NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON SECTION 355(e) "NON-PLAN" ISSUES

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New York State Bar Association
Tax Section

Section 355(e) "Non-Plan" Issues

I. Introduction

This report, prepared by the Corporations Committee of the New York State Bar Association Tax Section[1], identifies a number of "non-plan" issues that should be addressed by regulations to be promulgated under Section 355(e) of the Internal Revenue Code, and recommends ways to resolve those issues to provide greater clarity as to the scope and application of Section 355(e).

In particular, we recommend that regulations clarify what kinds of transactions, other than actual acquisitions of stock, may constitute an acquisition of stock for purposes of Section 355(e), prescribe how calculations are to be made in those cases, and prescribe rules for the timing and methods to be used for calculations that take into account multiple transactions. We also make a number of recommendations intended to clarify the application of Section 355(e) in situations where a literal, technical reading of the statute may create unintended applications of the provisions; these situations arise especially in the application of the successor and predecessor provisions and in the context of testing for an acquisition at various levels in a single transaction.

[1] The principal drafter of this report was Kathleen Ferrell, with the assistance of her colleagues Neil Barr and Chris Peters. Helpful comments were received from Laura Barzilai, Kim Blanchard, Ron Creamer, Gary Mandel, Robert Jacobs, Deborah Paul and Michael Schler.

Statutory Overview

Section 355(e) generally applies to a distribution that otherwise meets the requirements for a tax-free distribution under Section 355, if the distribution is part of a plan (or series of related transactions) (hereafter, a "plan") pursuant to which one or more persons acquire directly or indirectly stock representing a 50 percent or greater interest in the distributing corporation or any controlled corporation. If Section 355(e) applies, the stock or securities of the controlled corporation do not constitute "qualified property" under Section 355(c)(2) or Section 361(c)(2), with the result that the distributing corporation will be required to recognize gain on the distribution. Temporary Regulations issued on April 23, 2002 deal with the circumstances under which a distribution and an acquisition will be treated as occurring pursuant to a plan.[2]

Exceptions

The statute provides a number of exceptions, including an exception for intragroup spins,[3] an exception for transactions already covered by Section

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[2] *See* Treas. Reg. Section 1.355-7T. The Temporary Regulations are the subject of NYSBA Tax Section Report #1020 (Oct. 28, 2002), *reprinted at* 2002 TNT 217-21. The Temporary Regulations succeed two sets of Proposed Regulations, *see* Prop. Treas. Reg. Section 1.355-7, as proposed on Aug. 19, 1999 (and later withdrawn) and Prop. Treas. Reg. Section 1.355-7, as proposed on Dec. 29, 2000, both of which were also the subject of Tax Section reports. *See* NYSBA Tax Section Report #968 (March 22, 2000), *reprinted at* 2000 TNT 72-20, and NYSBA Tax Section Report #991 (April 10, 2001), *reprinted at* 2001 TNT 72-17.

[3] Section 355(e)(2)(C). Note, however, that Section 355(f) provides that Section 355 does not apply to a distribution from one member of an affiliated group if the distribution is part of a plan or series of related transactions to which Section 355(e)(2)(A)(ii) applies after application of Section 355(e).

355(d),[4] and a series of exceptions for certain types of acquisitions that (except as provided in regulations) are not taken into account for purposes of determining whether Section 355(e) applies."[5] These excepted "acquisitions" are:

(1) The acquisition of stock in any controlled corporation by the distributing corporation. Section 355(e)(3)(A)(i).

(2) The acquisition of stock in any controlled corporation "by reason of holding stock in the distributing corporation." Section 355(e)(3)(A)(ii).

(3) The acquisition of stock in any successor corporation of the distributing corporation or any controlled corporation "by reason of holding stock in the distributing or controlled corporation". Section 355(e)(3)(A)(iii).

(4) The acquisition of stock in the distributing corporation or any controlled corporation to the extent that the percentage of stock owned directly or indirectly in the corporation by each person owning stock in the corporation immediately before the acquisition does not decrease. Section 355(e)(3)(A)(iv).[6]

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[4] Section 355(e)(2)(D). Generally, Section 355(d) applies to a transaction in which a party "purchases" the stock of the distributing corporation or the controlled corporation prior to the spin-off.

[5] Section 355(e)(3)(A)(i) – (iv).

[6] This exception is the result of technical corrections legislation modifying the original statutory language. *See* Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. (…continued)

These exceptions do not apply, however, if the excepted "acquisition" occurred pursuant to a "plan." Section 355(e)(3)(A) (flush language).[7]

Attribution and Aggregation Rules

Attribution rules are prescribed by Section 355(e)(4)(C)(ii), which provides that Section 318(a)(2) applies in determining whether a person "holds" stock or securities in any corporation, except that Section 318(a)(2)(C) is applied without regard to the phrase "50 percent or more in value." In addition, Section 355(e)(4)(C)(i) provides that the aggregation rules of Section 355(d)(7)(A) are applicable for purposes of Section 355(e). Under Section 355(d)(7)(A), a person and all persons related to the person within the meaning of Section 267(b) or 707(b)(1) are treated as one person.

Asset Transactions Treated as Acquisitions of Stock

Transactions involving asset acquisitions, such as tax-free reorganizations under Section 368(a)(1)(A) or (C), may be viewed under Section 355(e)(3)(B) as resulting in an acquisition of the stock of the transferor by the transferee corporation's shareholders. Specifically, this provision applies "except as provided in regulations" to the acquisition of assets of the distributing corporation

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No. 105-206, ' 6010(c)(2)(B), 112 Stat. 685, 813 (1998). Below, we suggest that regulations elaborate on the scope and application of this exception.

[7] For example, if A acquires 10% of D's shares pursuant to a plan that involves the subsequent pro rata distribution of Controlled's shares, the Controlled shares distributed to A should be treated as having been acquired pursuant to a plan.

or any controlled corporation by a successor corporation in an “A”, “C”, or “D” reorganization “or any other transaction specified in regulations.”

Successors and Predecessors

Section 355(e)(4)(D) provides that any reference to a controlled corporation or distributing corporation includes a reference to any predecessor or successor thereof. The statute does not define “predecessor” or “successor.”

II. Summary of Recommendations

In general, we believe that, in keeping with the thrust of the “plan” regulations, additional guidance should focus on identifying the types of transactions that are within the purview of Section 355(e), clarifying application of the rules to common transactions, and minimizing opportunities for technical application of the statutory language to find acquisitions in unintended circumstances. We specifically address certain scope issues arising in the context of the successor and predecessor rules and the rules that could be applied to treat asset transactions as an acquisition of stock. We also believe that “retesting” transactions (for example, to find that an increase in the vote or value of outstanding stock should be treated as an acquisition) generally should be limited to those cases where the shift in vote or value occurs pursuant to a plan, or where a subsequent event occurs pursuant to a plan, and that event has the effect of increasing the percentage interest, by vote or value, represented by shares previously acquired pursuant to a plan. Our specific suggestions for dealing with redemptions and recapitalizations or other shifts in vote or value are discussed below. Combined with anti-avoidance rules, this approach should limit the potential reach of Section 355(e) to its intended scope and permit taxpayers to achieve certainty in the application of the rules to common business transactions, without being required to seek a private letter ruling.[8]

In addition, because the statute employs a numerical test that can be implicated by reason of a series of related transactions that can occur over a period of years (and that can be interspersed with transactions that are not part of a plan), regulations should provide some kind of "counting" conventions. Although some of the provisions implementing Section 382 can be used as a model, we do not believe the purposes of Section 355(e) are served by adopting a complicated set of rules modeled upon Section 382. Generally, we believe the "counting" rules should be devised in a manner that permits calculations at the ultimate shareholder level based on actually outstanding shares and does not require "segregation rules" or an elaborate tracking of separate public groups.

