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Report No. 1436
March 13, 2020

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

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
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The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
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Re: *Report No. 1436 – Report on Procedural Guidance for Private Letter Rulings on Divisive Reorganizations: Revenue Procedure 2018-53 and Plan of Reorganization Issues*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1436 commenting on the guidelines in Revenue Procedure 2018-53 and other issues relating to the concept of a "plan of reorganization" in the context of requests for private letter rulings.

We commend the Internal Revenue Service and the Department of the Treasury for their efforts in facilitating the ruling process for Section 355 transactions by issuing Revenue Procedure 2018-53, as well as Revenue Procedure 2017-52 and other guidance, which we believe are helpful to taxpayers and the government. Our Report addresses practical issues arising under the current standards of Revenue Procedure 2018-53, and also requests procedural guidance for rulings related to the scope of "plan of reorganization" in the context of distributions to shareholders and delayed distributions of controlled company stock.

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

Respectfully submitted,

Andrew H. Braiterman
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Report No. 1436

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON PROCEDURAL GUIDANCE FOR PRIVATE LETTER RULINGS ON DIVISIVE REORGANIZATIONS:

REVENUE PROCEDURE 2018-53 AND PLAN OF REORGANIZATION ISSUES

March 13, 2020

TABLE OF CONTENTS

I. INTRODUCTION

This report (the "**Report**") of the New York State Bar Association Tax Section makes recommendations for procedural guidance for private letter rulings ("**PLRs**") requested by taxpayers seeking guidance on debt allocations and other transactions that occur as part of the plan of reorganization that includes a distribution of the stock of a controlled corporation ("**Controlled**") intended to qualify as tax-free under section 355[1] (a "**Spin-off**").[2] [3]

Section 355 plays an important role in the life cycle of corporate businesses as the sole remaining provision following the repeal of the General Utilities doctrine[4] that allows a corporation to divide in a tax-free manner. In a typical Spin-off, a corporation ("**Distributing**") distributes to its shareholders and/or security holders[5] the stock and securities of Controlled. Controlled may be a preexisting corporation or Distributing may transfer property to preexisting or newly formed Controlled pursuant to section 368(a)(1)(D) (a "**D Reorganization**"). It is typical for Distributing to allocate some of its debt to Controlled as part of a D Reorganization so that each of Distributing and Controlled has the appropriate capital structure following the Spin-off. It is also often necessary as a business matter for the Spin-off and certain related transactions to be undertaken over a period of time, in light of the complexity of accomplishing a separation of a complex multinational company and the capital markets dynamics of separating a public company into two.

Many of the issues discussed in this Report relate to Revenue Procedure 2018-53,[6] which was issued by the Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**Service**") to provide procedures for taxpayers requesting PLRs for transactions involving the repayment or assumption of Distributing debt in the context of a D Reorganization ("**Creditor Transactions**"). We understand that Treasury and the Service are continuing their study of Creditor Transactions

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[1] Unless otherwise indicated, all "section" or "§" references are to the Internal Revenue Code of 1986, as amended (the "**Code**"), and the regulations promulgated thereunder (the "**Treasury Regulations**" or "**Treas. Reg.**").

[2] The drafters of this Report were Lawrence Garrett, David Rievman, Karen Gilbreath Sowell, Michael Cardella, James Coss, James Lee, Thomas Wood, and Sherry Xie. Helpful comments were received from William Alexander, Neil Barr, Andrew Braiterman, Peter Canellos, Robert Cassanos, Tijana Dvornic, Stephen Fattman, Peter Furci, Shane Kiggen, Brian Krause, Michael Mollerus, Andrew Needham, Richard Nugent, Deborah Paul, Elliot Pisem, Yaron Reich, Michael Schler, Jodi Schwartz, David Sicular, Eric Sloan, Eric Solomon, Linda Swartz, Jonathan Talansky, Joseph Toce, Shun Tosaka, Philip Wagman, and Sara Zablotney. Certain of the drafters and other members of the working group have or expect to have pending ruling requests that involve some of the issues addressed herein. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

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

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

[5] For ease of reading, this Report generally refers to Distributing's shareholders and security holders together as "shareholders" except where a distinction is relevant.

[6] 2018-43 I.R.B. 667.

addressed by Revenue Procedure 2018-53 and expect to make modifications to such guidance. In addition, this Report requests procedural guidance for PLRs related to distributions of cash or other property to shareholders and delayed distributions of Controlled stock to Distributing's shareholders ("**Shareholder Transactions**").

