tax-free under section 355. However, the scope of this allowance is not entirely clear.

Under one view, this legislative history establishes that Congress intended for section 355(e) to be the appropriate rule of law to apply to a pre-arranged post-spin-off restructuring and acquisition of Controlled — at least where Distributing has been in control of Controlled before adopting the plan to undertake the spin-off. Under this view, the recapitalization was undertaken merely to permit Distributing to *retain* control of Controlled following the IPO, and therefore, should not be disregarded on account of the post-spin-off recapitalization.

The conclusion rests on two premises. First, applying the step transaction doctrine to find a violation of the Control Requirement would have the effect of subjecting a post-spin-off recapitalization of Controlled to different, more stringent requirements than a post-spin-off recapitalization of Distributing. This result arguably is inconsistent with Congress' intention to create parity among spin-off transactions.

Second, not applying the step transaction doctrine comports with Congress' intention that the Control Requirement be administered "in a manner that prevent[s] the tax-free spin-off of a less-than-80-percent controlled subsidiary" because Distributing has historically been in control of Controlled in Case 4. On this view the legislative history strives only to prevent a tax-free spin-

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95 H.R. Rep. No. 105-220, at 529-30 (1997); 1997-4 C.B. 1457, at 1999-2000.

off where the *relationship* between Distributing and Controlled is transitory and illusory. As discussed above, if one approaches the issue from this perspective, the relevant question to ask in determining whether Case 4 offends the policy underlying the Control Requirement is whether the post-spin-off recapitalization, in effect, nullified this relationship.

However, the legislative history of Section 355(e) could be read more narrowly. It could be argued that the legislative history reveals Congress' intent that the step transaction doctrine not be applied to find a violation of the Control Requirement *solely* on account of a post-spin-off transaction (even pursuant to a pre-spin-off binding contract) involving Controlled. The legislative history quoted above states that section 355(e) was not intended to change the Control Requirement of current law, and nothing in the legislative history suggests that Congress intended to validate a pre-spin-off transaction arguably affecting "control" the effects of which are unwound by way of a post-spin-off transaction involving Controlled. Moreover, reliance on the historic relationship between Distributing and Controlled may be misplaced where the Controlled Class B stock (which is issued in connection with the spin-off) — not the historic stock — gives Distributing the requisite control of Controlled.[96]

Moreover, it may not be correct to say that a post-spin-off recapitalization of Controlled generally should be permissible because section 355(e) provides that Controlled should not be subject to more stringent requirements than Distributing. This view would assert that Congress did not intend that the comparable results generally intended for a spin-off of Distributing and Controlled would go so far as to allow the avoidance of a fundamental requirement (the Control Requirement) that only applies to Controlled. In addition, there is no evidence that Congress intended section 355(e) to preempt the Control Requirement. Section 355(e) does not affect whether the spin-off is tax-free to the shareholders of Distributing, and there is no indication that Congress intended that shareholders should receive tax-free treatment when application of the step transaction doctrine would cause the Control Requirement to be violated.

However, this narrow reading of the legislative history to section 355(e) arguably loses its force when considered in light of the basic transaction that section 355(e) was intended to address — that is, where immediately after a spin-off but pursuant to a binding agreement entered into prior to the spin-off, Controlled merges with another company in a transaction which, if effected prior to the spin-off, would have caused Controlled to have violated the control requirement. Like the recapitalization at issue in Case 4, this transaction involves steps undertaken prior to the spin-off (*i.e.*, the execution of the merger agreement) and the same section 355 control issues.

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[96] The same business result could be achieved if the voting power of the Distributing stock in Controlled is not changed in the primary offering by Controlled, Controlled issues low-vote stock to the public, Distributing spins off its stock of Controlled and, after the spin-off, the stock issued to the public is recapitalized into the class of stock that was held by Distributing and spun-off. In that case, the step transaction issue is whether the low-vote stock issued by Controlled in contemplation of the spin-off should be treated as high-vote stock even before the spin-off (thus depriving Distributing of control) in light of the plan to convert it into high-vote stock after the spin-off.

Similarly, suppose the facts are the same is in Case 4, except that, after the spin-off, instead of recapitalizing to achieve a single class of voting stock, Controlled combines, pursuant to a plan, with another, unrelated corporation at a price reflecting a premium for the anticipated trading value of Controlled shares (*i.e.*, a Reverse Morris Trust transaction) and the Controlled shareholders receive shares of the surviving corporation with identical voting rights. Based on the legislative history described above, it would seem difficult to conclude that this transaction should fail the Control Requirement unless the acquiring corporation modifies its capital structure to allow for the issuance of high-vote stock to the Controlled shareholders. It is difficult to see a basis for distinguishing these cases based on the form of the post-spin-off transaction. In fact, in the case of a Reverse Morris Trust transaction, because the shareholder vote to approve the post-spin-off combination is made at the same time as the vote to approve the spin-off itself, the transactions appear to be more clearly part of a single plan.

On the other hand, even though the classic Reverse Morris Trust transaction (not involving a pre-spin IPO or recapitalization) involved a binding contract before the spin-off, there was no underlying event that occurred before the spin that could be stepped together with a post-spin transaction to defeat the Control Requirement before the spin. As a result, the support for Reverse Morris Trust transactions intended by section 355(e) arguably does not mean that section 355(e) was intended to validate Case 4. Moreover, if the IPO and spin-off in Case 4 was followed by a Reverse Morris Trust transaction rather than a post-spin recapitalization, it could be argued (just as can be argued for Case 4 itself) that the relatively low voting power of the stock issued in the IPO is transitory and should be disregarded because it is soon to be converted into stock of the unrelated corporation that all has a single vote per share.

Application of Traditional Step Transaction Principles

As discussed in Part II, the step transaction doctrine should be considered only where there is an appropriate factual basis for recharacterizing Case 4 under the traditional step transaction tests.

The facts indicate that Controlled's board of directors intended that, following the spin-off, they would submit to a shareholder vote a proposal to convert the dual-class voting structure adopted in the pre-spin-off recapitalization into a single-class structure. So Case 4 clearly would be vulnerable under the end result test. Nevertheless, one could question whether it is appropriate to apply the end result test to the exclusion of the other step transaction tests in these circumstances. While neither the Service nor the courts have articulated clear standards for determining which step transaction test to apply in a given case, the Service has suggested that it will respect formally separate steps undertaken pursuant to the single, integrated plan so long as each of the steps is meaningful in its own right and does not depend on the other steps for its substantiation.[97] In other words, one could argue that a series of steps linked by a common plan

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[97] *See, e.g.,* Rev. Rul. 79-250, 1979-2 C.B. 156 ("the substance of each of a series of steps will be recognized and the step-transaction doctrine will not apply, if each such step demonstrates independent economic significance, is not subject to attack as a sham, and was undertaken for valid business purposes and not mere avoidance of taxes"); Rev. Rul. 78-330, 1978-2 C.B. 40 (respecting the cancellation of a debt owed by a parent to a subsidiary as separate from a subsequent, in order to avoid the application of section

or intention should not be integrated or recharacterized on step transaction principles unless they are mutually interdependent.