III. Discussion

A. General Approach for Testing for a 50% or Greater Acquisition of Stock.

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[8] We believe that timely clarification of the legal issues under Section 355(e) is particularly necessary in light of the IRS's decision to substantially curb the issuance of Section 355 private letter rulings. *See* Rev. Proc. 2003-48, 2003-49 I.R.B. 86 (Jun. 24, 2003). As a result of the IRS's revised ruling practice, we believe that distributing and controlled corporations will more frequently seek opinions of counsel with respect to the application of Section 355(e) where, historically, a supplemental IRS ruling would have been obtained. Additional regulations under Section 355(e) are needed to guide practitioners in advising taxpayers with respect to these transactions.

Before examining whether any exception might apply, Section 355(e) requires the taxpayer to determine whether one person or a group of persons has acquired "directly or indirectly" a 50 percent or greater interest in the stock of either the distributing or the controlled corporation. Regulations should clarify the manner in which the threshold Section 355(e) test is to be performed, including at what level ownership should be tested, when the test should be performed, and how and when a series of transactions is to be taken into account. In general, we believe the Section 355(e) test should be performed immediately after each acquisition of stock that is treated as part of a plan pursuant to Section 355(e) and Treas. Reg. Section 1.355-7T, and immediately after each other transaction or event (*e.g.*, a redemption, a recapitalization or a shift in voting rights) that is treated as occurring as part of a plan.[9]

The test should be performed at the ultimate shareholder level by aggregating the number of then-outstanding shares that are considered to have been acquired, at any time, pursuant to a plan (other than acquisitions with respect to which one of the statutory or regulatory exceptions apply). Section 355(e) should apply if those shares, by vote or value, constitute a 50% or greater interest

[9] The temporary regulations at Section 1.355-7T should be amended to provide rules identifying those situations in which transactions such as redemptions, recapitalizations or other events that result in increases in vote or value, or shifts in vote or value among different classes of stock, will be treated as part of a plan. As noted below, because shifts in value may occur more unpredictably than shifts in vote, we believe separate plan tests should be developed for shifts in value and shifts in vote.

in the relevant corporation,[10] using as the denominator the aggregate vote or value (depending on which numerator is being tested) of the total number of shares then outstanding.[11] In other words, the numerator would be the aggregate of all outstanding shares (or votes) acquired pursuant to a plan, and the denominator would be the actual number of outstanding shares (or votes). This approach means that the denominator will be increased by the issuance of shares that are not considered to be issued as part of a plan (for example, by reason of the application of one of the safe harbors or one of the statutory exceptions) as well as by shares issued pursuant to a plan, and that the denominator will be decreased by redemptions, whether or not considered to be effected as part of a plan. We believe this is a neutral approach that promotes a "natural" application of the percentage test required by the statute.

1. *Testing at Ultimate Shareholder Level.* Section 355(e) does not explicitly test at the level of the ultimate shareholders as do Section 382 and the "reverse acquisition" rules under the consolidated return regulations. Instead, Section 355(e) seems to require testing at any level of ownership, while

[10] Conversely, Section 355(e) should not be triggered if, immediately after a testing event, the relevant corporation's "good" shareholders (those who did not acquire stock pursuant to a plan) hold more than 50%, by vote and value, of the corporation's shares.

[11] For this purpose, Treasury and the IRS should consider treating shares as outstanding if they are so treated for state law purposes (disregarding shares held by wholly-owned subsidiaries of the issuer). Under such an approach, restricted stock issued for compensatory purposes would be treated as outstanding without regard to whether the holder has made a Section 83(b) election. *See* NYSBA Tax Section Report # 1042 (Oct. 23, 2003) (NYSBA proposal with respect to the treatment of restricted stock in the corporate reorganization context).

simultaneously applying attribution rules and aggregation rules that imply testing at the ultimate shareholder level. Furthermore, the significant exceptions from acquisition treatment include the exception in Section 355(e)(3)(A)(iv), which explicitly looks to the ultimate shareholders, and the "by reason of holding" exceptions in Section 355(e)(3)(A)(ii) and (iii), which do not explicitly apply at the "indirect" or ultimate shareholder level. We believe that regulations should clarify these inconsistencies in a way that exposes the underlying principles of Section 355(e), looking to the overall intended effects of the statute.

a. The Attribution Rules. Regulations should clarify that the statutory attribution rules apply for purposes of determining whether there has been an "acquisition" and provide that, in general, only changes in the stock ownership of the ultimate owners will be taken into account.[12] For example, assume that individuals A and B own all the stock of D corporation. D owns all the stock of a subsidiary corporation C. All the subsidiary C corporation stock is distributed to A and B pro rata in a transaction that otherwise qualifies under Section 355. As part of a plan, A and B then drop all the stock of C received in the distribution into H holding company in exchange for all the H stock. Does H "directly" acquire the stock of C in a transaction that triggers the statute, subject to the exceptions contained in Section 355(e)(3)(A)? Because there was no increase in

[12] We do not believe, however, that it would be appropriate for regulations to ignore actual transfers among individuals whose stock is constructively owned by another person. For example, Brother's acquisition of Sister's controlled shares should not be ignored merely because those shares are still constructively held by a Parent.

the indirect ownership of C by A or B, we believe that the better regulatory approach to this case would be to provide that H's ownership increase is irrelevant, and that the acquisition analysis is applied at the ultimate level of ownership, *i.e.*, the A and B level determined after application of the attribution rules.[13]

We believe the regulations should specify that the numerical tests of Section 355(e) are applied first by looking at whether there has been an increase in the ownership interests of any of the ultimate holders of the stock determined through application of the attribution and aggregation rules (modified as appropriate), and then looking to see whether an exception may apply, at that level, if the 50% threshold would otherwise be crossed.[14] That approach would reject the notion that Section 355(e) could be triggered by an acquisition at any level, irrespective of whether there has been a change in ultimate indirect

[13] We note that the Blue Book to the Taxpayer Relief Act of 1997 appears to suggest that the statute does apply, subject to the exception of Section 355(e)(3)(A)(iv), presumably because of the 100 percent direct acquisition by H, even though the ultimate economic ownership of A and B has not changed. *See* JOINT COMM. OF TAX'N, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 at 201, Ex. 2 (Dec. 17, 1997). If the statute is applied at more than one level, the 50 percent test should, of course, not be applied in a manner that produces double counting of ownership increases through the same chain of ownership by cumulating the increases at more than one level.