Spin-offs often are executed only after the taxpayer receives a PLR, both because they are complex and because the potential tax exposure from a Spin-off that fails to qualify for nonrecognition treatment can be devastating, with significant tax liabilities to both Distributing and its shareholders. While PLRs are not always sought for various timing or other business reasons, taxpayers and their advisors place tremendous value in the PLR program and the potential ability to receive comfort from the Service on their transformational transactions. The PLR guidelines set forth in Revenue Procedure 2018-53, and other revenue procedures related to Spin-offs, are helpful for taxpayers to understand the parameters within which a PLR may be available and help the Service streamline its review process, allowing more taxpayers to receive PLRs on a more efficient basis.

However, in practice, these procedural requirements often have the effect of defining the parameters of what is acceptable for a Spin-off, with potentially significant commercial, financial, and capital markets impacts. While the revenue procedures generally indicate that a PLR may be available even if the taxpayer is unable to comply with the particular requirements or to make certain representations, taxpayers typically cannot tolerate the attendant uncertainty regarding the tax treatment of their significant business transactions. Therefore, often a taxpayer undertaking a Spin-off is required to stay within the stated parameters of the revenue procedures. Even where a taxpayer does not seek a PLR, the revenue procedure standards influence the views of the firm delivering the tax opinion, with the result that the revenue procedure standards may have the same practical effect as substantive law. In light of this reality, it is important that the PLR procedural guidelines be grounded in the applicable law and statutory policies, with a practical recognition of commercial and market challenges and realities, and without exposing the Service to a risk of issuing PLRs in inappropriate circumstances.

Part II provides the relevant background for assessing appropriate PLR guidelines in this area, including an overview of the statutory language of section 361, certain plan of reorganization authorities, and the current revenue procedures for Spin-off PLRs. Part III provides additional context for PLR guidelines and discusses certain guiding principles that appear to underlie Revenue Procedure 2018-53 and that we believe should inform any successor guidance. Part IV discusses specific considerations, case studies, and recommendations for PLR guidelines related to the plan of reorganization and timing aspects of section 361 in Creditor Transactions and Shareholder Transactions. Finally, Part V discusses specific considerations, case studies, and recommendations for PLR guidelines related to debt allocation limitations in Creditor Transactions.

II. RELEVANT BACKGROUND FOR ASSESSING RULING GUIDELINES

The tax law has provided for the tax-free treatment of certain forms of corporate separations since the enactment of the first corporate reorganization provisions in the Revenue Act of 1918,[7] with the Revenue Act of 1954 introducing section 355 in substantially its current form.[8] There are numerous requirements under section 355 to limit qualifying transactions to those that effect a true separation of two operating businesses.[9]

Spin-offs have evolved over the decades as corporations have become increasingly multinational with complex capital structures. Recognition of this evolution is an important consideration when developing PLR guidelines to ensure that modern taxpayers can utilize Spin-offs to divide their businesses effectively. For purposes of analyzing the proper role of the plan of reorganization for D Reorganizations and the acceptable uses of § 361 Consideration (as defined below) in the context of PLR submissions, this Report reviews the relevant statutory language and guidance related to the plan of reorganization. This review is not comprehensive but, instead, is included to confirm that this Report's recommendations for PLR guidelines are consistent with applicable law. Generally, the other requirements for D Reorganizations and Spin-offs are not directly relevant to the subject of this Report.

A. Statutory Language

In order to qualify as a D Reorganization, Distributing must distribute stock or securities of Controlled to its shareholders "in pursuance of the plan" of reorganization.[10]

If a transaction or a series of transactions qualifies as a D Reorganization, sections 357[11] and 361 govern the tax consequences to Distributing of the transfer of assets by Distributing to Controlled in exchange for (1) Controlled stock, Controlled securities,[12] money, or other property

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[7] Revenue Act of 1918, 40 Stat. 1060 (1919).

[8] Internal Revenue Code of 1954, Pub. L. 83-591, 68 Stat. 730 (1954).