If this view is correct, the question is: does the fact that the pre-spin-off recapitalization and post-spin-off recapitalization were separated by a shareholder vote establish that the two steps were independent?

As discussed in Part II, the concept of mutual interdependence is ambiguous. Some courts, such as the Seventh Circuit in *McDonald's of Zion*, have tested for mutual interdependence by asking whether the parties to a series of transactions would have undertaken a particular step except in contemplation of completing the series. But others, such as the Tax Court in *McDonald's of Zion*, ignore the parties' intentions, and focus mainly on whether the individual steps would have had meaningful economic consequences had the series not been completed. On this narrow interpretation, individual steps will be respected if they have independent economic significance.

Under the broad interpretation of the mutual interdependence test, the outcome of Case 4 depends on the relevant facts and circumstances. In some cases in which there is a pre-spin-off recapitalization (or issuance of low vote stock), the adoption of the dual-class voting structure creates a potential for illiquidity in the high-vote shares, less liquidity in the low-vote shares, and difficulty for Controlled to be included in one or more equity indexes. Accordingly, a post-spin recapitalization into a single class of stock is anticipated. In these cases, the broad interpretation of the mutual interdependence test would be satisfied.[98] In other cases, though, where the spin-off would be effected even in the absence of assurance of a shareholder vote, for example in an internal spin-off, the mutual interdependence test would not be satisfied.

If the narrow interpretation of the mutual interdependence test is applied, the determination of whether the post-spin-off recapitalization in Case 4 is mutually interdependent with the steps preceding it depends chiefly on the significance of the public shareholder vote. In Rev. Rul. 75-406, the Service indicated that a public shareholder vote is a factor to be accorded considerable weight. In that ruling, the Service ruled that separating the spin-off and subsequent acquisition of Controlled by a public shareholder vote was sufficient to stave off a recharacterization under the *Court Holding* doctrine. There, the distributee-shareholders' ownership of Controlled stock was "real and meaningful," the Service reasoned, because the shareholder vote offered them an opportunity to reject the acquisition. By analogy, in Case 4, the question would be whether the shareholder vote was "real and meaningful" because the shareholders of Distributing had the opportunity to vote to retain the dual-class voting structure. If so, the disproportion in the voting

357(c), in anticipation of a prearranged merger of the debtor subsidiary into another subsidiary); *McDonald's of Zion*.

98 We note that it is common in Reverse Morris Trust transactions for the shareholder vote for the acquisition to occur prior to the spin-off, in which case it is clearly a foregone conclusion that the post-spin-off reorganization will occur.

rights between the various classes of Controlled stock would be respected under the mutual interdependence test, even though hindsight shows that it was short-term.[99]

On the other hand, one might attempt to distinguish Rev. Rul. 75-406 on the basis that a shareholder vote is less meaningful here than it is in the context of a Reverse Morris Trust transaction.[100] The combination of one corporation with another, unrelated corporation can be among the most significant events in the lifecycle of a corporation and whether the shareholders will approve it may be subject to uncertainty. By contrast, a recapitalization like that in Case 4 may be argued to be a less consequential event or the outcome of the vote may be considered virtually certain: although the holders of the Class A stock must surrender their disproportionate voting rights in Controlled, they continue to hold shares representing the economics of the same corporation, and by giving up the high vote they are making those shares more liquid. In addition, surrendering high-vote stock arguably may have a negligible impact on the actual voting influence of any one shareholder because, regardless of the disproportionate voting rights, it is unlikely that a single holder could exercise the pivotal vote in any shareholder vote taken by a widely held public company. Moreover, this cost is often outweighed by the benefits of recapitalizing into a single class of stock (*e.g.*, eliminating disparities in the trading price between the Class A and Class B stock). Consequently, in Case 4, a favorable shareholder vote may be anticipated. However, there may be instances in which the surrender of high-vote stock entails a real economic cost. For example, the disproportionate voting rights may attract a premium in a tender offer from a party seeking to acquire effective control of Controlled and the high-vote shareholder could be relinquishing this potential benefit by voting in favor of a post-spin-off recapitalization.[101]

The fact that the outcome of a shareholder vote (as well as the holding of the vote) may have been highly likely is not, by itself, sufficient to establish that the narrow interpretation of the mutual interdependence test is satisfied. Rather, in cases in which there is a pre-spin-off recapitalization (or issuance of low vote stock), the relevant question is whether the benefits of

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99 Case 3 posits that the sole matter on which the holders of Class A stock voted was the proposal to convert the dual-class voting structure into a single class structure. However, there may be a stronger case for respecting the post-spin-off recapitalization as separate from the steps that preceded it on different facts. For example, if the holders of Class A stock participated in at least one election of Controlled's directors, a stronger argument could be made that the steps have independent significance, and thus would satisfy the mutual interdependence test.

100 We note that a shareholder vote alone may not preclude the application of the step transaction doctrine when assessing other provisions of subchapter C, including other spin-off requirements. For example, if pursuant to the plan there is a shareholder vote for Distributing to be acquired, the Device Requirement could be violated, or section 355(e) could apply. As an additional example, a purchase of target corporation stock by the acquiring corporation prior to and in connection with a shareholder vote to acquire the remainder of the target corporation stock for acquiring voting stock could violate the "solely for voting stock" requirement for a reorganization described in section 368(a)(1)(B).

101 Where there is a significant shareholder, it is more common for such a recapitalization to entail a real economic cost. The application of the step transaction doctrine should not be dependent upon an inquiry into the particulars of the shareholder group and the potential for economic benefits associated with the voting power. A shareholder vote has been respected in the tax law as a general matter, without inquiry into voting history and economic relevance.

recapitalizing into a single class of stock were substantial enough to warrant the inference that the post-spin-off recapitalization was economically compelled. Again, whether this standard is met will depend on all of the relevant facts and circumstances.

While Treasury and the Service study Case 4, we recommend safe harbors be provided that may be relied upon by taxpayers without necessitating a private letter ruling or supplemental submission. Specifically, under the facts of Case 4, if a taxpayer's shareholders exercise their high-vote franchise for a number of times to be specified in the safe harbor (which could be once or multiple times) or the taxpayer maintains a dual voting structure for a specified period of time,[102] a subsequent recapitalization may be undertaken, even if planned at the time of the pre-spin-off recapitalization (the "**Separate Recapitalization Safe Harbor**"). The passage of time or intervening exercise of voting power suggests the transactions should not be combined under the step transaction doctrine. Further, if Controlled has a historic capital structure with high-vote and low-vote stock, as opposed to undertaking a recapitalization to put such a structure in place prior to and in connection with the spin-off, we recommend Treasury and the Service adopt a parallel safe harbor. Specifically, if the pre-spin-off capital structure has been in place for a specified period of time or Controlled's shareholders exercise their voting power for a specified number of times, Controlled should be able to undertake a post-spin-off recapitalization, even if planned at the time of the spin-off (the "**Historic Capital Structure Safe Harbor**").

Analysis of Case 5

Assuming that the Control Requirement can be satisfied where Distributing obtains control of Controlled in anticipation of the spin-off, the issue remains as to whether the step transaction doctrine should be applied in Case 5 to disregard the recapitalization into control when it is followed, after the spin-off, by a second recapitalization that reverses the effects of the first recapitalization. In this regard, Case 5 resembles Case 4.