[14] *Compare* Section 382(l)(3)(A)(ii)(II) (Section 318(a)(2) applied "except as provided in regulations, by treating stock attributed thereunder as no longer held by the entity from which attributed.").

ownership, and would resolve most of the ambiguities associated with application of the exceptions at multiple levels.[15]

b. The Statutory Exceptions. If it is correct to test for "acquisitions" by looking only to changes at the ultimate shareholder level, it follows that the exceptions in Section 355(e)(3)(A) should be attributed upward as well. Consider a situation where, as above, each of A and B are long time equal (50/50) shareholders of the distributing corporation, D. As part of a plan to split-off controlled, A transfers its D stock to new holding company H, and D distributes all the stock of controlled to H in exchange for H's D stock. The principle of Section 355(e)(3)(A)(ii), governing receipt of controlled stock "by reason of holding" stock of distributing, should be applicable here to permit the split-off to avoid the consequences of Section 355(e), but this result is unclear if the availability of the exception is determined at the H level. The "flush" language of Section 355(e)(3)(A) provides that the subparagraph does not apply if the stock held before the "acquisition" being tested was acquired pursuant to a plan, and, in the example, H acquired its D shares from A as part of the split-off plan.

Likewise, it is uncertain how the attribution rules apply where stock of the distributing or controlled corporation is distributed, pursuant to a plan, through a partnership that holds stock of the distributing corporation. For example, assume

[15] As noted above, we are generally of the view that this approach should not be carried so far as to ignore an actual acquisition by an individual from another individual merely because "ultimate ownership" continues to be attributed to another person, say a parent.

A owns 51 percent of P, a partnership for federal income tax purposes, and B owns the remaining 49 percent. P owns 100 percent of the stock of Distributing. Distributing distributes Controlled to P in a transaction that otherwise qualifies under Section 355, and, pursuant to a plan, P distributes 51 percent of Controlled to B in complete redemption of B's interest in P. As in the preceding example, the principle of Section 355(e)(3)(A)(ii) should be applied to find that B is treated as having acquired only 2 percent of Controlled pursuant to a plan; the remaining 49 percent held by B should be viewed as having been acquired by B, as a continuing shareholder in Controlled, "by reason of holding stock" in Distributing. We believe that the better regulatory approach to these and similar cases would be to give effect to the principle of Section 355(e)(3)(A)(ii) by applying the Section 355(e) test (including the exception) at the ultimate shareholder level.

2. *Time for Testing*. Unlike Section 382, Section 355(e) does not specify a "testing date," although it seems obvious that, at least, one must test for a greater than 50% acquisition immediately after an "acquisition" that occurs pursuant to a plan. Some of the technical issues associated with how certain transactions must be taken into account for purposes of Section 355(e) (*e.g.*, redemptions, vote or value shifts, serial and successive transfers) could be usefully addressed by specifying when the Section 355(e) test should be performed. One approach would be to perform the test immediately after each actual acquisition of stock that is considered to be part of a plan, and to require

"retesting" of those acquisitions immediately after any redemption, recapitalization or change in the relative vote and value of different classes of stock. As discussed below, we recommend that "retesting" occur only when the subsequent event is treated as part of a plan, and then look only to the effect that event has on the vote and value of previously acquired "bad" shares (*i.e.*, shares acquired pursuant to a plan). An alternative (broader) approach would be to treat each event that results in an increase in a shareholder's interest in the corporation as an "acquisition" and test the effect of that acquisition, subject to the statutory exceptions, at that time.

3. *Method for Aggregating Serial and Successive Acquisitions; Numerators and Denominators.* We believe the Section 355(e) test, when it is required to be performed, should be based on a cumulative assessment of the actual percentage of the stock (by vote or value) of the relevant corporation that is considered to be "bad" **B** *i.e.*, acquired pursuant to a plan. In other words, the numerator would be the aggregate of all outstanding shares acquired pursuant to a plan, and the denominator would always be the actual number of outstanding shares, subject to certain exceptions described below. Such a general approach is uncomplicated and generally permits "natural" calculations based on actual percentage ownership. This approach also resolves technical points such as

whether successive acquisitions of the same shares should be aggregated to determine whether there is a 50 percent or more acquisition (they should not be).[16]

4. *Overlapping Shareholders.* The problem of the "overlapping shareholder" occurs, for instance, when an unrelated third party acquires the stock of either the distributing or the controlled corporation pursuant to a plan that includes the spin-off, and there is a shareholder who historically holds stock in both the third party and the target. Another case of the "overlapping shareholder" problem occurs when a pre-existing shareholder purchases additional stock in distributing or controlled pursuant to a plan that includes a spin-off. Overlapping shareholder scenarios can be broken down into two categories – those in which the parties have actual knowledge of the overlap and those in which they do not.

With respect to the latter category (*i.e.*, where the parties to the transaction do not have actual knowledge), the regulations could reasonably provide that Section 355(e) accords no benefit to the overlap. In other words, "good" shares held by an overlapping shareholder (shares that were not acquired pursuant to a plan) would be counted in the denominator but not in the numerator, and "bad" shares held by the same shareholder (shares that were acquired pursuant to a plan)

[16] For example, assume D is owned 50 percent each by individual W and X. D spins off C to W and X, and immediately after the transaction W and X each own 50 percent of the stock of C and D. Pursuant to a pre-arranged plan, W sells a 40 percent stock interest in D to Y, who pursuant to the same plan sells 20 percent to Z. Although a total of 60 percent of stock acquisitions occurred, the transactions all related to the same 40 percent interest and should not trigger Section 355(e).

would be counted in both the denominator and the numerator.[17] We note that this treatment of overlapping shareholders is arguably less favorable to taxpayers than the treatment suggested by Section 355(e)(3)(A)(iv).[18] However, in light of the administrative difficulty of dealing with overlapping shareholders in a public company scenario where the corporate parties to the transaction do not have actual knowledge of the overlap, the Service may wish to adopt a simple, administrable rule that avoids confusion and potential abuse.[19]

In situations where the parties to the transaction do have actual knowledge of an overlapping shareholder,[20] we believe regulations should follow the general approach of Section 355(e)(3)(A)(iv). That approach would avoid the application of Section 355(e) in situations where, as a policy matter, Congress has recognized

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[17] This might happen, for instance, if the shareholder is also a shareholder in the third party corporation that has acquired (or been acquired by) the distributing or the controlled corporation pursuant to a plan.

[18] *Cf.* Treas. Reg. Section 1.367(a)-3(c)(ii) ("For purposes of this paragraph (c)(1)(ii), any stock of the transferee foreign corporation owned by U.S. persons immediately after the transfer will be taken into account, whether or not it was received in exchange for stock or securities of the U.S. target company.").

[19] A more taxpayer friendly approach would be to permit the taxpayer to treat a certain percentage of public shareholders as overlapping based on statistical sampling. Regulations would need to identify acceptable sampling methods and time frames. The most useful version of such a rule would permit taxpayers to identify overlapping shareholders prior to the closing of a transaction. *Cf.* Rev. Proc. 81-70, 1981-2 C.B. 729. There is precedent for treating a certain percentage of public shareholders as overlapping in Treas. Reg. Section 1.382-3(j)(3). However, we do not think the purposes of Section 355(e) would be well served by adopting rules as complex as those contained in Section 382.