[9] *See generally* N.Y. ST. BA. ASS'N, TAX SEC., *Report on Proposed Regulations under Section 355 Concerning the Device Prohibition and Active Trade Or Business Requirement* (Rep. No. 1356, Oct, 14, 2016) (examining, *inter alia*, the device prohibition of section 355(a)(1)(B) and the active trade or business requirement of section 355(b) and analyzing an example that may otherwise not reflect a "true separation of business"); N.Y. ST. BA. ASS'N, TAX SEC., *Report on Notice 2015-59 and Revenue Procedure 2015-43 Relating to Substantial Investment Assets, De Minimis Active Trades or Businesses and C-to-RIC Spin-offs* (Rep. No. 1342, Apr. 12, 2016) (similar); N.Y. ST. BA. ASS'N, TAX SEC., *Report on the Role of the Step Transaction Doctrine in Section 355 Stock Distributions: Control Requirement and North-South Transactions* (Rep. No. 1292, Nov. 5, 2013) (examining, *inter alia*, the requirement that Distributing possess section 368(c) control of Controlled prior to the Spin-off).

[10] Section 368(a)(1)(D).

[11] Section 357 governs Controlled's assumption of (or taking assets subject to) the liabilities of Distributing in connection with the D Reorganization.

[12] For purposes of this Report, the term "Controlled securities" refers to debt instruments issued by Controlled that qualify as "securities" for federal income tax purposes.

(collectively, "**§ 361 Consideration**"; money or other property received, "**boot**")[13] and (2) Controlled's assumption of (or taking assets subject to) liabilities of Distributing, as well as the distribution of the § 361 Consideration by Distributing to its shareholders and creditors.

Under section 361(a), Distributing does not recognize gain or loss upon the receipt of Controlled stock or securities in exchange for property "in pursuance of the plan of reorganization." Under section 361(b)(1)(A), if Distributing receives boot in the exchange, Distributing does not recognize gain as long as the boot is distributed "in pursuance of the plan of reorganization." Under section 361(b)(3), any transfer of boot "in connection with the reorganization" by Distributing to its creditors "in connection with the reorganization" is treated as a distribution "in pursuance of the plan of reorganization," except to the extent that the money or other property exceeds the adjusted basis of the assets transferred to Controlled less the liabilities assumed. Thus, assuming that Distributing does not receive boot in excess of the net adjusted basis of the assets that it transfers to Controlled, Distributing does not recognize gain upon the receipt of § 361 Consideration provided that the § 361 Consideration is transferred to Distributing's shareholder or creditors "in pursuance of the plan of reorganization" (the "**plan of reorganization limitation**").[14] Under section 361(c), Distributing does not recognize gain or loss upon the distribution of Controlled stock or securities to its shareholders "in pursuance of the plan of reorganization," and the transfer of Controlled stock or securities to Distributing's creditors "in connection with the plan of reorganization" is treated as a distribution to shareholders "in pursuance of the plan of reorganization."

We note that section 361 by its terms requires a particular form to achieve a tax-free result when § 361 Consideration is used by Distributing to repay debt in a Creditor Transaction, even where the transactions accomplish the same economic results. For example, the statute permits Distributing to transfer Controlled debt to repay Distributing's own debt,[15] but it does not permit Distributing to sell Controlled debt and immediately repay its debt with the proceeds. In the context of modern Creditor Transactions and financing structures, taxpayers may not always be able to readily conform to these formalities, necessitating some consideration in the development of procedural guidelines for PLRs.

B. Plan of Reorganization Limitation

The Code does not define the term "plan of reorganization" or prescribe a time period in which the transactions pursuant to a plan of reorganization must occur. The Treasury Regulations provide

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[13] The definition of § 361 Consideration as used in this Report is consistent with the defined term in Revenue Procedure 2018-53. While the assumption of liabilities technically is consideration in the exchange, the definition of § 361 Consideration does not include liability assumptions.

[14] While the statute uses "in connection with the reorganization" and "in pursuance of the plan of reorganization," there is no indication that the two phrases were intended to have different meanings.

[15] *See* section 361(b)(3), (c)(3).

limited guidance applicable to all types of reorganizations, both acquisitive and divisive.[16] Treasury Regulation section 1.368-1(c) provides that "a plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 368(a) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Treasury Regulation section 1.368-2(g) further provides:

> The term plan of reorganization has reference to a consummated transaction specifically defined as a reorganization under section 368(a). The term is not to be construed as broadening the definition of reorganization as set forth in section 368(a), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges or distributions as are directly a part of the transaction specifically described as a reorganization in section 368(a). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 368(a), but the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 368(a) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

Courts and the Service have examined the plan of reorganization limitation, often applying step transaction principles to determine the scope of a plan of reorganization.[17] There does not seem to be a clear message from the case law, other than to suggest that no single interpretation

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[16] For a more thoroughgoing discussion of plan of reorganization concepts and authorities, *see* Sara B. Zablotney, "Sticking to your Resolutions: Acting under a Plan of Reorganization," 163 Tax Notes 29, at 34 (April 1, 2019).