However, Case 4 and Case 5 implicate different policy and Code structure considerations. To begin with, in determining whether to apply the step transaction doctrine to find a violation of the Control Requirement in Case 4, it was argued that application of the step transaction doctrine would not advance the policy underlying the Control Requirement because, there, Distributing had long had control of Controlled and maintained control until the spin-off. By contrast, in Case 5, Distributing obtained control pursuant to a plan to spin-off Controlled, raising the step transaction issue discussed in Case 4. Further, it could be argued that Case 5 violates the Control Requirement under general step transaction principles.

Further, in Case 4, it was argued that, based on the legislative history to section 355(e), the post-spin-off recapitalization should not affect the satisfaction of the Control Requirement. It is not clear that this legislative history is pertinent in Case 5. As mentioned above, the legislative history reveals that, in enacting section 355(e), Congress sought to eliminate the differential

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[102] We note that for purposes of section 355(e), there should be an acquisition in Case 5 measured by comparing the voting stock after the first recapitalization into control to the voting stock after the second recapitalization. We do not believe it is appropriate to measure the change in voting stock by looking merely to the net change from the two recapitalizations.

treatment of post-spin-off transactions involving Distributing and post-spin-off transactions involving Controlled. However, the legislative history indicates that it nonetheless expected that step transaction doctrine would apply in its usual manner to prevent the spin-off of a non-controlled subsidiary, and this could include a situation in which Distributing obtains control of Controlled in anticipation of the spin-off and, pursuant to the same plan, the effects of that transaction were transitory or illusory. On the other hand, the transaction can be argued to be neither transitory nor illusory because a post-spin-off shareholder vote by each class of shares is required in order for the classes to become one. In this sense, Case 5 is distinguishable from the transitory and illusory fact pattern in Rev. Rul. 63-260, where the contribution of Controlled stock by its shareholder, A, to Distributing had to occur to allow for the distribution of Controlled back to A. In Case 5, while a vote in favor of a post-spin-off recapitalization may be anticipated, the spin-off has occurred regardless of whether the later vote to recapitalize materializes. On the other hand, as in Case 4, to the extent that section 355(e) is being relied on in Case 5 to override general step transaction principles, it is difficult to see why Case 5 would not be permissible even if, immediately after the spin-off, there would be an automatic recapitalization of Controlled stock into a single class of stock without the need for a shareholder vote.

We note, however, as in Case 4, a conclusion that section 355(e) does not protect Case 5 would have broader implications. For example, suppose the facts are the same as those in Case 5, except that, after the spin-off, instead of recapitalizing, Controlled combines with another, unrelated corporation in a Reverse Morris Trust transaction, pursuant to which Controlled shareholders will realize a premium value in excess of what Controlled stock would be expected to trade at and will receive shares of the surviving corporation with identical voting rights. Moreover, Distributing could in the alternative transfer stock of Controlled in Case 5 to a new holding company along with an active business that is relatively modest in size and distribute the holding company in the spin-off, obviating the need for recapitalizing the stock of Controlled before or after the spin-off. Unless the Treasury and the Service believe these transactions do not or should not work, the ability to distribute Controlled without the recapitalization suggests the application of the step transaction doctrine in Case 5 has little to protect.

Recommendation

As discussed above, we do not believe that Case 3 presents a policy issue because Controlled has no plan or intention to recapitalize its dual-class voting structure. Where this is a plan to undertake the post-spin recapitalization like in Case 5, however, competing policies are implicated, creating a more difficult question. While the same points regarding the separate shareholder vote that were made in Case 4 may be made in Case 5, the two cases may be viewed differently under the lens of the policies of the Control Requirement and section 355(e). We suggest Treasury and the Service consider providing some form of the Separate Recapitalization Safe Harbor and the Historic Capital Structure Safe Harbor as discussed in Case 4, although a longer specified period might be appropriate in Case 5.

V. THE ROLE OF THE STEP TRANSACTION DOCTRINE IN CHARACTERIZING NORTH-SOUTH TRANSACTIONS IN THE SPIN-OFF CONTEXT

The term "north-south" traditionally refers to a scenario in which a shareholder contributes property to a corporation and the corporation distributes property to the shareholder as part of the same plan. Every north-south transaction raises the same question: should the component transactions be respected as a separate contribution and distribution or should they be recharacterized as legs of a unitary sale or exchange?

The north-south issue arises in a range of transactional contexts and, while the characterization question is the same, the stakes and issues presented are often markedly different. The examples below illustrate common north-south fact patterns and how the stakes vary depending on the Code provisions whose application is at issue.

Reorganization of businesses in connection with a spin-off: P is directly engaged in Businesses A and B. P owns all of the stock of SA, which is directly engaged in Business A, and SA owns all of the stock of SB, which is directly engaged in Business B. Pursuant to a plan to separate Businesses A and B, (1) Parent contributes its Business A assets to SA; (2) SA distributes all of the SB stock to P; and (3) P distributes all of the SA stock to its shareholders in a transaction qualifying under section 355.

Is the distribution of the SB stock to P a tax-free distribution under section 355? Or is the distribution of SB treated as in exchange for Parent's contribution of Business A assets to SA, resulting in a taxable exchange under section 1001 in whole or in part?

Incorporation of business in connection with a financing transaction: X, an individual, wishes to incorporate her sole proprietorship. Pursuant to a plan, (1) X transfers the assets of the sole proprietorship to a new corporation, N, in exchange for all of N's stock; and (2) X loans money to N in exchange for a note.

Is X treated as engaging in a section 351 exchange of her assets for N stock and a separate lending transaction? Or is X treated as exchanging her assets and the cash for N stock and the note, with gain recognized under section 351(b)?[103]

Cash distributed in connection with stock transfer: USP owns all of the stock of FS1 and FS2, both of which are controlled foreign corporations[104] for US federal income tax purposes. FS1

[103] *See, e.g., Sylvan Makover*, T.C. Memo 1967- 53 (where a partnership transferred all of its business assets to a newly formed corporation in exchange for all of the stock of the corporation and the partnership loaned the corporation cash in exchange for a demand note; the court found no factual basis for applying the mutual interdependence test to integrate the transactions); *H.B. Zachry*, 49 T.C. 73 (1967) (where a parent corporation transferred property to a corporation in exchange for stock of a subsidiary and the subsidiary purchased preferred stock from the parent corporation; the court found each transaction had a separate business purpose and did not integrate them).

[104] Section 959(a).

has E&P; FS2 does not. Pursuant to a plan, (1) FS2 distributes cash to USP; and (2) USP transfers all of the FS1 stock to FS2 in a transaction described in section 351.

Is FS2 treated as making a section 301 distribution to USP that is separate from the transfer of FS1 stock to FS2 in a section 351/B reorganization exchange? Or is the cash distribution made in exchange for the FS1 stock, resulting in the application of section 304?[105]

In all three examples, a shareholder contributes property to a corporation pursuant to a plan whereby the corporation transfers different property to the same shareholder. Should all examples be treated alike, with the step transaction doctrine applying to all three examples or to none?

