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August 18, 2008

Re: Formal Guidance for Stock Buybacks and "North South" Transactions[1]

Dear Sirs:

We write to suggest that the Internal Revenue Service ("IRS") publish formal guidance regarding (i) permissible stock buybacks following a putative section 368(a)[2] reorganization or section 355 distribution,[3] and (ii) the effect of a North/South Transaction (as defined below) prior to a putative section 355 distribution. At present, IRS private letter rulings represent substantially

[1] The principal drafters of this letter are Jodi J. Schwartz, Linda Z. Swartz, Richard M. Nugent, and Laura R. Pomeroy-Gerber with substantial assistance from Lawrence M. Garrett, Joshua Gordon and Jonathan Kushner. Helpful comments were received from David S. Miller, Michael L. Schler, Deborah L. Paul, and Andrew H. Braiterman.

[2] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] For convenience, we also refer to a putative section 355 distribution as a "spinoff". Our analysis would also apply to a section 355 distribution effected, in whole or part, as a splitoff.

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all of the available guidance in these areas. While private rulings certainly provide valuable insight into the government's view of potentially acceptable transactions, taxpayers generally may not rely on private letter rulings that are not addressed to them,[4] and, thus, an environment of uncertainty exists. Accordingly, we recommend that the IRS publish formal guidance to increase certainty and efficiency in the reorganization and spinoff areas.

STOCK BUYBACKS

I. Background

A. Continuity of Interest

A section 368(a) reorganization generally must satisfy the continuity of interest ("COI") test, which requires that a substantial part of the value of the proprietary interests in the target corporation be preserved.[5] The section 368 Treasury regulations confirm that a 40 percent continuing equity interest received by the target corporation shareholders in a reorganization satisfies COI.[6]

In 1998, the government adopted COI regulations addressing pre- and post-reorganization dispositions of target or acquiring corporation stock to eliminate uncertainty presented by inconsistent case law.[7] The 1998 regulations clarified that "sales of Target stock occurring prior to a reorganization and sales of Acquiror stock by Target shareholders after a reorganization, in each case to parties unrelated to the Acquiror, are disregarded for continuity of interest purposes."[8] The regulations contained the following example illustrating the effect of a stock repurchase program on COI ("Example 8"):

> Effect of general stock repurchase program. T merges into P, a corporation whose stock is widely held and publicly traded and that has one class of common stock outstanding. In the merger, T shareholders receive common stock of P. Immediately after the

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[4] *See* I.R.C. § 6110(k)(3).

[5] Treas. Reg. § 1.368-1(e)(1)(i). This requirement is satisfied if, in a potential reorganization, a proprietary interest in the target corporation (i) is exchanged for an equity interest in the issuing corporation (as defined below), (ii) is exchanged by the acquiring corporation for a direct interest in the target corporation, or (iii) otherwise continues as a proprietary interest in the target corporation. *Id.* The "issuing corporation" is generally the acquirer or the corporation that controls the acquirer in the case of a triangular reorganization. *Id.* COI does not apply to a section 368(a)(1)(E) or (F) reorganization, and the government has requested comments on the extent to which COI applies to a section 368(a)(1)(D) reorganization. Treas. Reg. § 1.368-1(b); 71 Fed. Reg. 75898, 75899 (Dec. 19, 2006).

[6] *See* Treas. Reg. § 1.368-1(e)(2)(v), Ex. 2(ii).

[7] *See* N.Y. St. BA. Tax Sec. Report No. 1050, *Report on Continuity of Interest and Pre-Closing Stock Value Fluctuation*, 2004 TNT 17-21, 17 (Jan. 23, 2004).

[8] *Id.* at 11 (citing Treas. Reg. § 1.368-1(e) (1998)).