[17] *See, e.g.*, *Comm'r v. Gordon*, 391 U.S. 83 (1968); Rev. Rul. 76-108, 1976-1 C.B. 103 (involuntary transfer of stock to a foreign government taken into account as a step in a "plan of reorganization," thereby disqualifying a purported D Reorganization). Several commentators have written that the determination of when and how the step transaction doctrine should apply in a particular situation depends not just on the formal relationship between the steps, but also on substantive considerations and relevant statutory policies. *See* Marvin A. Chirelstein and Benjamin B. Lopata, "Recent Developments in the Step transaction Doctrine," 60 Taxes 970, 974 (1982) (The step transaction doctrine is "dependent for its application on underlying considerations of substantive tax policy or Code structure . . . . [I]t is necessary to go beyond the formal factors that on their face invite the doctrine's application and analyze the substantive considerations at issue in each transaction."); Ronald H. Jensen, "Of Form and Substance: Tax-Free Incorporations and Other Transactions under Section 351,", 11 Va. Tax Rev. 349, 372 (1991-1992) ("Courts have viewed the doctrine as an instrument for perceiving reality, that is, for determining what really took place. The courts typically employ the doctrine to ascertain 'what really happened,' and then apply the relevant legal principles to the facts thus determined. This approach misses the true nature of the step transaction doctrine. Legal doctrines are not, and by their nature cannot be, devices for determining reality. They do not add to our ability to discern the facts. Rather, legal doctrines, including the step transaction doctrine, are means of determining legal consequences. A necessary corollary of this observation is that the proper scope and limits of the doctrine must ultimately be grounded in the policy the law seeks to implement."). *See also* Peter L. Faber, "The Use and Misuse of the Plan of Reorganization Concept," 38 *Tax L. Rev.* 515, 516 (1983).

applies.[18] Further, the courts generally have sought to determine whether a transaction furthers the purposes of reorganization and have found that transactions that occur pursuant to a plan of reorganization must be sufficiently contemplated and memorialized (whether or not in writing) before the transaction occurs.[19] As with the Code and the Treasury Regulations, judicial precedents have not imposed specific, time-based or policy-based limitations on the scope of transactions treated as distributions made pursuant to the plan of reorganization.

C. Current Revenue Procedures for Spin-off PLRs

1. General

Currently, the Service will rule on the overall federal income tax consequences of Spin-offs or on significant issues raised by such transactions.[20]

2. Creditor Transactions

On October 13, 2017 the Service released a statement (the "**2017 Statement**") providing:

> If, in connection with a section 355 distribution, a distribution of stock, securities or other property to the distributing corporation's shareholders or creditors is substantially delayed, IRS will continue to rule on whether the delayed distribution is tax-free under section 355 or section 361. However, rulings on such issues will not be based solely on the length of the delay. Instead, IRS will rule on this issue only based on substantial scrutiny of the facts and circumstances (including the circumstances of the delay) and full consideration of the legal issues and the effects of a ruling on federal tax administration.[21]

Revenue Procedure 2018-53 was published the following October. It sets forth the Service's advance ruling guidelines with respect to requested rulings that Distributing does not recognize gain or loss upon Controlled's assumption of Distributing Debt or upon Distributing's receipt of § 361 Consideration and its distribution of such consideration to creditors in satisfaction of

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[18] In *J.E. Seagram Corp. v. Comm'r*, 104 T.C. 75, 96 (1995), the Tax Court acknowledged that the plan of reorganization concept is "one of substantial elasticity."

[19] *See, e.g., Seagram*, 104 T.C. 75; *Transport Products Corp. v. Comm'r*, 25 T.C. 853 (1956), *aff'd per curiam*, 239 F.2d 859 (6th Cir. 1956); *Avco Manufacturing Corp. v. Comm'r*, 25 T.C. 975 (1956); *Atwood Grain & Supply Co. v. Comm'r*, 60 T.C. 412 (1973); *Anheuser-Busch Inc. v. Helvering*, 40 B.T.A. 1100 (1939); *Helvering v. Bashford*, 302 U.S. 454 (1938); *Groman v. Comm'r*, 302 U.S. 82 (1937).