As discussed in Part II, substantive considerations should determine when and how the step transaction doctrine applies in a given context. Rather than making comprehensive recommendations regarding how to analyze north-south transactions in all contexts, the Report focuses on the issues we believe are of most immediate concern to taxpayers, and makes recommendations only for cases in which the north-south transaction takes place in the context where the "north" transaction is a spin-off.[106] In connection with a corporate separation, it is common for Distributing's shareholder ("**Parent**") to contribute property to Distributing. The reasons for the contributions vary: in some cases, it is to align the assets and operations of

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[105] *See, e.g.,* Rev. Rul. 80-239, 1980-2 CB 103. In Rev. Rul. 80-239, an individual ("**A**") owned all of the stock of corporation ("**Opco**"), which was engaged in a profitable manufacturing business. Over the years, Opco had accumulated substantial earnings and profits but had never paid a dividend. A, seeking to bail out the E&P of Opco at favorable gains rates, formed a new holding company ("**Holdco**"), and transferred his Opco stock to Holdco for all of the outstanding stock of Holdco and $100,000 in cash, which Holdco had obtained by borrowing against the Opco stock to be received in the exchange. Holdco subsequently repaid the loan with funds provided by Opco. The Service ruled that the $100,000 cash was a disguised dividend distribution from Opco to A, taxable as ordinary income to the extent of Opco's E&P. The Service stated that Holdco was a "mere conduit" for the distribution of a dividend from Opco to A. *See also*, TAM 200036002 (Nov. 16, 1999) (the end result test should be applied to determine whether a cash distribution should be respected as a post-transfer distribution or recast as boot in the prior section 351 exchange. Note, however, there is no published authority or guidance taking a similar view, and the authority upon which the TAM relies does not support the position it asserts); Treas. Reg. § 1.301-1(b) provides that a distribution is includible in income when the property is made unqualifiedly subject to demands of the shareholder. Consistent with this, Rev. Rul. 80-154, 1980-1 C.B. 68, indicates that a dividend made freely available to a recipient should be respected notwithstanding the subsequent contribution back to the distributing corporation for more shares. On the other hand, see CCM 201334037 (April 3, 2013), where a cash payment of interest from a US subsidiary to its foreign parent was integrated with a subsequent new loan from the parent to the subsidiary, even though the subsidiary did not need the new loan in order to pay the interest. Courts have concluded that corporations are free to choose the timing of their distributions to shareholders even if they are timed to provide a tax benefit. For example, in *Falkoff v. Commissioner*, 604 F.2d 1045, the Service unsuccessfully attempted to "shift" a corporation's distribution of cash to its sole shareholder to a subsequent tax year by arguing that the distribution and subsequent steps all occurred pursuant to a single integrated plan. Based primarily on the annual tax accounting concept, the court refused to shift the distribution made in the first tax year to a subsequent tax year when earnings and profits arose.

[106] If the Treasury and the Service would like the Tax Section to analyze north-south transactions in other contexts, we would be happy to do so.

Parent's businesses so as to facilitate a separation; in others, to enable Distributing to satisfy the ATB Requirement. In any case, the issue is whether the contribution should be treated as exchanged for the distribution of Controlled to Parent. Thus, if the step transaction doctrine is applied to recharacterize the two transfers between Parent and Distributing as an exchange, there may be a taxable event in connection with an otherwise wholly tax-free spin-off. Moreover, if the value of the contributed assets exceeds 20 percent of the value of Controlled, application of the step transaction doctrine could render the spin-off wholly taxable, for failure to satisfy the Distribution-of-Control Requirement.

There are authorities that apply the step transaction doctrine to collapse transactions in north-south situations as well as authorities that respect the taxpayer's form. It is difficult to distill an overriding principle that can be applied in all contexts that raise these difficult north-south issues, in part because the various contexts involve different policies that must be examined. For example, in assessing the role of the step transaction doctrine where cash is issued to the transferor in connection with a section 351 transaction, section 304 and section 357(c) policies must be considered. Such policies are not relevant however, in assessing a north-south transaction in which the north transaction is a distribution of Controlled stock. The approach advocated throughout this Report — that the applicability of the step transaction doctrine depends on substantive considerations — implies that transactions that display the same formal characteristics need not be treated identically.[107] Thus, authorities addressing other Code provisions and policies should not be viewed as determinative of the scope of the step transaction doctrine in the context of north-south transactions in the spin-off context.

Part V.A discusses the scant authorities and policies at issue in analyzing north-south transactions that arise in spin-off transactions. Part V.B posits various case studies based on transactions currently subject to the North-South No-Rule, and considers whether application of the step transaction doctrine would be appropriate.

A. North-South Transactions where the North Transaction is a Spin-off — Authorities and Policies

1. Cases and Published Guidance

There is no case law or published guidance addressing the proper characterization of north-south transactions in the context of corporate separations. However, certain courts have held that a transaction structured as an integrated exchange should be disaggregated into a section 355 distribution and capital contribution.[108]

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[107] *See* Chirelstein & Lopata, *supra* note 15, at 979.

[108] In *Commissioner v. Baan*, 382 F.2d 485 (9th Cir. 1967) and *Commissioner v. Gordon*, 382 F.2d 499 (2d Cir. 1967). (collectively, the "**Baan-Gordon cases**"), Pacific Telephone & Telegraph ("**Pacific**") transferred its non-California-based telephone business and cash to a newly formed subsidiary ("**Northwest**") in exchange for all of the stock of Northwest and a note. On September 29, 1961, Pacific distributed to its

2. Historic IRS Standard

Prior to the issuance of Rev. Proc. 2013-3, the Service regularly issued private letter rulings in which it respected north-south transactions between Parent and Distributing as separate transactions rather than as an exchange where the taxpayer represented that there was "no regulatory, legal, contractual or economic compulsion or requirement" that Parent make all or part of the contribution of assets to Distributing as a condition to Distributing's distribution of the Controlled stock (the "**Historic IRS Standard**").[109] Thus, under this standard, a distribution and a contribution could be respected as separate even if they occurred pursuant to the same plan and in close temporal proximity to one another.

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minority shareholders rights to purchase approximately 57 percent of the Northwest stock at a bargain price. On June 12, 1963, Pacific issued to its minority shareholders rights to purchase the remaining 43 percent of the Northwest stock at a bargain price. All of the rights issued in the two offerings were exercised. In connection with these transactions, Pacific obtained a private letter ruling to the effect that Pacific shareholders who exercised their rights would be considered as receiving a taxable dividend from Pacific in an amount equal to the difference between the exercise price and the fair market value of the Northwest stock, determined as of the date of exercise.