[20] Regulations should identify acceptable methods for acquiring and demonstrating actual knowledge. For example, regulations might permit or require closing date surveys of public shareholders. Moreover, it would seem reasonable to deem a corporation to have knowledge of public securities filings of its shareholders for all Section 355(e) purposes. *See, e.g.*, Treas. Reg. Section 1.355-6(f)(3).

it should not apply.[21] For instance, Section 355(e) should not apply in a situation where two shareholders, A and B, each own 50% of D (worth 100x after the spin-off of C) and D is merged pursuant to a plan with X (worth 900x prior to the acquisition of D), which is wholly-owned by A. In such a situation, the rules of Section 355(e)(3)(A)(iv) would provide that there has only been an "acquisition" of 45% of D, because A's ownership in the combined D/X company did not decrease and B's ownership decreased only from 50% to 5%.[22]

B. What Constitutes an Acquisition.

1. *Increase in Ownership of Person Who Does Not Engage in Transaction*. Regulations should address the circumstances under which an "acquisition" results from an increase in the percentage ownership of a person as a result of a transaction not involving that person. This issue can arise in the context of redemptions (including split-offs), recapitalizations and changes in the rights of outstanding shares pursuant to the terms of the instrument (*e.g.*, stock the voting rights of which change upon transfer).

For example, assume that D corporation conducts business 1 and business 2, respectively. Business 1 is worth 40x and business 2 is worth 80x. Individuals

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[21] *See* Senate Report 105-174 (Restructuring and Reform Act of 1998), pp. 174-175 *and* Conference Report to H.R. 2014, 105-220 (Taxpayer Relief Act of 1997), pp. 532-533.

[22] *Cf.* Treas. Reg. Section 1.280G-1(d), A-27(b) ("If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition or stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change *and not with respect to the ownership interest in the other corporation*.") (emphasis supplied).

X, Y and Z each own 40 shares of the D common; X, however, acquired 19 of her 40 D shares pursuant to a plan. D contributes business 2 to C corporation and distributes the stock of C to Y and Z in complete redemption of their stock. Because Y and Z's ownership of C, in aggregate, increased only from 66⅔ percent to 100 percent, they certainly did not acquire a 50 percent interest. After the transaction, however, X's ownership of D is 100 percent, whereas before the distribution it was 33⅓ percent; thus, before applying any statutory exceptions, X's ownership did increase by more than 50 percent. Moreover, 19 of X's 40 D shares were acquired pursuant to a plan. Did the redemption of Y and Z result in an *acquisition* by X, cognizable by the statute, of more than 50 percent of the stock of D? Treasury regulations could be crafted to treat all such transactions as causing an "acquisition" to the extent any shareholder increases his interest, subject to the exceptions provided in the statute. In the case described above, if there were an acquisition, Section 355(e)(3)(A)(ii) and (iii), relating to acquisitions "by reason of holding stock" in distributing or controlled or a successor thereof, should provide an exception to the application of Section 355(e). We are generally of the view, however, that the purposes of Section 355(e) would be adequately served by a narrower approach to the "acquisition" concept.

One approach that would appropriately narrow the possible scope of the "acquisition" concept would be to treat an increase in the percentage ownership of a shareholder by reason of a transaction not involving that shareholder as an "acquisition" for purposes of section 355(e) only if (i) the transaction is pursuant to a plan and (ii) the result of the transaction is to increase the percentage of stock, by vote or value, considered to be held by a person who previously acquired shares pursuant to a plan. Another way to express this idea would be to look at a subsequent transaction only if it is a step related to a previous acquisition of "bad" shares, so that the original acquisition must be retested. In addition to giving effect to the statutory exceptions, this methodology would be one way to ensure that increases in the percentage interests represented by shares that were acquired in an excepted transaction (*e.g.*, shares issued to employees upon exercise of options) are not treated as bad "acquisitions."

2. *Redemptions.* In the case of redemptions, this approach could be implemented by requiring application of the Section 355(e) test, to retest the consequences of prior acquisitions, immediately after any redemption that occurs pursuant to a plan.[23]

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[23] A redemption (or issuance) of stock that does not occur pursuant to a plan should not trigger application of the Section 355(e) test, but those redemptions (or issuances) would need to be taken into account in some manner for purposes of determining the Section 355(e) consequences of any subsequent planned "acquisition." Consistent with our general approach for calculating the Section 355(e) test described above, if a subsequent acquisition pursuant to a plan occurred, the effect of the intervening redemption (or issuance) would be reflected in the denominator. One way to provide a "neutral" impact would be to treat a redemption (or issuance) that did not occur as part of a plan as having been pro rata, so that the redemption (or issuance) does not affect the percentage of shares owned by persons who have previously acquired pursuant to a plan. In other words, the shares redeemed would be subtracted from (or the shares issued would be added to) the denominator and an appropriate percentage of the redeemed (issued) shares would also be subtracted from (added to) the numerator of previously acquired "bad" shares.

Alternatively, redemptions and issuances that do not occur pursuant to a plan could be taken into account in the denominator, without affecting the numerator. This alternative approach (…continued)

For example, assume that Distributing spins off Controlled to its shareholders X, Y and Z, each of whom owns 30 of the 90 outstanding Distributing shares and each of whom receives 30 Controlled shares. After the spin-off, Controlled issues 10 shares to 10 employees, pursuant to the exercise of compensatory options granted before the spin. Controlled now has 100 shares outstanding. Buyer A acquires 20 Controlled shares from Y pursuant to a plan. Thereafter, pursuant to a pre-arranged plan, Controlled redeems Y's 10 remaining shares. Buyer B subsequently acquires 25 Controlled shares from X pursuant to a plan.

Under the approach suggested by this report, the planned redemption by Controlled from Y should result in a retesting of Buyer A's acquisition, but the redemption would not be treated for purposes of Section 355(e) as an acquisition by the issuer, nor would it result in an acquisition by Z, the "old and cold" Controlled shareholder whose interest increased or by the employees, whose interests were also increased by the redemption. Applying these principles to the example above, immediately after the redemption, only 20 of the 90 then-outstanding Controlled shares would be treated as having been acquired pursuant to a plan. The subsequent acquisition by Buyer B, however, would trigger the application of Section 355(e) because Buyer A and Buyer B, collectively, have

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is arguably simpler (and more in line with our suggested basic rule for testing whether there a 50% or greater acquisition) in that it does not require an "artificial" tainting or cleansing of shares in the numerator. However, it would create unintended detriments (in unplanned redemptions) and benefits (in unplanned issuances) for taxpayers.

acquired 45 of Controlled's 90 then-outstanding Controlled shares pursuant to a plan.

As another example, assume that Distributing spins off Controlled to its shareholders. After the spin-off, Controlled has 100 shares outstanding. Pursuant to a plan, Controlled immediately redeems 50 shares. (Ignore the "device" issue here for the sake of discussion.) Thereafter, also pursuant to a plan, Buyer X acquires 25 Controlled shares. Under the approach suggested by this report, regulations would clarify that (i) the redemption does not cause Controlled to be treated as having acquired shares pursuant to a plan, (ii) the redemption does not cause the "old and cold" shareholders whose interest has increased to be treated as acquiring shares pursuant to a plan and (iii) Buyer X has acquired 25 of Controlled's 50 then-outstanding shares pursuant to a plan, thus triggering the application of Section 355(e).