[20] *See* Rev. Proc. 2017-52, 2017-41 I.R.B. 283; Rev. Proc. 2020-1, 2020-1 I.R.B. 1. In Revenue Procedure 2013-3, 2013-1 I.R.B. 113, the Service stated that it would no longer rule on whether section 355 or section 361 applied to Distributing's distribution of Controlled stock or securities in exchange for, and in retirement of, putative Distributing debt if such Distributing debt was issued in anticipation of the distribution. In Revenue Procedure 2017-38, 2017-22 I.R.B. 1258, the Service removed this no-rule position.

[21] *IRS statement regarding private letter rulings on certain corporate transactions* (October 13, 2017), https://www.irs.gov/newsroom/irs-statement-regarding-private-letter-rulings-on-certain-corporate-transactions.

Distributing Debt pursuant to section 361(b)(3) or (c)(3).[22] Revenue Procedure 2018-53 is the first published guidance the Service has issued to provide specific PLR guidelines for Creditor Transactions.

To request an advance ruling, the taxpayer must describe (1) the Distributing Debt, (2) the § 361 Consideration, and (3) the transactions that will implement Controlled's assumption of liability for Distributing Debt or Distributing's receipt of § 361 Consideration and its distribution of such consideration to creditors in satisfaction of Distributing Debt.[23] The taxpayer must also submit information and analysis to establish that (1) any assumption of Distributing Debt by Controlled will be consideration received by Distributing in the D Reorganization, and (2) any distribution of § 361 Consideration by Distributing to its creditors in satisfaction of Distributing Debt will be in connection with the plan of reorganization.

Revenue Procedure 2018-53 also requires the taxpayer to submit (or explain why it cannot submit) a number of specific standard representations in connection with a PLR. The standard representations (1) provide that Distributing is the obligor in substance of the debt that will be assumed or satisfied,[24] (2) provide that no holder of the debt that will be assumed or satisfied is related to either Distributing or Controlled,[25] (3) set forth certain procedures for so-called "intermediated" exchanges,[26] (4) describe what debt will be considered "historic" debt of Distributing,[27] (5) define the historic average amount of debt with respect to which the Service will issue its ruling,[28] (6) set forth parameters relating to the time period in which Distributing Debt is to be satisfied with § 361 Consideration,[29] and (7) provide that Distributing does not have plans to immediately re-borrow an amount equal to the assumed or satisfied debt or otherwise functionally retain the proceeds.[30]

As discussed above, the tax law does not impose specific, time-based or policy-based limitations on what distributions are to be treated as made pursuant to the plan of reorganization.

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[22] For purposes of Revenue Procedure 2018-53, an obligation is "**Distributing Debt**" if (1) Distributing is the obligor, and (2) the obligation (a) is evidenced by a debt instrument (defined in Treasury Regulation section 1.1275-1(d)) that is not a contingent payment debt instrument subject to Treasury Regulation section 1.1275-4 and (b) by its terms is payable only in money.

[23] Rev. Proc. 2018-53, section 3.03.

[24] *Id.*, section 3.04(1).

[25] *Id.*, section 3.04(2).

[26] *Id.*, section 3.04(3).

[27] *Id.*, section 3.04(4).

[28] *Id.*, section 3.04(5).

[29] *Id.*, section 3.04(6).

[30] *Id.*, section 3.04(7).

In contrast, Revenue Procedure 2018-53 adopts specific time-based rules for administering the plan of reorganization limitation in the context of Creditor Transactions (the "**Time-Based Limits**"). In circumstances where Distributing Debt will be satisfied within the 30-day period beginning on the date of the first distribution of Controlled stock, Revenue Procedure 2018-53 does not require the taxpayer to make any representations or submit information regarding the reasons that the satisfaction of Distributing Debt is not simultaneous with or immediately pursuant to the first distribution of Controlled stock. In circumstances where Distributing Debt will not be satisfied within that 30-day period, Revenue Procedure 2018-53 requires the taxpayer to represent that "[t]here are one or more substantial business reasons for any delay in satisfying Distributing Debt with § 361 Consideration beyond 30 days after the date of the first distribution of Controlled stock to Distributing's shareholders. All the Distributing Debt that will be satisfied with § 361 Consideration will be satisfied no later than 180 days after such distribution."[31] Revenue Procedure 2018-53 further provides that the taxpayer "should submit information and analysis to establish the substantial business reasons" for the delay.[32] In addition, where a distribution will occur more than 180 days after the date of the first distribution of Controlled stock, the taxpayer "should submit information and analysis to establish that, based on all the facts of circumstances, the satisfaction will be in connection with the plan of reorganization."[33]