Two of Pacific's shareholders challenged this determination. The shareholders maintained that Pacific intended to divest itself of all of the stock of Northwest; the first distribution was simply one step in a plan that culminated with the distribution and exercise of the rights to acquire the remaining stock twenty months later. Thus, the shareholders contended that the distribution and subsequent exercise of the stock rights should be stepped together and treated as a tax-free spin-off under section 355 and an unrelated contribution to capital in the form of cash by the shareholders. The Service argued, among other things, that the distribution was not made "with respect to" the Pacific shareholders' stock, as required by section 355(a)(1)(A). The Tax Court disagreed with the Service. On appeal, the Second Circuit upheld the Tax Court's decision that there was a tax-free spin-off by Pacific and a separate cash contribution by those shareholders to Pacific. The Second Circuit rejected the Service's argument that the phrase "distribute . . . with respect to . . . stock" excludes distributions for which Distributing receives consideration. However, in the other case, the Ninth Circuit reversed the Tax Court, finding that there was a taxable exchange between the shareholders and Pacific because the shareholders' receipt of stock rights and their payment of cash consideration rendered the transaction, in substance, a "sale of corporate assets" (*i.e.*, the stock of Northwest by Pacific). The court noted that "the fundamental basis of non-recognition of gain or loss under section 355 is that no tax should be imposed when the same people continue to own the same businesses with only formal changes in the business organization." In a consolidation of the two cases, the Supreme Court determined that the 1961 distribution and the 1963 distribution were separate transactions because, at the time of the 1961 distribution, Pacific was under no binding obligation to distribute the remainder of the Northwest stock. *See Commissioner v. Gordon*, 391 U.S. 83 (1968). Thus, because Pacific did not distribute 80 percent of the stock of Northwest in the 1961 distribution, the Distribution-of-Control Requirement was not satisfied. The Court specifically reserved decision on the whether the receipt of consideration violated the Shareholder Status Requirement, leaving a split between the circuits regarding this issue.

109 *See, e.g.*, PLR 201202007 (Sept. 30, 2011) (steps (v), (1), and (2)); PLR 201149012 (Sept. 9, 2011) (steps (xxxiii) and (xl)); PLR 201123022 (Mar. 14, 2011) (steps (ii) and (viii)); PLR 201033007 (May 21, 2010) (steps (xxv) and (xxx)); PLR 201030005 (Apr. 28, 2010) (steps (iv) and (v)); PLR 201007050 (Nov. 13, 2009) (steps (i) and (v)). In addition, the Service relied on the same representation in respecting a north-south transaction between Distributing and Controlled. *See* PLR 201136009 (May 23, 2011).

Although the Service did not elaborate extensively on the theory underlying this administrative standard,[110] it appears to have been grounded in an application of the narrow version of the mutual interdependence test. As discussed in Part II, under the narrow version of the mutual interdependence test, a step in a series of related transactions is generally treated as having independent significance if three conditions are met.[111] First, at the time the step was taken, there was no binding legal obligation to take the later steps. Second, the taking of the step did not compel, and was not compelled by, the taking of the later steps. Third, the step would have had meaningful economic or legal consequences without the taking of the later steps. The requirement that there be "no regulatory, legal, contractual or economic compulsion or requirement" that Parent make the contribution as a condition to distributing the Controlled stock, ensures that the first two conditions are met. With respect to the third requirement, the fact that section 355 requires a business purpose for the spin-off means that it is likely that the spin-off would meet the requirement of having meaningful economic or legal consequences had the contribution not occurred. Thus, the Historic IRS Standard suggests that the step transaction doctrine is applicable in such cases only where the contribution lacks independent economic significance.

3. Code and Policy Considerations

The primary Code requirement that must be considered in the analysis of north-south transactions in spin-offs is the requirement under section 355(a)(1)(A) that Distributing "distribute to a shareholder, with respect to its stock, . . . solely stock or securities" of Controlled (the "**Shareholder Status Requirement**"). The phrase "with respect to its stock" in section 355(a)(1)(A) was presumably intended to limit the applicability of section 355 to a distribution made by Distributing to a shareholder in the shareholder's status as an owner of stock in Distributing, as opposed to the shareholder's status as an employee, creditor or some other status that would implicate other tax considerations.[112] When a "north" transfer of property is made in

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110 *But see* Amy S. Elliott, Service May Extend 'North-South' Ruling Position, 133 TAX NOTES 548, 548 (2011) relating statements made by William Alexander, Service Associate Chief Counsel (Corporate), concerning the scope of the north-south policy); Amy S. Elliott, Service Rethinking Repayments of Distributed Debt in Spinoff, 133 TAX NOTES 144, 144 (2011) (relating statements made by Steve Fattman, counsel, Service Office of Associate Chief Counsel (Corporate) concerning the scope of the north-south policy).

111 *See McDonald's of Zion, supra*.

112 *See* Treas. Reg. § 1.301-1(c) ("Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such."). *See also Stuchell v. Commissioner*, T.C. Memo 1978-236 ("The regulations under section 301 make it clear that the qualifying phrase 'with respect to its stock' is intended to mean that the dividend rules are 'not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such."). GCM 38714 (May 7, 1981) ("Treas. Reg. § 1.301-1(c) makes clear that the phrase 'with respect to its stock' contained in section 301(a) is intended to limit the applicability of section 301 to a distribution made by a corporation to a shareholder in the shareholder's status as an owner of stock in the corporation . . . .) This regulatory provision is undoubtedly derived from the Senate Finance Committee report, accompanying the enactment of section 301, that illustrates the limiting nature of the 'with respect to its stock' language by stating, '[f]or example, a distribution of property to a shareholder who is a creditor

connection with a "south" transfer to the distributing corporation, it is not clear whether or when the combination of transactions means the shareholder is not receiving property in its capacity as a shareholder. In fact, the *Baan-Gordon* cases may suggest that it is not relevant.

Beyond this requirement, there are two related major policies seemingly relevant to the north-south analysis. First, the section 355 (and ancillary) provisions recognize that, in anticipation of a transformational division of businesses, assets and liabilities will be moved between entities to achieve the desired business objectives and satisfy the section 355 requirements. As the only remaining provision following the repeal of the *General Utilities* doctrine that allows a corporation to divide in a tax-free manner, the law has evolved toward leniency in arranging businesses prior to a spin-off.

Second, and consistent with the above, for certain significant purposes, the section 355 provisions treat Distributing and the members of its affiliated group as a single taxpayer. The foremost example of this is the ATB Requirement. As modified in 2006, the ATB Requirement looks at all members of Distributing's or Controlled's "separate affiliated group" ("**SAG**"), as defined in section 1504(a) without regard to section 1504(b), for purposes of satisfying the various elements of the ATB Requirement. The effect of this rule is to treat Distributing or Controlled and all members of their respective SAG as a single entity.

The reason for the change was to reduce the need for a single corporate group to undertake complicated restructurings in order to satisfy the ATB Requirement. The House Report provides:

Prior to a spin-off under section 355 of the Code, corporate groups that have conducted business in separate corporate entities often must undergo elaborate restructurings to place active businesses in the proper entities to satisfy the five-year active business requirement. If the top-tier corporation of a chain that is being spun off or retained is a holding company, then the requirements regarding the activities of its subsidiaries are more stringent than if the top-tier corporation itself engaged in some active business. The Committee believes that it is appropriate to simplify planning for corporate groups that use a holding company structure to engage in distributions that qualify as tax-free under section 355.