a. *When is a Redemption Pursuant to a Plan?* When is a Redemption Pursuant to a Plan? Regulations will need to apply the "plan" concept in this context. Although we are generally of the view that this is appropriately a facts and circumstances test, regulations could seek to identify certain "per se" situations and safe harbors. For example, where a controlling shareholder acquired its interest pursuant to a plan, it may be reasonable to deem any redemption that occurs within the statutory presumption period (or some other testing period) as also occurring pursuant to a plan. Conversely, if there are no 5% or greater shareholders among the holders of shares acquired pursuant to a plan, it may be reasonable for regulations to prescribe a "safe harbor" for certain open market redemptions, e.g., redemptions that meet the requirements of section 4.05(1)(b) of Rev. Proc. 96-30 could be deemed to be not pursuant to a plan.[24] In the case of redemptions occurring as a result of a split-off, we believe the increase in the percentage interests in the distributing corporation of non-redeeming shareholders caused by a split-off should not be treated as an "acquisition" for purposes of Section 355(e) unless those shareholders acquired their interests in the distributing corporation pursuant to a plan. This is consistent with the approach taken on the flush language of Section 355(a)(3)(A) with respect to shares of the controlled corporation acquired on a split-off. Shares of the controlled corporation received in a split-off are treated as an acquisition where the distributing corporation shares previously held were acquired pursuant to a plan. Accordingly, regulations could provide that if any shares in the distributing corporation were acquired pursuant to a plan involving the split-off, the Section 355(e) consequences of that acquisition must always be retested immediately after the split-off. For example, assume P owns all the 90x outstanding shares of D corporation, which in turn holds all 90x of the shares of C. Prior to the split-off, and not pursuant to a plan, D issues 10x shares (10% of its stock) to the public. Later, pursuant to a plan, X acquires a 20% interest in D (25x shares out of 125x

[24] These requirements are: (i) there is a business purpose for the stock purchase; (ii) the stock to be purchased is widely held; (iii) the stock purchases will be made in the open market; and (iv) there is no plan or intention that the aggregate amount of stock purchases will equal or exceed 20 percent of the outstanding stock of the corporation.

shares) in a transaction that would not be treated as a "purchase" for purposes of Section 355(d) and immediately thereafter D distributes the stock of C to P in redemption of P's 90x D shares. Under the suggested approach, the increase in the public's interest in D would not be treated as an acquisition because of the split-off, but X's original acquisition would be retested, with the result that Section 355(e) would be triggered.

b. Which Shares are Redeemed? Whether a redemption is treated as occurring pursuant to a plan, and therefore triggers a retesting of a previous acquisition, could depend on whether or not the redeeming corporation has knowledge of the identity of either the shareholders from whom it is redeeming or the shareholders whose interests will be increased as a result of the redemption. Regulations should address the circumstances under which taxpayers will be deemed[25] to have actual knowledge or a duty to inquire and will also need to provide conventions for dealing with redemptions from public shareholders.

The following examples provide a discussion point for various alternative rules that could be used to determine whether a redemption occurs pursuant to a plan.

> *Example #1: Actual knowledge; "Good" shares redeemed.* D is a public corporation that owns all the stock of C. D spins off all the C stock pro

[25] Again, we believe regulations should deem a corporation to have knowledge of its shareholders' public securities filings for all Section 355(e) purposes. *See infra* note 18.

rata to its shareholders, including principal shareholders X and Y, each of whom owned 10% of D's shares. D now has 100x of stock outstanding. Pursuant to a pre-arranged plan, A corporation acquires 60x newly issued shares of D stock in exchange for assets. A has therefore acquired a 37.5% interest in D pursuant to a plan.

Three months thereafter, also pursuant to a pre-arranged plan, D redeems 40x of the outstanding D stock from the public (*i.e.*, not from X, Y or A) for cash so that D now has 120x of stock outstanding, and A's 60x shares represent a 50% interest in D.

The increase in A's ownership caused by the redemption could be viewed either as an acquisition in itself, or as part of the original acquisition by A. The approach under discussion would require reapplication of the Section 355(e) test to A's acquisition of 60x shares, immediately after the redemption. In this case, because D has actual knowledge that the result of the redemption is to increase A's interest to 50%, Section 355(e) should be triggered.[26] The increases in the percentage interests held by X and Y should not be treated as "acquisitions" by reason of Section 355(e)(3)(A)(iv).

Example #2: No actual knowledge. D distributes 100% of the stock of C to its public shareholders. Pursuant to a plan, C merges with T, an unrelated corporation. After the merger, the former T shareholders own

[26] *Cf.* Treas. Reg. Section 1.355-6(b)(4), Ex. 1 (post-distribution redemption triggers application of Section 355(d) where redemption structured to avoid Section 355(d)).

40x of the C stock and the historic C shareholders hold 60x of C's stock. C then effects a redemption of 20x of its stock under circumstances not qualifying for a "safe harbor" and therefore treated as part of a plan.[27]

Because the redemption is pursuant to a plan, the approach under discussion would require reapplication of the Section 355(e) test. In the absence of actual knowledge as to whose shares are being redeemed, there are several paths the regulations could take. The regulations could, for instance, view the redemption as coming pro rata from all the public shareholders. If this approach were followed, the former T shareholders would continue to be deemed to own only 40% of the stock of C. This approach would effectively exclude from the reach of Section 355(e) the effect of pre-arranged redemptions where neither the distributing nor the controlled corporation has actual knowledge of the identity of the redeemed shareholders. While this would certainly be a taxpayer-favorable result from a Section 355(e) perspective, it is also the case that pre-arranged redemptions of this sort would be evidence of "device."[28] Accordingly, the potential to abuse Section 355(e) in this way is circumscribed by the generally applicable Section 355 rules. However, to the extent such an approach presents significant abuse potential despite the "device" rules, regulations could provide, instead, that pre-arranged redemptions are presumed to reduce the number of

[27] As noted above, open market redemptions described in section 4.05(1)(b) of Rev. Proc. 96-30 could form the basis for a safe harbor.

[28] *See* Treas. Reg. §1.355-2(d).

"good" shares outstanding, unless the taxpayer can prove otherwise.[29] If this were the rule, the T shareholders in the example above would be viewed as owning 50% of C, triggering Section 355(e).

3. *Treatment of Shifts in Value in Different Classes of Stock.* Because the Section 355(e) test refers to vote or value, a shift in the value of outstanding shares could cause an acquisition by the holder whose shares represent an increased percentage of value by reason of the shift. Consider the following example.

Example. The stock of D corporation is owned one share each by 51 individuals. D conducts two businesses, business 1 and 2. Pursuant to a pre-arranged plan, D transfers the assets of business 1 to C and distributes the stock of C to the 51 individual shareholders. D is then immediately recapitalized. The 51 historic D shareholders each get 1 share of voting non-participating preferred stock in exchange for their common stock, and a new shareholder X receives, in exchange for a cash contribution to D, 49 common shares, each with a vote equal to 1 share of the preferred. Immediately after the spin-off, the voting preferred is worth 51 percent of the value of D, and the common is worth 49 percent. At the

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[29] Query, what would the taxpayer be required to demonstrate to overcome such a presumption? Would it be required to solicit a statement from the selling shareholder to the effect that he acquired the redeemed shares in the C-T merger? Would this be sufficient? If the selling shareholder owned shares in C and T prior to the merger, should he be permitted to designate the redeemed shares as "bad" shares, or should the shareholder be treated as having had redeemed a pro rata portion of his "good" and "bad" shares? Would statistical sampling be appropriate? *See, e.g.,* Rev. Proc. 81-70, 1981-2 C.B. 729.

end of one year, however, because D grows in value and the growth in value inures to the benefit of the common, the common held by X is worth 60 percent of D and the preferred owned by the old shareholders of D is worth only 40 percent.