3. Shareholder Transactions

There currently are no PLR guidelines addressing the timing and other requirements for distributions of § 361 Consideration to Distributing shareholders as part of a Spin-off.[34] As noted above, the Service indicated in the 2017 Statement that it will apply "substantial scrutiny" in considering whether to rule on a Spin-off involving a delayed distribution to Distributing shareholders.

III. CONTEXT FOR PLR GUIDELINES AND DISCUSSION OF GUIDING PRINCIPLES

The overarching purpose of section 355 is to permit the tax-free separation of existing businesses supported by business exigencies. Sections 357 and 361 generally permit the parties to a corporate separation to adopt the optimal capital structures for Distributing and Controlled according to their own business judgment and without taxing the assumption of liabilities, the receipt of Controlled securities, or a debt-funded distribution in connection with the transfer of a business from Distributing to Controlled. In addition to the plan of reorganization limitation that applies to Distributing's receipt of § 361 Consideration, there are other statutory limitations on certain Creditor Transactions: for example, section 357(c) generally requires gain recognition to the extent that liabilities assumed exceed the aggregate basis of the transferred assets, and section

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[31] *Id.*, section 3.04(6).

[32] *See id.*

[33] *Id.*

[34] Note that Revenue Procedure 2018-53 does address distributions of Controlled securities to Distributing security holders.

361(b)(3) generally requires gain recognition to the extent that boot received exceeds the net basis of the transferred assets. Section 361(c), on the other hand, permits nontaxable distributions of Controlled securities without limitation by the basis of contributed assets.[35] We believe that the Service should apply these limits in a manner consistent with the overarching purpose of section 355. Specifically, the Service's PLR guidelines should be designed and applied in a manner that gives taxpayers flexibility to tailor the capital structures for Distributing and Controlled so long as (1) the transaction format undertaken is consistent with the Code's prescribed formats for tax-free treatment, and (2) the overall effect achieved is consistent with identified policies underlying the Code's limitations. Moreover, the PLR guidelines should avoid creating further artificial distinctions between economically similar transaction formats because such distinctions merely increase the costs of implementing bona fide business transactions without advancing any real policy objective.

Our analysis and proposed alternatives are based on three guiding principles which appear to underlie the standards and representations provided in Revenue Procedure 2018-53. While one may question whether one or more of these principles are strictly necessary in light of the statutory framework, we believe that these principles are consistent with the relevant policies underlying this framework and have accepted them as providing a reasonable approach to administering the PLR program.

First, it appears that the Time-Based Limits are rooted in a level of connectivity between the Spin-off and the Creditor Transaction that ensures that (1) Distributing cannot inappropriately convert boot into a discretionary fund that is invested in its business and used in the ordinary course

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[35] Section 361(b)(3) was modified in 2004 to impose a net basis limitation on the amount of boot that can be received by Distributing and transferred to its creditors on a tax-free basis. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004), §898(a). Based on the legislative history, it appears that the purpose of the amendment was to create symmetry between the tax treatment of liabilities assumed under section 357(c) and the receipt of boot used to satisfy liabilities under section 361(b)(3). *See* Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress Part Seventeen: American Jobs Creation Act of 2004 (Public Law 108-357)*, at 498-9 (May 31, 2005) (stating that "Congress was concerned that taxpayers engaged in section 355 transactions could effectively avoid the rules that require gain recognition if the [Controlled] assumes liabilities of [Distributing] that exceed the basis of the assets transferred to [Controlled]," and noting that Distributing's repayment of Distributing Debt with cash boot "is economically similar to the actual assumption by [Controlled] of [Distributing]'s liabilities, but was taxed differently under prior law because section 361(b) did not contain a limitation on the amount that can be distributed to creditors"). *See also* Neil J. Barr, "Uncertainty Regarding the Tax Treatment of Liabilities in Divisive Reorgs Survives the AJCA," 105 Tax Notes 1125, at 1128 (Nov. 22, 2004). Section 361(c)(3) does not impose a basis limitation on the amount of securities that can be used to retire Distributing Debt. In 2010, Congress proposed an amendment to section 361 that would have treated Controlled securities similarly to cash or other property, such that the distribution of Controlled securities would also be subject to a basis limitation. *See* H.R. 4486, 111th Cong., 2d Sess. (Jan. 21, 1986) (referred to the House Ways and Means Committee); S. 3380, 111th Cong., 2d Sess. (May 17, 2010) (referred to the Senate Finance Committee). In its technical explanation, the Joint Committee on Taxation recognized that under section 361 in its current form, Distributing could use Controlled's securities to retire Distributing Debt, "recognize no gain, and be in the same economic position as if its debt had been directly assumed by [Controlled] or as if it had retired its debt with cash received from [Controlled]," even though only the latter transactions are subject to a basis limitation. *See* Staff of the Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in the "American Jobs and Closing Tax Loopholes Act of 2010," for Consideration on the Floor of the House of Representatives*, at 295-6 (May 28, 2010). The proposed amendment to section 361(c) was not enacted.