> merger, P repurchases a small percentage of its common stock in the open market as part of its ongoing stock repurchase program. The repurchase program was not created or modified in connection with the acquisition of T. Continuity of interest is satisfied, because based on all of the facts and circumstances, the redemption of a small percentage of the P stock does not affect the T shareholders' proprietary interest in T, because it was not in connection with the merger, and the value of the proprietary interest in T is preserved.[9]

In Revenue Ruling 99-58,[10] the IRS addressed stock buybacks after a putative reorganization in which target merged into acquiring, a publicly and actively traded corporation whose stock was widely held. Acquiring modified its preexisting stock buyback program to permit the repurchase of the same number of shares issued in the merger; the number of shares to be repurchased would not exceed the number outstanding prior to the reorganization. The ruling assumes that acquiring (i) announced its intention to repurchase shares prior to the merger, (ii) did not negotiate the buyback program with the target or its shareholders, and (iii) made the repurchases after the merger, on the open market, through a broker for the prevailing market price.[11] The IRS concluded that the open market share repurchases satisfied COI where there was no agreement between acquiring and target's shareholders that the latter's stock ownership would be transitory, the mechanics of the repurchase program did not favor the target's shareholders, and any repurchase of the target shareholders stock would be coincidental.[12]

Revenue Ruling 99-58 arguably conflicted with Example 8 in the 1998 COI regulations because, in the ruling, acquiring modified its buyback program in connection with the merger to permit the repurchase of the same number of shares issued in the merger. In 2000, the IRS removed Example 8 from the regulations, explaining that, "[i]n the example, P repurchases a small percentage of its stock after a reorganization, as part of a preexisting stock repurchase program. . . . Because Example 8 suggests a more restrictive approach to COI than was intended in this context, Example 8 is removed by this Treasury decision."[13]

B. Device

To satisfy section 355, a distribution cannot be used principally as a device for the tax-free distribution of corporate earnings and profits to distributing's shareholders.[14] The Treasury regulations adopt a "facts and circumstances" approach to the device test, weighing factors that may evidence device against factors that indicate the absence of device.[15] Factors

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[9] Treas. Reg. § 1.368-1(e)(6), Ex. 8, *before amendment* by T.D. 8898, 2000-2 C.B. 276 (emphasis added).

[10] 1999-2 C.B. 701.

[11] *Id.*

[12] Rev. Rul. 99-58, 1999-2 C.B. 701.

[13] T.D. 8898, 2002-2 C.B. 276.

[14] *See* I.R.C. § 355(a)(1)(B); Treas. Reg. § 1.355-2(d).

[15] *See* Treas. Reg. § 1.355-2(d)(1).

that are evidence of device include a subsequent sale or other taxable disposition of distributing or controlled stock, and the evidence grows stronger as the period of time between the distribution and sale becomes shorter.[16] A sale of distributing or controlled stock by shareholders after the distribution "pursuant to an arrangement negotiated or agreed upon before the distribution" is substantial evidence of device.[17] Accordingly, post-distribution stock sales by shareholders of distributing or controlled stock pursuant to a stock buyback program are subject to scrutiny under the device test.

Prior to Revenue Procedure 96-30,[18] taxpayers seeking a private letter ruling on a spinoff generally had to represent that:

> (a) There is no plan or intention by distributing's shareholders or security holders to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in, or securities of, either distributing or controlled subsequent to the transaction, other than stock repurchases satisfying subsection (b) below; and
>
> (b) Purchases by distributing or controlled of its stock subsequent to the transaction, provided:
>
> > 1. There is a corporate business purpose for the purchase;
> >
> > 2. The stock purchased is widely held;
> >
> > 3. The stock purchases will occur in the open market and, to the best of the corporation's knowledge, will not be made from (i) directors or officers or (ii) any shareholder owning 1% or more of the corporation's outstanding stock; and
> >
> > 4. There is no plan or intention that the aggregate stock purchases will equal or exceed 20% of the corporation's outstanding stock.[19]

Revenue Procedure 96-30 replaced these representations with new, slightly liberalized representations, effectively removing clauses (i) and (ii) of representation (b)(3).[20]

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16 Treas. Reg. § 1.355-2(d)(2)(iii).

17 Treas. Reg. § 1.355-2(d)(2)(iii)(B).

18 1996-1 C.B. 696 (effective for ruling requests postmarked after June 4, 1996).

19 *See* Rev. Proc. 91-63, 1991-2 C.B. 865.

20 *Id.* at 4.05(b). Additionally, Revenue Procedure 96-30 revised representation (a) to contain an alternate representation for publicly traded companies, allowing them to represent that there is no plan or intention by (i) any shareholder owning at least 5% of distributing's stock or (ii) to the best knowledge of distributing's management, any particular remaining shareholder or security holder of distributing to dispose of stock in, or securities of, either distributing or controlled after the transaction. Rev. Proc. 96-30, 1996-1 C.B. 696.