In addition, while a trade or business acquired in a taxable transaction generally may not be relied upon to satisfy the ATB Requirement pursuant to section 355(b)(2)(C) and (D), there is an exception for purchases made within an affiliated group. Under current Regulations and the Service's historic ruling practice, taxable acquisitions by one member of an affiliated group of an active trade or business conducted by another member of the same affiliated group are specifically exempted from the application of section 355(b)(2)(C) and (D).[113] Notwithstanding

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of the corporation in satisfaction of his claim against the corporation is not within the scope of section 301.' S. Rep. No. 1622, 83d Cong., 2d Sess. 231 (1954).

Furthermore, Treas. Reg. § 1.311-1(e)(1) states that, '[s]ection 311 does not apply to transactions between a corporation and a shareholder in his capacity as debtor, creditor, employee, or vendee, where the fact that such debtor, creditor, employee, or vendee is a shareholder is incidental to the transaction.'"

113 Treas. Reg. § 1.355-3(b)(4)(iii). Significantly, current Regulations provide,

that taxable acquisitions occurring solely between members of the same affiliated group literally run afoul of sections 355(b)(2)(C) and (D), the current Regulations make clear that such acquisitions are not those to which sections 355(b)(2)(C) and (D) were intended to apply. We note that Prop. Treas. Reg. § 1.355-3(b) issued in 2006 does not contain a broad affiliate exception for taxable (or deemed taxable) acquisitions of a business.[114] In Notice 2007-60,[115] however, the Service announced it would not challenge a taxpayer's reliance on the affiliate exception under current Regulations to distributions effected before the proposed regulations are issued in temporary or final form. Treasury and the Service are continuing to study whether and to what extent the affiliate exception should be retained.[116]

There are other examples throughout section 355 that provide special exceptions to the general rules where affiliates undertake transactions that may otherwise violate a statutory requirement:

- For purposes of applying the "hot stock" rule of section 355(a)(3)(B), temporary regulations exempt all purchases within an affiliated group as defined in section 1504(a) (without regard to section 1504(b)).[117] Under the "hot stock" rule, if Distributing purchases stock of Controlled in a taxable transaction within five years of the distribution, such stock may not be distributed tax-free under section 355(a). Temporary regulations issued in 2008 provide that purchases from affiliates will not be taken into account for purposes of this rule.

- Section 355(d) denies tax-free treatment at the corporate level if any person holds "disqualified stock" in Distributing or Controlled after the spin-off. For this purpose, "disqualified stock" is stock acquired by "purchase", which definition includes capital contributions of cash, debt, or similar items.[118] An exception to this general definition of purchase is provided for cash-like items transferred by members of an affiliated group as

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> The requirements of section 355(b)(2)(C) and (D) are intended to prevent the direct or indirect acquisition of a trade or business by a corporation in anticipation of a distribution by the corporation of that trade or business in a distribution to which section 355 would otherwise apply. A direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group is not the type of transaction to which section 355(b)(2)(C) and (D) is intended to apply. Therefore, in applying section 355(b)(2)(C) or (D), such an acquisition, even though taxable, shall be disregarded.

114 REG-123365-03.

115 2007-2 C.B. 466.

116 "These temporary regulations retain the affiliate exception of former § 1.355-2(g) . . . . The Service and Treasury Department, however, continue to study what impact transfers between affiliates should have on the satisfaction of the ATB requirement and the application of the hot stock rule and believe that, when finalized, the rules regarding the ATB requirement and the hot stock rule should generally be applied consistently with respect to transactions between affiliates." TD 9435, 73 FR 75946 (Dec. 15, 2008). *See* New York State Bar Association, Tax Section, *Report on Proposed Regulations Regarding the Active Trade or Business Requirement of Section 355(b),* January 11, 2008.

117 Temp. Treas. Reg. § 1.355-2T(g)(2)(ii). TD 9435, 73 FR 75946 (Dec. 15, 2008).

118 Section 355(d)(5)(B).

defined in section 1504(a), if the transferor, transferee and any controlled corporation of the transferee do not cease to be members of the affiliated group pursuant to the plan that includes the transfer.[119]

- Section 355(f) provides that section 355(e) will not apply to a spin-off within an affiliated group (as defined in section 1504(a)) if such distribution is part of a plan pursuant to which one or more persons acquire 50 percent or more of the stock of Distributing or Controlled.

B. Case Studies

Below we posit four case studies based on transactions that are subject to the North-South No-Rule. Cases 1 through 3 involve the same basic fact pattern: Parent transfers property to Distributing in a purported contribution that otherwise qualifies under section 351 and, in a related but nonetheless formally separate transaction, receives a distribution of the stock of Controlled in an internal spin-off that otherwise qualifies under section 355. Case 4 involves a contribution and distribution to a party other than the transferor of the property in the contribution. While Case 4 has not traditionally been considered a north-south transaction because there is no exchange between the same two entities, it is nonetheless subject to the North-South No-Rule.

The cases raise two issues. First, is application of the step transaction doctrine necessary or appropriate to protect the purpose of the Shareholder Status Requirement? Second, if so, under what circumstances? The step transaction doctrine supplies various criteria for determining whether the separate steps of a north-south transaction are sufficiently related to warrant treating them as reciprocal legs of a single exchange. The decision as to which test is best suited for this purpose depends on the Code and policy considerations at stake.

We recommend that if the step transaction doctrine has a role to play in the context of spin-offs where the "north" transaction is the spinoff, it be applied narrowly. We appreciate the broader universe of north-south questions will take time to consider and that it may be difficult to issue general guidance for spin-offs prior to the conclusion of that study. Because transactions among affiliates are common in preparing for a spin-off and, as discussed above, the law generally provides special exceptions for them, we recommend below that safe harbors be provided for north-south transactions where the "north" transaction is a spinoff and the "south" transaction is a contribution by an affiliate as defined in section 1504(a) (without regard to section 1504(b)).[120] As illustrated in the case studies, there are two reasonable views of the scope of the Report's proposed affiliated group exception that could be adopted by Treasury and the Service in guidance. One such view would be that the step transaction doctrine should apply in the

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119 Treas. Reg. § 1.355-6(d)(3)(v)(A).

120 We note that the section 355(d) and section 355(e) exceptions for affiliate transactions do not extend to transactions among foreign affiliates and other corporations that are not considered "includible" under section 1504(b).

affiliated group context only if one transfer economically compels the other. The other view holds that the policy of permitting corporate divisions is so strong that the step transaction doctrine should never be applied to treat a contribution by an affiliate as in exchange for Controlled stock. Regardless of which approach is adopted by Treasury and the Service, providing the recommended safe harbors will provide certainty and consistency to the administration of the law in these common circumstances.[121]

Case 1

Facts

Parent is engaged, both directly and through its affiliates, in Business A and Business B. Parent owns all of the outstanding stock of Distributing, which is engaged in Business A. Distributing, in turn, owns all of the outstanding stock of Controlled, which is engaged in Business B. Pursuant to a single, integrated plan to separate Business A and Business B, (1) Parent contributes Business A assets to Distributing (the "**Contribution**"), (2) Distributing spins off Controlled to Parent (the "**Internal Spin-off**"), and (3) Parent spins off Distributing to its shareholders (the "**External Spin-off**"). Thus, Parent retains its Business B assets and the stock of Controlled, which is also engaged in Business B; Business A is separated from Business B in the Contribution and External Spin-Off. The sole reason for the Contribution is to facilitate a complete separation of Business A and Business B. The north-south transactions in Case 1 are the Contribution and the Internal Spin-off.[122]

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121 Treasury and the Service have turned off step transaction principles in certain north-south transactions. For example, generally, if a partner transfers property to the partnership, and the partnership transfers money or other property to the partner within the same two-year period, the transaction is presumed to be a disguised sale unless the facts and circumstances clearly establish the contrary. *See* Treas. Reg. § 1.707-3(c)(1). However, the regulations establish an exception to this presumption for (i) guaranteed payments, (ii) payments of a preferred return, (iii) operating cash flow distributions and certain assumptions of debt. *See* Treas. Reg. § 1.707-3 and -5.