Should the increase in the relative market value of the common be treated as an acquisition, or otherwise affect the Section 355(e) consequences of the original acquisition by X of 49 common shares? As a policy matter, we believe that if a shift in value of stock acquired pursuant to a plan is reasonably certain at the time of the acquisition (*i.e.*, the terms of the different classes of stock are designed to produce this result), that shift in value should be taken into account for purposes of Section 355(e).[30] However, in the non-participating preferred example in the text above, if the recapitalization is in fact value for value, it would not be possible to know whether the common will increase or decrease. Moreover, we do not believe the goal of administrability is served by articulating a rule that requires tracking fluctuations in the relative values of different classes of stock held by public groups.[31] It may be that an "anti-abuse" rule that requires retesting of the original transaction under certain circumstances would be the best way to address this issue. Alternatively, an anti-abuse rule could provide for more detailed rules that seek to identify situations where, as part of a plan, the capital structure of the target corporation is designed to circumvent the purpose of

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[30] For example, accreting preferred stock could be structured in a manner reasonably certain to result in a predictable increase in proportionate value compared to the common.

[31] The desire for an administrable rule that generally does not track fluctuations in value has precedent in the Code. *See* Section 382(l)(3)(C).

Section 355(e), and provide different remedies depending on the technique employed.[32] For instance, regulations could provide that in certain circumstances the value portion of the test would apply only with respect to stock that would be treated as participating in corporate growth to a significant extent for tax purposes.

4. *Treatment of Shifts in Voting Rights in Different Classes of Stock.* Shifts in voting rights present a problem that is similar to the value shift issue discussed above. Consider the following example:

> *Example*. D owns 40 percent of the common stock of C and individual X owns 60 percent. The stock of C at that time is a single class of common stock. D engages in the following series of transactions. First, the stock of C is recapitalized into two voting classes, Class I and Class II. Class I, which is worth 40 percent of C and has the right to elect eight directors (80% of the vote), is received by D in exchange for its previously held common stock. Class II, which is worth 60 percent and has the right to elect two directors (20% of the vote), is received by X in exchange for his previously held C stock. D then spins off C.

Should the pre-spin-off recapitalization be treated as resulting in the acquisition of a 40 percent interest in the stock of C, based on the shift in voting

[32] Such an approach has been pursued in the context of Section 382. *See* Treas. Reg. Section 1.382-2T(f)(18)(ii) which treats stock as not stock in certain situations for purposes of Section 382.

rights? If so, a post-spin purchase of stock with an additional 10 percent of the vote (if pursuant to a plan) would trigger Section 355(e). In this case, D's acquisition of an additional 40 percent vote should be treated as an "acquisition," as a technical matter, however, it appears that the acquisition would be protected by the literal language of Section 355(e)(3)(A)(i), and it might be argued that the indirect acquisition by D's shareholders should be protected consistent with the purpose of that provision. The exception contained in Section 355(e)(3)(A)(ii), relating to acquisition of controlled stock "by reason of holding" distributing corporation stock could also be read to provide additional support for finding that the acquisition by D's shareholders in the recapitalization and spin-off is protected. We note, however, that there is no particular policy justification for this result, and Section 355(e)(3)(A) contemplates that regulations could limit the reach of the enumerated exceptions. The "recap-into-control" technique is widely known, and has been employed in a number of well-publicized transactions. The potential application of Section 355(e) to these types of recapitalizations should be squarely addressed in the regulations.

More generally, regulations should identify the circumstances under which a shift in voting rights can result in an acquisition or a retesting requirement.

Because opportunities for shifts in voting rights normally occur only as a result of deliberate choices in structuring the terms of stock, and because voting shifts are readily measurable, we do not believe it would be burdensome to require taxpayers to track shifts in the voting power of different classes of stock during the presumption period (or other relevant testing period). For the same reasons, we generally are of the view that, if a voting rights shift occurs within the relevant testing period and the effect of the shift is to increase the voting interest of "bad" shares (shares acquired pursuant to a plan), the Section 355(e) consequences of that earlier acquisition should be retested. In other words, shifts in voting rights that occur within some specified period of the distribution should generally be treated as occurring pursuant to a plan, and should be taken into account in determining the consequences of earlier planned acquisitions. Dealing with voting rights shifts as an opportunity for retesting the consequences of an earlier acquisition would appear to be consistent with the approach suggested in example 5 of the temporary "plan" regulations and with the special rules of Safe Harbor V.[33]

Finally, regulations should clarify the extent to which an increase in the conversion ratio of Distributing convertible stock or securities should be treated as an "acquisition" within the meaning of Section 355(e). For example, suppose Distributing has convertible preferred stock outstanding that contains a standard anti-dilution provision. As a result of the distribution of Controlled and pursuant to the terms of the instrument, the conversion price of the convertible security is reduced to adjust for the dilutive effect of the spin-off. As a general matter, it seems that so long as the convertible preferred was not acquired pursuant to a

[33] *See* Treas. Reg. Section 1.355-7T(j), Example 5, paragraph (iii); Treas. Reg. Section 1.355-7T(d)(5)(ii)(B).

plan, the reduction in the conversion price should not result in an "acquisition" cognizable by Section 355(e) since the preferred holders did not participate in the transaction and the change occurs pursuant to the terms of the instrument.[34]

C. Treatment of Asset Acquisitions, Predecessors and Successors

1. *In General.* Section 355(e)(3)(B) provides that if the assets of the distributing corporation or any controlled corporation are acquired by a successor corporation in an "A", "C", or "D" reorganization or any other transaction identified by the Secretary of the Treasury, "the shareholders (immediately before the acquisition) of the corporation acquiring such assets shall be treated as acquiring stock in the corporation from which the assets were acquired." Because Section 355(e) generally applies to acquisitions of stock, this part of the statute seems to be intended to deal with transactions that involve a change in the beneficial ownership of the distributing or controlled corporation through the acquisition of all (or substantially all) of the target company's assets where the target ceases to exist, such as "C" reorganizations, which are actual asset acquisitions, or such as "A" reorganizations, which are treated like asset transactions for tax purposes.[35] Presumably, the general purpose of the provision

[34] *Cf.* Treas. Reg. Section 1.305-7(b) (which provides that Section 305(c) will not apply to find a deemed stock distribution "in connection with a change in the conversion ratio or conversion price of convertible preferred stock (or securities) or in the exercise price of rights or warrants, made pursuant to a bona fide, reasonable adjustment formula … which has the effect of preventing dilution of the interest of the holders of such stock or securities … .").

[35] It would be helpful to clarify, in this regard, that the reference to "D" reorganizations is meant to cover acquisitive "D" reorganizations, but not divisive "D" reorganizations.

is to treat the shareholders of the acquiring corporation as acquiring stock in the target equal in percentage to the percentage owned by such shareholders in the acquirer after the transaction, although there are no rules for translating asset acquisitions into stock acquisitions. Because "successor corporation" is not defined in the statute and because of the reference in the statute to "any other transaction specified in regulations by the Secretary," the application of Section 355(e)(3)(B) and its statutory function are unclear.

The scope of Section 355(e)(4)(D) is similarly ambiguous. It provides, without elaboration, that "any reference to a controlled corporation or a distributing corporation shall include a reference to any predecessor or successor of such corporation." For instance, this rule could (and a plain reading of it arguably does) cover each of the reorganization transactions specifically referenced in Section 355(e)(3)(B), sometimes with absurd results.