of business, with the distribution to shareholders or creditors being effectively funded out of operating cash flows generated in the ordinary course of business, and (2) with respect to distributions of retained stock or securities to creditors, Distributing cannot, in effect, speculate on the value of Controlled stock or securities over time.

Second, with respect to Creditor Transactions, section 361 is intended to facilitate the allocation of historic Distributing liabilities between Distributing and Controlled and should not be a vehicle for increasing the aggregate liabilities of Distributing and Controlled (the "**Debt Allocation Principle**"). Stated differently, with respect to a Creditor Transaction, section 361(b)(3) and (c)(3) require that boot and Controlled securities received in the section 361 exchange actually be used to retire Distributing Debt. If the aggregate debt of Distributing and Controlled on a combined basis increases in connection with a Creditor Transaction, then the transaction may be more akin to a partial sale of Controlled's business than a mere reallocation of Distributing Debt (e.g., if pursuant to a single plan Distributing issues debt, retains the proceeds for general business uses, and retires the newly issued debt with § 361 Consideration, Distributing has increased its net cash position in connection with a disposition of Controlled's business).[36] By the same token, Distributing and Controlled should be permitted to increase their aggregate liabilities to the extent those additional liabilities are not being incurred simply to replace Distributing Debt that was nominally repaid with boot or Controlled securities. Where an increase in debt is functionally unrelated to the D Reorganization (e.g., ordinary course borrowings or a borrowing to address an unforeseen circumstance), there is no concern that the increase is part of an overall plan to effect a synthetic sale of Controlled's business.

Third, where the Debt Allocation Principle is satisfied, the mechanics used to effectuate the Creditor Transaction should have diminished importance, so that the form of the transaction generally should be respected, and tax-free treatment should be accorded, where the form is consistent with the requisite transactional pattern permitted by section 361. Stated differently, because section 361 accords differential treatment to economically equivalent transactions (e.g., an exchange of Controlled securities for Distributing Debt is acceptable even though the creditors immediately market the Controlled securities to new investors, but a direct sale of Controlled securities by Distributing and use of the proceeds to retire Distributing Debt is not), the form of a transaction generally *is* its substance for purposes of section 361, and the step transaction doctrine generally should not be employed in this context where the overall result is consistent with the policies underlying section 361 and the form of the transaction is consistent with its permitted transactional patterns. Applying step transaction or similar "anti-abuse" principles more rigidly

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[36] These issues are not implicated by Shareholder Transactions. Because a Shareholder Transaction necessarily involves a transfer of value from Distributing to its shareholders, it cannot resemble a synthetic sale in which no debt is actually retired. In a Shareholder Transaction, Distributing is a conduit for the transfer of boot from Controlled to Distributing's shareholders, and Distributing is necessarily precluded from retaining the proceeds of a borrowing and using such proceeds in its business.

and expansively would impose artificial constraints on commercial transactions that otherwise meet the policy objectives of section 361.[37]

To illustrate this approach, we examine a number of fact patterns below that we believe are reflective of common commercial situations, many of which may be unnecessarily constrained under the current ruling guidelines.[38] There are, of course, many other fact patterns that one could encounter. This Report does not pretend to provide answers for all of those situations, nor does it attempt to set the outside boundaries for the plan of reorganization limitation or other aspects of section 361. This Report merely proposes reasonable PLR guidelines for the Service to consider in its advance ruling program, based on the principles that are the foundation of Revenue Procedure 2018-53.