122 Application of Step Transaction Tests: *End result test*. Case 1 should satisfy the end result test because, at the time of the Contribution, there was a plan to undertake the Internal Spin-off.

Mutual interdependence test. The outcome of Case 1 turns on whether the mutual interdependence test is applied broadly or narrowly. If mutual interdependence is tested by asking whether Parent would have contributed the Business A assets except in contemplation of the External Spin-off of Distributing, the answer would seem to be "no." There is no independent business purpose for the Contribution; it merely serves to facilitate the ultimate separation of Business A and Business B. Yet, if mutual interdependence is tested by asking whether the Contribution would have had meaningful economic or legal consequences apart from the Internal and External Spin-offs, the answer would clearly be "yes." The Contribution resulted in a genuine alteration of the ownership of the Business A assets and a pre-existing business relationship between Parent and Distributing (*i.e.*, before the Contribution, they conducted Business A jointly and after the Contribution Business A was conducted solely by Distributing). Moreover, the Contribution was not compelled by either the Internal Spin-off or the External Spin-off. Thus, if the mutual

Policy and Code Structure Considerations

As discussed in Part V.A, the phrase "distributes . . . with respect to . . . stock" contained in section 355(a)(1)(A) presumably was intended to limit the applicability of section 355 to a distribution made by Distributing to a shareholder in the shareholder's status as an owner of stock in Distributing. Arguably, if Distributing transfers Controlled stock to a shareholder as consideration for the shareholder's transfer of money or other property to Distributing, the transaction is not a distribution with respect to the shareholder's stock, because the shareholder's status as an owner of Distributing stock is incidental to the transaction. Such a transaction, the argument runs, is more appropriately viewed as an exchange and thus should be governed by section 1001, not section 355.

Assuming this view is correct, it would seem appropriate for the step transaction doctrine to police this limitation on the applicability of section 355. But determining which of the three traditional tests for applying the doctrine is best suited for this role presents a challenge. On the one hand, respect for the limiting language of section 355(a)(1)(A) demands that taxpayers not be permitted to artificially separate a single exchange into two formally separate transfers. But, on the other hand, far-reaching application of step transaction principles may conflict with the policies behind sections 355 and 368, including that corporations should be able to modify the form in which they hold existing businesses without the reorganization giving rise to a taxable event.

Commonly, corporate groups operate in an integrated fashion and do not have their businesses and related assets neatly packaged in the manner to accomplish the desired reorganization or separation. Consequently, when a decision is made to separate businesses, often significant restructuring of business assets is required, as depicted in Case 1. Congress, Treasury and the Service have recognized this reality and in various ways designed the reorganization and spin-off rules to accommodate it, as discussed above.

Recommendation

The hallmark of an exchange is reciprocal transfers of property. The mere fact that the Contribution and distribution (the Internal Spin-off here) occur pursuant to a single, integrated plan is not sufficient to demonstrate that the transfers are reciprocal (*i.e.*, that the Business A assets represent consideration for the Controlled stock, and vice versa). Nor is the mere fact that the Contribution and Internal Spin-off serve a common purpose (that is, separating the two businesses).

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interdependence test turns solely on independent economic or legal significance, the Contribution and the Internal Spin-off should be respected as separate transactions.

Binding commitment test. Case 1 should not satisfy the binding commitment test because Distributing was under no legal or contractual obligation to undertake the Internal Spin-off once Parent had undertaken the Contribution.

We do not believe the type of property that is contributed to Distributing in the Contribution should be relevant. While Case 1 posits the contribution of business assets, it should not matter whether the assets are related to Distributing's business, cash, or intercompany debt.

While the existence of independent business purposes for the Contribution and Internal Spin-off would be a sufficient reason to call off the step transaction doctrine, it is not, in our view, necessary. We do not recommend requiring the taxpayer to establish a separate business reason for the south contribution as such a standard will inevitably lead to uncertainty regarding the treatment of the transaction.

We recommend that safe harbor guidance be issued that confirms the Contribution in Case 1 be respected as separate from the Internal Distribution, regardless of the type of property and regardless of the reason for the Contribution. Specifically, we recommend the safe harbor provide that any contribution of any type of property made by an affiliate within the meaning of section 1504(a) (without regard to section 1504(b)), be respected as separate from a distribution of stock to its shareholder(s), where there is no economic compulsion to make the contribution.

Case 2

Facts

The facts are the same as in Case 1, except that Parent must make the Contribution (or otherwise replace the value of the Controlled stock) prior to the Internal Spin-off so that Distributing will remain in compliance with debt covenants or regulatory minimum capital requirements following the Internal Spin-off.[123]

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[123] Application of Step Transaction Tests: *End result test*. Case 2 should satisfy the end result test because, at the time of the Contribution, there was a plan to undertake the Internal Spin-off and the External Spin-off.

Mutual interdependence test. Case 2 should satisfy the mutual interdependence test, regardless of whether it is applied broadly or narrowly. As in Case 1, the Contribution merely serves to facilitate the separation of Business A and Business B. So, presumably, the parties would not have undertaken the Contribution except in contemplation of the Internal Spin-off and the External Spin-off. Moreover, the debt covenants and regulatory capital requirements would have precluded Distributing from undertaking the Internal Spin-off without undertaking the Contribution (or some economically equivalent alternative transaction). Thus, Case 2 should satisfy the broad interpretation of the mutual interdependence test.

Case 2 should satisfy the narrow interpretation of the mutual interdependence as well. Under this interpretation, a step in a series of related transactions is generally treated as having independent significance if three conditions are met. First, at the time the step was taken, there was no binding legal obligation to take the later steps. Second, the taking of the step did not compel, and was not compelled by, the taking of the later steps. Third, the step would have had meaningful economic or legal consequences without the taking of the later steps. Here, the second condition is not satisfied, because Parent is

Policy and Code Structure Considerations

Case 2 implicates the same policy and Code structure considerations as Case 1.

Recommendation

Under one view, the fact that Parent is economically compelled to make the Contribution (or otherwise replace the value of the Controlled stock) as a condition of receiving the Controlled stock in the Internal Spin-off suggests that the status of Parent of as a shareholder of Distributing may not be the only status in which Parent is receiving the distribution. Because section 355(a)(1)(A) was intended to limit the applicability of section 355 to a distribution made by a corporation to a shareholder in the shareholder's status as owner of stock in the corporation, the step transaction doctrine may be properly applicable in Case 2. Under this view, consistent with the Historic IRS Standard, Case 2 could remain part of the North-South No-Rule pending further study.