In Revenue Procedure 2003-48,[21] the IRS announced that it will no longer address device in the private letter ruling context.[22] Consequently, device issues, including the effect of stock buyback programs, generally are now addressed solely in opinions of counsel.

C. Forms of Repurchase

1. Open Market Repurchases

Two typical open market repurchase programs effected through dealers are "10b-18 programs" and "10b5-1 plans". Both plans are intended to comply with securities laws designed to restrict market manipulation and dealing when the issuer has inside information.

Under a "10b-18 program", in exchange for a commission, the issuer arranges for the dealer to buy shares on the issuer's behalf from time to time. If the issuer wants to buy shares on a particular day, it calls its dealer and places an order, specifying the number of shares and, if desired, price limits at which to buy. The dealer generally attempts to achieve volume weighted average pricing ("VWAP") for the day, that is, the average price of all shares sold, by purchasing shares throughout the day. The dealer's purchases, like any issuer share repurchases, are subject to the volume, time and manner of purchase restrictions of Rule 10b-18 under the Securities Exchange Act of 1934 (the "Exchange Act"). The issuer may only purchase shares under a 10b-18 program when it is not in possession of material nonpublic information ("MNPI") or not otherwise subject to repurchase blackouts.

Under a "10b5-1 plan," the issuer repurchases shares on days during which it would otherwise be blacked out (due to earnings blackouts or possession of other nonpublic information). In a 10b5-1 plan, the dealer will purchase shares in the future without any further instructions (or direction) from the issuer. The dealer establishes a grid of prices and share amounts up front and, in exchange for a fixed per share commission, purchases shares pursuant to that grid during the life of the plan without instruction from the issuer.[23]

Rule 10b-18 allows issuers to execute up to one block trade per week (if the issuer is not otherwise in the market on the day of the block trade). Issuers who would like to repurchase blocks as part of their 10b-18 program generally indicate that interest to their dealers who will generally call buy-side contacts that may wish to sell and/or place an "indication of interest" on Bloomberg seeking to buy a block at a specified price (generally at a discount to the last trade). The dealer will generally seek a block only during the first 15 minutes of the trading session, as a block purchase will prevent the issuer from making any other purchases under Rule 10b-18 for the remainder of the trading day. If the dealer cannot find a block in the first 15

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[21] 2003-2 C.B. 86.

[22] *See* Rev. Proc. 2003-48, 2003-2 C.B. 86 (taxpayers must represent that distribution "is not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both.").

[23] The intent of these plans is to satisfy the "affirmative defenses" section of Rule 10b5-1, which allows insiders to discreetly trade their stock on the market without risk of liability. To appropriately make use of this safe harbor, insiders must adopt a 10b5-1 plan at a time when they are unaware of MNPI, and the plan must satisfy certain additional requirements.

minutes, it will begin executing the 10b-18 order in the open market in order to avoid "missing VWAP" (by buying shares for prices above the VWAP of all shares traded that day).

Dealers do not, as a matter of policy, disclose the identity of block sellers to buyers or vice versa, and the issuer has no right and generally has no ability to discover the identity of a block seller. A block seller, however, may be able to conclude that the issuer is the buyer of a block since issuers generally disclose share repurchase programs.

2. Self Tenders

In a self tender, the issuer offers to purchase its shares in the public equity markets at a premium to the then-current market price. The issuer announces the proposed tender offer, files documents with the Securities and Exchange Commission and mails tender offers documents to its shareholders. The issuer's board of directors may (or may not) recommend that shareholders tender, and the tender documents will generally disclose whether directors and management intend to tender. A tender offer must remain open for at least 20 business days, and must be available to all shareholders.

Issuers may offer to purchase their shares at a fixed price. More commonly, however, issuers use a "Dutch auction" tender offer that invites shareholders to tender at prices specified by the shareholders, subject to maximum and minimum prices predetermined by management. After receipt of the tenders in a Dutch auction, the lowest purchase price within the price range that will permit the purchase of the desired number of shares will be the "clearing price" for the shares. All shareholders who tendered shares at or below the clearing price receive the clearing price for all shares purchased. The issuer prorates the shares purchased if more than the maximum amount are tendered, and returns shares tendered at prices above the clearing price. In the case of shares not held in street name through brokerage accounts, tender documents generally allow the company to know whether a particular record shareholder has tendered.