For example, if the assets of the distributing corporation or any controlled corporation are acquired by a successor corporation in an "A" reorganization, Section 355(e)(3)(B) provides that the shareholders of the acquiring corporation are treated as acquiring stock in the corporation from which the assets were acquired. This is clearly an intended and appropriate result. But what happens if, as part of a plan, D corporation spins off C and then acquires a smaller Target in an "A" reorganization? One might observe that since the assets of neither D nor C are being acquired, Section 355(e)(3)(B) should not be implicated. However, Section 355(e)(4)(D) states that any reference to a controlled corporation or a distributing corporation includes a reference to a predecessor or successor of such corporation. Under a very technical reading of the statute, the assets of a predecessor corporation of the distributing corporation (*i.e.*, Target) are acquired by a successor corporation (*i.e.*, D). Thus, D's shareholders are treated as acquiring the stock of Target. Literal application of the statute produces the result that there has been a distribution that is part of a plan pursuant to which one or more persons (*i.e.*, D's shareholders) are deemed to have acquired stock representing a 50-percent or greater interest in a predecessor of the distributing corporation (*i.e.*, Target). Although this might appear to be a case to which the exception in Section 355(e)(3)(A)(iii) could apply – D's shareholders are deemed to have received stock in Target by reason of holding stock of D – the language of the exception refers only to the acquisition of stock "in any successor corporation." Therefore, Section 355(e) would literally appear to apply to this example. Certainly, Congress did not intend this result.[36]

It is also not clear whether more than one entity may be a successor.[37] Broad construction of the term "successor" could lead to that result. For example, the acquisition of some, but not all, of the assets of another corporation could be

[36] Target's shareholders do, of course, directly acquire an interest in D, and that acquisition would and should be taken into account for purposes of Section 355(e).

[37] *Compare* Treas. Reg. Section 1.381(a)-1(b)(2)(i) *with* Treas. Reg. Section 1.1502-1(f)(4).

treated as a stock acquisition.[38] Although we think neither Section 355(e)(3)(B) nor Section 355(e)(4)(D) should be applicable to a taxable asset acquisition or the acquisition of only a portion of the relevant corporation's assets (other than pursuant to a "C" or "D" reorganization), the broad statutory language leaves open the possibility that either provision could apply.

Taxpayers would benefit from guidance as to the scope of the application of both the asset acquisition rule of Section 355(e)(3)(B) and the predecessor/successor rule of Section 355(e)(4)(D). Neither provision explicitly references Section 381 or any other provision that would limit the scope of the "successor" concept as a technical matter, nor does either provision establish a standard that the transaction must be a carryover basis transaction, relate to substantially all of the distributing or controlled corporation's assets or result in a shift in the beneficial ownership of the underlying business. However, the structure of Section 355(e) as a whole -- in particular, the specific reference under Section 355(e)(3)(B) to "A", "C" and "D" reorganizations -- suggests that Section 355(e)(3)(B) is intended to be the sole provision applicable to acquisitive asset transfers.[39] Accordingly, we would recommend that regulations establish that Section 355(e)(3)(B) applies to the statutorily enumerated acquisitive asset

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[38] *Cf.* Letter from Brian B. Gibney and Steven M. Flanagan, Ernst & Young LLP, to Internal Revenue Service (April 24, 2001) in which the authors urged promulgation of rules to clarify that asset dispositions should not be treated as an acquisition for Section 355(e) purposes.

[39] Presumably Section 355(e)(3)(B) would not have been necessary were Section 355(e)(4)(D) meant to apply to acquisition transactions.

reorganizations and to other specifically identified acquisitive transaction patterns that present opportunities for abuse (with clarifying language that its scope is no broader). We believe that this approach properly excludes from Section 355(e) asset transfers occurring pursuant to a plan (for example, a Section 721 transfer to a partnership[40] or a Section 1031 like-kind exchange) that, as a policy matter, should not trigger application of Section 355(e).

Assuming guidance narrowly circumscribes the circumstances under which an asset transfer will be treated as a stock acquisition under Section 355(e)(3)(B), we would recommend that regulations further provide, subject to possible application of a general anti-abuse rule, that an entity may be treated as a "successor" or "predecessor" under Section 355(e)(4)(D) *only* if there has been an asset transfer in which there has been no meaningful change in the beneficial ownership of the business relied upon to satisfy Section 355(b) (*e.g.*, entities acquiring the underlying business pursuant to a Section 332 liquidation, an "F" reorganization or the formation of a holding company under Section 351).[41]

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[40] Post-distribution transfers to a partnership are discussed in greater detail below.

[41] We believe the specific reference in 355(e)(3)(B) to "A", "C" and "D" reorganizations suggests that Section 355(e)(4)(D) is better viewed as a statutory stop-gap intended to apply to situations where there has literally been an asset transfer but – unlike the situations enumerated in Section 355(e)(3)(B) -- no change in the beneficial ownership of the underlying business. For example, a distributing corporation should not be able to avoid the application of Section 355(e) by liquidating under Section 332, after the distribution, into its corporate parent, which is itself an acquisition target. We believe that the predecessor/successor provisions were intended to ensure application of Section 355(e) on these and similar facts. Focusing on ultimate shareholder ownership to inform the application of Section 355(e)(3)(B) and Section 355(e)(4)(D) produces the correct result as a policy matter.

Limiting application of the "predecessor" and "successor" concepts to such transactions would effectively eliminate the possibility of multiple predecessors or successors, and would properly exclude asset transactions that require recognition of gain at the corporate level. Focusing Section 355(e)(4)(D) on transfers of the business or businesses relied upon to satisfy Section 355(b) in transactions in which there is no meaningful change in the beneficial ownership of the business is one way to limit the successor and predecessor provision of Section 355(e)(4)(D) where the form of the transaction would otherwise attract unintended application of Section 355(e).[42] It would be appropriate, however, to add an anti-abuse rule to prevent avoidance of Section 355(e) by structuring an interest in a non-successor transferee entity (including a partnership) in a manner that effectively permits the holder of the interest to control the corporate transferor (distributing or controlled, as the case may be) or which otherwise is intended to provide substantially the same rights and economics as direct stock ownership in the distributing or controlled corporation.[43] Concern with the possibility that acquisitions of interests in lower tier entities could produce results

[42] As noted above, the rule should include non-acquisitive asset transfers of the business or businesses relied upon to satisfy Section 355(b), including asset transfers that result in acquisition of such business or businesses through lower-tier corporate entities.

[43] *See, e.g.*, Treas. Reg. Section 1.382-4(d), which deals with circumstances under which options will be treated as stock for purposes of Section 382. *See also Alumax v. Commissioner*, 109 T.C. 133, *aff'd*, 165 F.3d 822 (11th Cir. 1999) (special arrangements giving certain shareholders control over matters normally within the purview of the Board of Directors could be viewed as the equivalent of voting stock.) Such an anti-abuse rule might also seek to reach situations in which a shareholder (or other interest holder) acquires an interest in both the top tier and one or more lower tier entities, or interests in a lower tier entity that are exchangeable into D or C stock. In this regard, we note that shares of distributing or controlled stock acquired pursuant to such an exchange right may themselves be treated as acquired pursuant to a plan.

intended to be covered by Section 355(e) could explain the drafting of the statute in a way that seems to test for an acquisition at multiple levels.[44] The purpose of clarity would be better served by addressing this concern in an anti-abuse rule.