On the other hand, the Contribution was necessitated in furtherance of the divisive reorganization and was made between members of the affiliated group. The other areas of section 355 law referred to above do not distinguish on the basis of the reason for the transaction among affiliates. Consistent with those areas, Case 2 may be viewed as indistinguishable from Case 1. This view would also have the benefit of removing the uncertainty in determining whether a Contribution is economically compelled, furthering the goal of consistency and certainty of consequences.[124]

Case 3

Facts

The facts are the same as in Case 1, except that Distributing does not have an active trade or business other than the business of Controlled. Thus, the Contribution is necessary for Distributing to satisfy the ATB Requirement; for this reason, the Parent Group would not

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economically compelled to make the Contribution (or otherwise replace the value of the Controlled stock) in order to undertake the Internal Spin-off and the External Spin-off. Thus, under the narrow interpretation, the Contribution would be stepped together with the Internal Spin-off.

Binding commitment test. Case 2 should satisfy the binding commitment test because there was a contractual obligation to undertake the Contribution as a condition of either the Internal Spin-off or the External Spin-off (or vice versa).

124 For example, under the Historic Service Standard, it was not clear whether debt contributed to the capital of Distributing to allow Distributing to refinance its external debt to allow for a spin-off would be viewed as a compulsion.

undertake the Internal Spin-off without undertaking the Contribution, as the tax cost associated with a taxable distribution of the Controlled stock would be prohibitive.[125]

Policy and Code Structure Considerations

Case 3 implicates the same policy and Code structure considerations as Cases 1 and 2.

Recommendation

The ATB Requirement recognizes corporations often do not have their businesses aligned perfectly in anticipation of a spin-off and allows the relevant corporation to obtain a business as part of the spin-off restructuring. Thus, it is appropriate to treat the contribution to Distributing to reorganize the businesses as separate and not in exchange for the stock of Controlled, as long as there is no non-tax economic compulsion to do so.

We recommend that safe harbor guidance be issued that confirms the Contribution in Case 3 is respected as separate from the internal distribution.

Case 4[126]

Facts

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[125] Application of Step Transaction Tests: *End result test*. Case 3 should satisfy the end result test because, at the time of the Contribution, there was a plan to undertake the Internal Spin-off.

Mutual interdependence test. Case 3 should satisfy the broad interpretation of the mutual interdependence test because the parties would not have undertaken the Internal Spin-off without first undertaking the Contribution. Case 3 may be viewed as satisfying the narrow interpretation of the mutual interdependence test because there is a sense in which the Contribution is compelled by the Internal Spin-off. However, the ATB Requirement could be satisfied through transactions other than the Contribution (e.g., a tax-free acquisition by Distributing of qualifying ATB assets from an unrelated third party). Further, because there is no economic compulsion to transfer Parent's Business A assets, Business A assets should not be treated as consideration for Controlled stock (or vice versa).

Binding commitment test. Case 3 should not satisfy the binding commitment test because there was no legal or contractual obligation for Parent to undertake the Contribution as a condition of either the Internal Spin-off or the External Spin-off (or vice versa). The desire to qualify the spin-off under section 355(b) does not arise to an obligation of reciprocity.

[126] The North-South No Rule reads: "Whether transfers of stock, money, or property by a person to a corporation and transfers of stock, money, or property by that corporation to that person (or a person related to such person) in what are ostensibly two separate transactions (so-called "north-south" transactions), at least one of which is a distribution with respect to the corporation's stock, a contribution to the corporation's capital, or an acquisition of stock, are respected as separate transactions for Federal income tax purposes."

Parent and Affiliate own all of the stock of Distributing, which owns all of the stock of Controlled. Pursuant to a single, integrated plan, (1) Distributing splits off Controlled to Parent in exchange for Distributing shares (the "**Internal Split-off**"), and (3) Affiliate contributes intercompany debt to Distributing (the "**Debt Transfer**"). The north-south transactions in Case 4 are the Internal Split-Off and the Debt Transfer.

Analysis

Case 4 is not a traditional north-south transaction because the person that receives the distribution (Parent) is different from the person (affiliate of Parent) that made the contribution. Yet, the North-South No-Rule would include this transaction in its reach under the related party language (because Parent, the recipient of the distribution is *related to* its affiliate, the person which made the contribution). As written, the North-South No-Rule applies whenever (i) Distributing makes a distribution of stock and (ii) there is a transfer of property to Distributing or any person related to Distributing.[127] This fact pattern would present itself commonly as a result of intercompany debt settlements and other restructuring asset movements.

There are many examples where this expanded notion of north-south could apply to common pre-spin-off restructurings. For example:

Affiliate transfers the stock of a target corporation to Distributing and the target corporation liquidates in a "sideways" D reorganization. Distributing spins off Controlled. This transaction is sanctioned by the regulations as a means of satisfying the ATB Requirement,[128] yet technically raises an issue under the North-South No-Rule.

Parent owns Distributing and Distributing owns Controlled and Sub. Sub liquidates into Distributing prior to the distribution of Controlled stock in order to qualify Distributing for the ATB Requirement in California. Sub is a person that transfers property to Distributing, Distributing transfers stock of Controlled to Parent, and at least one of these is a distribution with respect to stock.

Treasury and the Service have not articulated what concern underlies the expansion of the notion of north-south transactions to include transactions that do not appear to be susceptible to recharacterization as exchanges. It is possible the government was concerned about the ability of a shareholder corporation to direct transfers among its subsidiaries. We note that as a general matter, transactions undertaken by one corporation (Distributing) are not combined or attributed to another corporation (Affiliate) simply because the latter corporation is related to the former corporation.

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[127] Note the language in the 2013-2014 Priority Guidance Plan describing the guidance project associated with the North-South No-Rule does not include the related party fact patterns of Case 4: "[g]uidance regarding when a transfer by a person to a corporation and a transfer by that corporation to that person, ostensibly in two separate transactions, should be respected as two separate transactions for Federal income tax purposes."

[128] *See* Treas. Reg. § 1.355-3(b)(3).

Recommendation

There are many variations of the related party north-south transaction that, if present, result in the inability to obtain a ruling on such transactions. While we appreciate the government's interest in studying the issues implicated by the No-Rules, the breadth of the related party rule in the context of the North-South No-Rule is inconsistent with general tax principles, including the ATB Requirement.

We respectfully urge Treasury and the Service to tailor this aspect of the No-Rule to include only the fact patterns that prompted the inclusion of the related party concept. In addition, because this aspect of the North-South No-Rule has created uncertainty regarding fact patterns that were historically not of concern, we recommend including a safe harbor to confirm that related party north-south transactions generally will not be treated as exchanges. If it is determined that Case 2 or other specific transactions should remain subject to the North-South No-Rule, the related party safe harbor should be modified accordingly to preclude the use of a related party to engage in Case 2 or such other transactions.