3. Accelerated Stock Buybacks and Other Derivative Repurchases

Derivative share repurchase products allow issuers to achieve specific corporate finance, accounting or economic objectives while repurchasing shares. For instance, products like the Accelerated Stock Buyback ("ASB"), sometimes also called an Accelerated Stock Repurchase, allow issuers to monetize the volatility in their stock by selling options to dealers in exchange for discounts and/or price protection on their share repurchases. In addition, derivative products often provide favorable accounting treatment allowing issuers to improve their financial metrics, as described below.

ASB

The most common derivative repurchase product in the United States is the ASB, which allows an issuer to immediately reduce its number of shares outstanding for GAAP earnings per share ("EPS") purposes. A dealer borrows a number of the issuer's shares in the public stock loan market and sells them to an issuer in a single block trade, entering into a "make-up contract" with a fixed maximum maturity to determine the final pricing of the shares. During the "make-up" period, the dealer repurchases shares for its own account in the open

market to cover its short positions. The dealer returns the purchased shares directly to the stock lender on a daily basis. At maturity, the issuer or dealer settles the "make-up contract" by delivering cash or shares to settle the final value of the ASB.

Economically, the number of shares retired under an ASB is generally based on the notional amount of the ASB divided by the Rule 10b-18 VWAP over the term of the contract. The buyback is usually sized by setting a fixed dollar amount, although it is possible to set a fixed number of shares. The length of the "make-up" period can be fixed or variable; a variable maturity feature is economically an option purchased by the dealer, which the dealer normally pays for by offering the issuer a discount on the VWAP paid for the shares. An ASB can also be structured with a collar, which sets a maximum and minimum number of shares the issuer will retire in exchange for the fixed upfront payment and provides limited exposure to potential increases in the repurchase price, while potentially forgoing a payment from the deal if the stock falls below a floor price. More exotic structures incorporating additional derivatives are also possible.

Fixed Share Forward

In a fixed share forward, the issuer enters into a contract with a dealer obligating the issuer to buy, and the dealer to sell, a fixed number of shares at some point in the future at a fixed price based on the stock price when the contract is executed. The shares repurchased in the fixed share forward may generally be treated as retired for GAAP EPS purposes immediately upon entry into the contract.

Other Derivatives

Other share repurchase derivatives are also used in the market. For example, an issuer may write a below-market put option on its own shares; if the stock price drops, the holder will exercise the put, requiring the issuer to repurchase shares at a price below the price when it entered the contract. By contrast, if the stock price rises or stays stable, the issuer generally does not repurchase shares but receives an above-market return on its cash (monetizing the put premium).

II. Discussion

A long series of private letter rulings clarify the rules regarding buybacks in the reorganization and spinoff areas.[24] In particular, the private rulings address ASBs,[25] tender

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[24] In the reorganization context, see PLR 200141040 (Oct. 16, 2001) (target pre-merger tender offer); PLR 200729002 (July 20, 2007) (acquiring repurchase program permitted open market repurchases through broker and privately negotiated transactions); PLR 200740005 (Oct. 5, 2007) (ASB in connection with reorganization; acquiring expanded previously arranged repurchase program when merger was announced to reduce dilutive effects). In the spinoff context, see PLR 9724027 (June 13, 1997) (controlled permitted to repurchase shares through tender offer in which no officers, directors or 1% or greater shareholders would participate); PLR 9824034 (June 16, 1998) (tender offer); PLR 199914028 (Apr. 12, 1999) (block purchase); PLR 199941027 (Oct. 18, 1999) (tender offer); PLR 200017035 (May 1, 2000) (tender offer); PLR 200023031 (June 12, 2000) (block purchase); PLR 200039032 (Oct. 2, 2000) (purchase resembling an ASB); PLR 200125011 (June 25, 2001) (put and call options); PLR 200130003 (July 30, 2001) (distributing and controlled entered into put and call options with

offers,[26] and block purchases.[27] At different times, the IRS has imposed additional conditions or required additional representations regarding non-open market buybacks, such as the requirement that distributing have no knowledge that officers, directors or 1% or greater shareholders would participate[28] or that the counterparty to a derivative make purchases on the open market.[29] Regarding block trades, some earlier rulings permit block trades as long as the sellers' identity is unknown,[30] while other, more recent rulings also permit block trades with specifically identified sellers as long as the repurchases occur pursuant to a 10b-18 program and

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unrelated banks; neither distributing nor controlled could identify ultimate sellers or had knowledge of shareholder plans to sell stock, except for fractional shares received in spinoff); PLR 200645011 (Nov. 10, 2006) (block purchase, modified Dutch auction tender offer, ASB); PLR 200710011 (Mar. 9, 2007) (block purchase, modified Dutch auction tender offer, ASB); PLR 200741013 (Oct. 12, 2007) (block purchase, modified Dutch auction tender offer, ASB); PLR 200750009 (Dec. 14, 2007) (ASB).