Limiting the application of Sections 355(e)(3)(B) and 355(e)(4)(D) as suggested would answer or avoid numerous other questions. For example, overlapping ownership issues in asset acquisitions could be addressed in the same way as in stock acquisitions. In addition, subject to the application of specific anti-abuse provisions, partnerships generally would not be viewed as successors or predecessors. These issues are now discussed in more detail.

2. *Overlapping Shareholders.*

Example. After a spin-off, D is worth 200x and D's stock is owned 25 percent by individual X (worth 50x) and 75 percent by the public (worth 150). A is worth 100x and is owned 100 percent by X. D merges into A in an all stock transaction. Immediately following the merger X owns 50 percent of A (150x/300x).

Did X acquire 50 percent of D (the full percentage ownership of X after the transaction), only 33**a** percent (the portion of A's post-merger value

[44] For example, if the distributing or controlled corporation drops substantially all of its assets into "S," a new subsidiary, then causes the subsidiary to issue a 20% stock interest to "W" corporation for business assets contributed by W, the subsidiary could be viewed as a successor under Section 355(e)(4)(D), and "W," the new corporate shareholder of S, could be treated as acquiring stock in the distributing or controlled corporation. Although we do not believe this transaction, without more, should attract Section 355(e), what if as part of the same plan, W had also acquired a direct 35% interest in the distributing or controlled corporation? What if there were other agreements intended to provide W with rights/economics substantially similar to those of a shareholder of distributing or controlled?

attributable to X's ownership A stock before the merger), or 25 percent (the amount by which X's direct or indirect ownership of the D assets increased)? Under a Section 382 analysis, X's ownership would be viewed as increasing by only 25 percentage points. Section 355(e), however, could be read to mean that an acquisition of 50 percent has occurred (since X now owns 50% of the combined A/D corporation). We believe that in this type of situation the basic rule of Section 355(e) should not apply. Instead, regulations should elaborate on the statutory exception set forth in Section 355(e)(3)(A)(iv), which we think addresses these situations. Under this rule, X's ownership did not decrease by virtue of the merger with A and the public's ownership decreased from 75% to 50%. Therefore, there would have been an acquisition of only 25% of D for purposes of Section 355(e). Stated differently, it should not be possible for X to "acquire" any portion of D from itself and this is what Section 355(e)(3)(A)(iv), in essence, provides.

3. *Partnership Transactions*

Example. D distributes all the stock of C corporation pro rata to D's shareholders. Then, pursuant to a pre-arranged plan, a substantial portion of C's assets are dropped down into a newly formed partnership for which C receives a general partnership interest. Assume that C's management activities with respect to the partnership's business and interest in the partnership are sufficient, under the principles of Revenue Rulings 92-17 and 2002-49, to constitute the continued conduct by C of the contributed business for purposes of Section 355(b).[45] After the transaction, X, who was not a shareholder of D, has a greater-than 50 percent economic interest in the partnership which it received for a contribution of assets to the partnership at the time of its formation.

Should X's holding or acquisition of the partnership interest be viewed as an acquisition of an interest in the stock of C? Both Sections 355(e)(3)(B) and Section 355(e)(4)(D) are potentially implicated.

Under Section 355(e)(3)(B), regulatory authority arguably exists to permit this transaction to be viewed as an asset transaction that could be translated into an acquisition of some deemed amount of stock if the partnership were viewed as a "successor corporation." By its terms, however, Section 355(e)(3)(B) only applies to asset acquisitions by another *corporation*[46]. Thus, the partnership would have to be viewed as a "successor" to C under Section 355(e)(4)(D) in order for Section 355(e) to be implicated. As discussed above, we do not generally recommend that the "successor" concept be so broadly interpreted. However, we do believe that an anti-abuse rule could appropriately treat an acquisition of an interest in a lower tier entity, including a partnership, as an

[45] *See* Rev. Rul. 92-17, 1992-1 C.B. 142 *as amplified by* Rev. Rul. 2002-49, 2002-32 I.R.B. 288.

[46] We observe that Treas. Reg. § 1.701-2(e) permits the Commissioner in certain circumstances to treat a partnership as an aggregate of its partners. In the case of an asset acquisition by a partnership, some of whose partners are corporations, if this rule applied it could treat the transaction as an asset acquisition directly by the corporate partners, thereby potentially implicating Section 355(e)(3)(B).

"indirect" acquisition of stock in the higher tier entity under certain circumstances.

We would support adopting an anti-abuse rule intended to prevent avoidance of Section 355(e) by structuring interests in partnerships in a manner that effectively permits the parties to achieve a result substantially identical to a corporate acquisition that would trigger Section 355(e), or which otherwise is intended to provide substantially the same rights and economics as direct stock ownership in the distributing or controlled corporation.[47] In this regard, we note that partnership structures may offer more abuse potential than purely corporate structures. Among other things, partnership structures are very flexible, leverage friendly and can be more easily implemented without running afoul of Section 355(b).[48] Nevertheless, we believe the proper focus of the regulations should be on what types of arrangements are tantamount to acquisitions of a direct interest in D or C (*i.e.*, what kinds of arrangements might constitute an "indirect" acquisition pursuant to an anti-abuse rule), rather than on the technical question whether the partnership should be viewed as a successor.

[47] For example, the parties to a transaction might achieve the proscribed effect by providing for partnership interests that are exchangeable for stock or paired with a stock interest, or might enter into management or voting agreements that have such an effect.

[48] For example, the Section 355(b) test can be satisfied if the controlled corporation maintains a 25% managing interest in a partnership to which the controlled corporation's assets are contributed immediately before or after the spin-off, but the Section 355(b) test would not be satisfied if it were to contribute the same assets to a 50% owned and controlled corporate joint venture immediately before or after the spin-off.

D. Miscellaneous Clarifications.

1. Section 355(e)(3)(A). A number of miscellaneous clarifications interpreting Section 355(e)(3)(A) should be made in the regulations. First, regulations should clarify that the language "shall not be taken into account in applying paragraph (2)(A)(ii)" contained in Section 355(e)(3)(A) means that those transactions are not viewed as "acquisitions" for purposes of Section 355(e). That clarification would be consistent with the general approach for the time for testing outlined above. In addition, regulations should provide that there are no exceptions to the principles expressed in Section 355(e)(3)(A) (*i.e.*, that the language "Except as provided in regulations" is a null set).

Regulations should also clarify that the flush language of Section 355(e)(3)(A) does not apply to paragraph (e)(3)(A)(i). For instance, if Distributing formed Controlled pursuant to a plan to distribute Controlled to its shareholders in a transaction qualifying under Section 355 and then subsequently contributed assets to Controlled in exchange for additional Controlled stock, the subsequent acquisition of stock should not be an "acquisition" for purposes of Section 355(e).

Finally, regulations could clarify that the reference to "successor" in Section 355(e)(3)(A)(iii) is meant simply to describe situations where there has been a transaction implicating Section 355(e)(4)(D) (*i.e.* a change in the entity in which ultimate ownership in distributing or controlled is held). We believe the key language of paragraph (e)(3)(A)(iii) is the "by reason of holding" language, which we think covers these situations without the need for according separate meaning to the word "successor."

2. *Section 355(e)(4)(A).* Regulations should clarify that for purposes of Section 355(e), voting power means the right to elect directors. [49]

[49] *See* Rev. Rul. 69-126, 1969-1 C.B. 218.