[25] PLR 200039032 (Oct. 2, 2000) (in addition to repurchases satisfying Revenue Procedure 96-30, distributing could repurchase less than 2% of its common stock from financial institution in transaction resembling ASB; financial institution would purchase stock on open market); PLR 200645011 (Nov. 10, 2006) (distributing effected block purchases, modified Dutch auction tender offers and ASBs; while distributing might know the seller's identity, all block purchases would satisfy Rule 10b-18, and no purchases would be made from shareholder owning at least 5% of distributing's stock at the time of purchase, and could repurchase more than 20% of its stock); PLR 200710011 (Mar. 9, 2007) (controlled could effect block purchases, modified Dutch auction tender offers, and ASBs; while controlled might know the seller's identity, all block purchases would satisfy Rule 10b-18, and no purchases would be made from shareholder then owning at least 5% of controlled's stock); PLR 200740005 (Oct. 5, 2007) (stock repurchased through ASB would not exceed amount of stock outstanding prior to merger or number of shares issued to target's shareholders; unrelated counterparty would purchase on the open market, and there was no preexisting understanding that target shareholders would sell their shares); PLR 200741013 (Oct. 12, 2007) (similar to PLR 200645011); PLR 200750009 (Dec. 14, 2007) (other than discussions with investment banks about facilitating ASB, there was no agreement, understanding, or substantial negotiations for section 355(e) purposes with respect to stock repurchases under buyback program).

[26] PLR 9724027 (June 13, 1997) (to the best of distributing's knowledge, no purchases in controlled's tender offer would be made from controlled's officers or directors or 1% or greater shareholders); PLR 9824034 (June 16, 1998) (tender offer repurchases by distributing and controlled, plus repurchases satisfying Revenue Procedure 96-30, would not exceed 20% of either company's outstanding stock or include officers or directors of either company); PLR 199941027 (Oct. 18, 1999) (no plan or intention for total repurchases by controlled, including through tender offer, to equal or exceed 20% of its outstanding stock or for controlled to purchase shares from any officers or directors); PLR 200017035 (May 1, 2000) (essentially same as PLR 199941027); PLR 200141040 (Oct. 16, 2001) (target pre-merger tender offer intended to increase holdings of target's largest shareholders; parties represented that tender offer financing would be repaid out of target's future earnings or capital contributions from acquiring); PLR 200645011 (Nov. 10, 2006) (tender offer among other repurchase techniques); PLR 200710011 (Mar. 9, 2007) (modified Dutch auction tender offer among other repurchase techniques); PLR 200741013 (Oct. 12, 2007) (same).

[27] PLR 199914028 (Apr. 12, 1999) (block purchaser would not know seller's identity, repurchases deemed to be made on open market within meaning Revenue Procedure 96-30); PLR 200023031 (June 12, 2000) (block purchases made through subsidiary in the business of matching securities buyers and sellers; while controlled could know seller's identity, controlled would not purchase shares from its chairman or 5% or greater shareholders, would instruct subsidiary not to buy on controlled's behalf when its clients, controlled's chairman or 5% or greater controlled shareholders were selling stock, and would not purchase shares as a block trade if controlled knew seller's identity before trade's execution); PLR 200710011 (Mar. 9, 2007) (block purchases among other repurchase techniques); PLR 200741013 (Oct. 12, 2007) (same).

[28] PLR 9724027 (June 13, 1997).

[29] PLR 200740005 (Oct. 5, 2007).

[30] PLR 200023031 (June 12, 2000); PLR 199914028 (Apr. 12, 1999).

no purchases are made from a 5% shareholder or institutional investor.[31] The private rulings do not impose any additional requirements where the seller in a block purchase is a former target shareholder. This approach is sensible since, as discussed below, the rulings and our recommended guidelines separately require the absence of any understanding with shareholders that their ownership of the issuer's stock would be transitory. Accordingly, any repurchase of a former target shareholder's stock in a block purchase would be coincidental.[32]

In light of the "no ruling" policy on device, published guidance would be useful to clarify the impact of stock buybacks on spinoffs. In addition, for both spinoffs and reorganizations, guidance formalizing and clearly articulating the government's positions in the private letter rulings cited above would be useful clarification in light of prevailing market practices. We generally believe that taxpayers should enjoy flexibility to use the most economically efficient method to repurchase shares, provided the issuer does not target specific large shareholders. Moreover, we do not believe that derivative transactions raise any tax policy concerns as long as the counterparty makes any subsequent purchases in the open market. Similarly, we believe that the "any and all requirement" in the tender offer rules eliminates, as a practical matter, the possibility of targeting specific shareholders.

We recommend that the IRS publish formal guidance allowing issuers to adopt or modify a stock buyback program (an "announced buyback program") in connection with a putative section 368(a) reorganization or section 355 distribution, provided that:

(a) The issuer is publicly traded;

(b) The number of shares repurchased pursuant to the same plan does not exceed the number of shares outstanding before, or issued in, the reorganization, or 20% of the issuer's outstanding stock in the case of a spinoff;[33]

(c) In the case of a reorganization, the repurchases occur after the transaction;[34]

(d) The repurchases occur pursuant to an announced buyback program:

1. on the open market at the prevailing market price;

2. via short sales or other derivative transactions between the issuer and another party, including an ASB, and the counterparty to the derivative makes its subsequent purchases on the open market;

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[31] PLR 200741013 (Oct. 12, 2007); PLR 200645011 (Nov. 10, 2006).

[32] *See* Rev. Rul. 99-58, 1999-2 C.B. 701.

[33] *See* Rev. Rul. 99-58, 1999-2 C.B. 701; Rev. Proc. 96-30, 1996-1 C.B. 696. We note that the IRS has also permitted a distributing corporation to repurchase more than 20% of its stock after a spinoff. PLR 200741013 (Oct. 12, 2007); PLR 200645011 (Nov. 10, 2006).

[34] A pre-spin buyback does not raise device issues.

3. via an offer to purchase made to all shareholders where the issuer does not know the identity of the seller(s) until after the offer closes; or

4. via a block purchase by the issuer or its broker from a shareholder not specifically solicited by the issuer or, to the best of the issuer's knowledge, not an officer or director of the issuer or a shareholder owning 5% or more of the issuer's outstanding stock, provided that, if the purchaser knows the identity of the seller in advance of the sale, the block purchase occurs as part of a 10b-18 program which, *inter alia*, allows only one block purchase per week and contains volume and other restrictions described above;[35] and

(e) There was no understanding with the shareholders that their ownership of the issuer's stock would be transitory.

NORTH/SOUTH TRANSACTIONS

In connection with a section 355 distribution by a wholly owned subsidiary, distributing's sole shareholder ("parent") frequently contributes certain assets (the "contributed assets") to distributing.[36] Because assets are going both into ("south") and out of distributing ("north"), practitioners often refer to the above transaction as a "North/South Transaction".[37] In certain instances, the contribution and distribution will be part of a larger corporate restructuring designed to properly align assets and operations within a corporate group. In others, the contribution may consist of assets and operations intended to permit distributing to satisfy the active trade or business requirement ("ATOB") in section 355(b).[38] Consistent with our experience, we assume that the contribution and the distribution are related transactions insofar as the contribution would not occur but for the subsequent putative section 355 distribution. As discussed below, we recommend that the government publish a revenue ruling confirming the tax treatment of a typical North/South Transaction.[39]

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35 For a general discussion of Rule 10b-18, see Part I.A above.

36 We assume that parent is a corporation which, in turn, distributes the controlled stock to its shareholders in another section 355 transaction.

37 We assume that, except for the issue raised by the North/South Transaction, the distribution otherwise satisfies the requirements of sections 368(a)(1)(D) and 355.

38 *See* Treas. Reg. § 1.355-3(b)(4)(i) (ATOB requirement may be satisfied with business acquired within five years of distribution in transaction in which no gain or loss was recognized); Treas. Reg. § 1.355-3(b)(4)(iii) (ATOB requirement may be satisfied with business acquired within five years of distribution from distributing's affiliate in taxable transaction); Notice 2007-60, 2007-35 I.R.B. 466 (taxpayers generally may continue to rely on Treasury regulation section 1.355-3(b)(4)(iii) until modified by new regulations).

39 While this letter is limited to the impact of a first step contribution on a second step distribution otherwise qualifying under section 355, we recognize that other transactions beyond the scope of this letter may present similar issues. Any formal guidance regarding North/South Transactions should be published without prejudice to the treatment of similar issues in other factual contexts.

A North/South Transaction has two potential characterizations. First, the transaction steps could be integrated and treated under the step transaction doctrine[40] as an exchange of the contributed assets for controlled stock.[41] This characterization could potentially jeopardize the qualification of the controlled stock distribution under section 355, if the fair market value of the contributed assets exceeds 20% of controlled's value and so distributing could not distribute controlled stock representing section 368(c) control,[42] or could give rise to a taxable event even in connection with a tax-free spinoff.

Alternatively, the components of a North/South Transaction could be viewed as separate steps consisting of parent's transfer of the contributed assets followed by the distribution of controlled stock to parent solely in respect of its distributing stock. In this case, parent would be treated as transferring the contributed assets to distributing in a tax-free section 351 exchange, and distributing would be treated as distributing 100% of the controlled stock to parent in a section 355 transaction.

The IRS has consistently issued private letter rulings for many years effectively treating parent's transfer of the contributed assets separately from the putative section 355 distribution.[43] All of these private letter rulings are consistent with the underlying policy of the reorganization provisions to provide nonrecognition treatment to transactions facilitating continuing ownership of corporate property in modified corporate form.[44]

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[40] The step transaction doctrine generally integrates a series of formally separate steps into a single transaction "if such steps are in substance integrated, interdependent, and focused toward a particular result." *See Penrod v. Commissioner*, 88 T.C. 1415 (1987); *Estate of Christian v. Commissioner*, T.C. Memo. 1989-413; Rev. Rul. 79-250, 1979-2 C.B. 156.

[41] *See Commissioner v. Baan*, 382 F.2d 485 (9th Cir. 1967) (substance of transaction was not a "distribution with respect to stock" because distributing's shareholders were required to pay cash to receive controlled stock), *aff'd sub nom*, *Commissioner v. Gordon*, 391 U.S. 83 (1968); *Owens Machinery Co. v. Commissioner*, 54 T.C. 877 (1970) (parent corporation transferred subsidiary stock to shareholder for cash and parent stock held by the shareholder; because shareholder paid cash, transaction was not a section 311 distribution with respect to stock). *See also* Rev. Rul. 64-155, 1964-1 C.B. 138 (actual receipt of shares is unnecessary for section 351 to apply to shareholder's transfer of property to wholly owned corporation); Rev. Rul. 70-240, 1970-1 C.B. 81 (X was deemed to receive Y share where shareholder owned all shares of X and Y, X sold substantially of its assets to Y at fair market value, and X transferred cash to common shareholder in a liquidating distribution, which resulted in a reorganization under section 368(a)(1)(D); shareholder was treated as receiving dividend under section 356(a)(2)).

[42] *See* I.R.C. § 355(a)(1)(D).

[43] *See, e.g.*, PLR 200611006 (Mar. 17, 2006) (distributing's contribution of property to controlled, followed by controlled's distribution of its subsidiary to distributing and distributing's distribution of controlled stock to shareholders qualified as section 368(a)(1)(D) reorganization); PLR 200411021 (Mar. 12, 2004) (parent contributed property to distributing, followed by distributing's distribution of controlled stock); PLR 200345049 (Nov. 7, 2003) (after receiving distribution of controlled stock, distributing's shareholder contributed property to distributing as part of bankruptcy reorganization, followed by distribution of distributing stock to shareholders; transactions qualified as section 368(a)(1)(G) reorganization); PLR 200215031 (Apr. 12, 2002) (distributing's shareholder contributed cash to distributing). *See also* PLR 200831006 (Aug. 1, 2008); PLR 200815020 (Apr. 11, 2008); PLR 200805011 (Feb. 1, 2008); PLR 200802009 (Jan. 11, 2008); PLR 200708017 (Feb. 23, 2007); PLR 9848029 (Nov. 27, 1998); PLR 9751043 (Dec. 19, 1997); PLR 9510005 (Dec. 5, 1994); PLR 9507036 (Nov. 21, 1994).

[44] *See* Treas. Reg. § 1.368-1(b) (purpose of reorganization provisions is to provide nonrecognition treatment to readjustments of continuing interest in property under modified corporate forms).

In light of its long history of granting these private rulings, it appears that the government has reached the conclusion that the transfer of the contributed assets in a standard North/South Transaction is treated separately from the putative section 355 distribution.[45] This conclusion is consistent with Revenue Ruling 69-407,[46] in which the government permitted a controlled corporation to recapitalize its stock into "high vote" and "low vote" stock so that distributing could distribute controlled stock representing section 368(c) control in a section 355 distribution. The separate treatment afforded the relevant steps in Revenue Ruling 69-407 supports the separate treatment of the contribution and distribution in the North/South Transaction private rulings.

Moreover, treating the components of a North/South Transaction separately is appropriate since, in general, the contribution merely facilitates the second step distribution and is not undertaken in exchange for the distributed stock (or other property). Separate treatment is consistent with the government's approach to intragroup transactions, including D reorganizations, which respect the form and order of property contributions to, and distributions from, a transferee corporation,[47] and the rule generally permitting a corporation to satisfy the ATOB requirement by acquiring an active business from an affiliate in a taxable transaction immediately before a spinoff.[48]

Accordingly, it would be extremely beneficial for taxpayers and their advisors if the government published official guidance in the form of a revenue ruling confirming the government's position that the transfer of contributed assets in a North/South Transaction is separate from the putative section 355 distribution and that a North/South Transaction will not be recast as an exchange of the contributed assets for controlled stock. Publication of a revenue ruling would allow taxpayers to forego the need to seek a private ruling confirming that a first step contribution will not disqualify an otherwise tax-free, second step section 355 distribution.

We recommend that the revenue ruling specifically hold, consistent with the government's approach in addressing other section 355 issues, that the components of a North/South Transaction represent independent steps.[49] Thus, the revenue ruling should

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[45] In general, the rulings do not specifically address the North/South Transaction, although they contain the general representation that no part of the consideration distributed by distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation." Rev. Proc. 96-30, § 4.02(4)(d)(i), 1996-1 C.B. 696; *see also* Official Summary of Ltr. Ruling that Spin-off of Unwanted Businesses Before Acquisition Qualifies as Tax-Free, 2000 TNT 250-54 (Dec. 28, 2000) (official summary to 1997 private ruling that included a North/South Transaction concluded, without explanation, that North/South Transaction steps did not represent taxable exchange). This representation ensures, among other things, that distributing's shareholders will not receive their controlled stock in exchange for the non-stock property contributed to distributing in the North/South Transaction.

[46] 1969-2 C.B. 50.

[47] *See* I.R.C. § 368(a)(1)(D).

[48] *See* Treas. Reg. § 1.355-3(b)(4)(iii) (ATOB requirement may be satisfied with business acquired within five years of distribution from distributing's affiliate in taxable transaction); Notice 2007-60, 2007-35 I.R.B. 466 (taxpayers generally may continue to rely on Treasury regulation section 1.355-3(b)(4)(iii) until modified by new regulations).

[49] For a discussion of potential supporting rationales for a North/South Transaction, see Wayne T. Murray, "The *Gregory* Rules of Section 355 Business Purpose Active Trade or Business Device", 782 PLI/TAX 243 (2007).

specifically provide that the step transaction doctrine is not applied to determine whether a distributed corporation was a "controlled corporation" immediately before a distribution otherwise qualifying under section 355 solely because of a post-distribution acquisition or restructuring of this corporation (whether prearranged or not).[50] We also recommend that the revenue ruling explain the reasoning for its conclusions.

We appreciate your consideration of our recommendations and comments. Please let us know if you would like to discuss this letter or if we can otherwise further assist you.

Respectfully,

David S. Miller

[50] Rev. Rul. 2003-79, 2003-2 C.B. 80; Rev. Rul. 98-27, 1998-1 C.B. 1159; *see also* H.R. Rep. No. 105-220, at 530 (1997), 1997-4 C.B. 1457, at 2000 ("the 80-percent control requirement . . . would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.").

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