IV. TIME-BASED LIMITS AND PLAN OF REORGANIZATION LIMITATION

A. Relevant Policy Considerations for Developing Ruling Guidelines for Time-Based Limits and the Plan of Reorganization Limitation in Creditor Transactions and Shareholder Transactions

Although not explicitly stated, the Time-Based Limits for Creditor Transactions in Revenue Procedure 2018-53 appear to be rooted in at least two policy concerns. First, the Service appears to believe that section 361(b) should be confined to situations in which Distributing acts as a strict conduit for conveying boot received from Controlled to Distributing's shareholders or creditors. A delayed distribution of boot may afford Distributing the opportunity to convert boot into a discretionary fund that is invested in its business and used in the ordinary course of business, with the distribution to shareholders or creditors being effectively funded out of operating cash flows generated in the ordinary course of business. Second, with respect to distributions of retained stock or securities to creditors (e.g., in an equity-for-debt exchange that occurs after the distribution of at least 80% of Controlled's stock to Distributing's shareholders, or a debt-for-debt exchange that occurs after the distribution of all of Controlled's stock to Distributing's shareholders), the Service appears to have a concern that Distributing could, in effect, speculate on the value of Controlled stock or securities over time, which is viewed as inconsistent with the general proposition that a divisive reorganization must effect a genuine separation of Distributing and Controlled.[39] While not specifically covered by Revenue Procedure 2018-53, we understand that similar concerns are present for Shareholder Transactions.

We believe that the policy concerns that appear to animate the current Time-Based Limits in Revenue Procedure 2018-53 are fundamentally legitimate, and we appreciate the Service's interest

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[37] This policy-based approach to step transaction principles is consistent with their application in other areas. *See, e.g.,* Rev. Rul. 2017-09, I.R.B. 1244.

[38] Moreover, in light of the fact that Revenue Procedure 2018-53 is intended to establish the conditions on which the Service is willing to provide PLRs, our discussion is generally focused on what parameters are appropriate for providing favorable rulings; we do not, for example, generally focus on fact patterns where it would be appropriate for the Service decline to provide rulings.

[39] *Cf.* Treasury Regulation section 1.355-2(b). While Shareholder Transactions are not addressed in Revenue Procedure 2018-53, we understand from discussions with officials at the Service that similar concerns exist.

in adopting some form of transparent principles or bright-line rules in the context of its advance ruling program. Nevertheless, there are countervailing considerations that lead us to conclude that the Time-Based Limits are too strict in their current form. First, as discussed above, none of the Code, the Treasury Regulations, or judicial precedents support a strict time-based limitation on the plan of reorganization requirement. Second, a rule that limits qualifying distributions to those that occur within six months of the section 355 distribution (except upon making an extraordinary showing of need) does not adequately account for commercial realities. For example, it will often be the case that debt matures reasonably close in time after the distribution, but not within six months, and that providing for an early call (or undertaking a tender offer) is expensive. As another example, because of capital markets considerations, it may be necessary to hold retained Controlled stock for more than six months prior to effecting an equity-for-debt exchange (e.g., to avoid having to price the exchange when the price of Controlled stock is under abnormal pressure because of a typical sorting out process immediately following a Spin-off in which shares of Distributing and Controlled migrate to their natural shareholder bases). Moreover, it is difficult to conclude that, as a general matter, distributions made during a longer period after the section 355 distribution are unrelated to each other. It is true that money is fungible and that delayed distributions could increase the risk that boot is transformed into funds generally available for investment in Distributing's ordinary business operations. But it is also true that the fungibility of money countenances against drawing arbitrary lines or presumptions that are too strict, even if these lines are softened by an exception whereby the taxpayer can "prove out" by demonstrating need; such an exception inevitably will require an intrusive inquiry that ultimately requires an assessment of the taxpayer's business judgment about a complicated subject matter (i.e., corporate finance).

On balance, we support adoption of transparent, administrable guidelines in the Service's PLR program. However, we believe these guidelines should be better aligned with commercial realities. We agree that time is a key factor in assessing the connection between the Spin-off and the Creditor Transaction, but believe the timeframes used in the Time-Based Limits in Revenue Procedure 2018-53 should be extended as a general matter. In addition, we believe there are other factors that should be considered in assessing whether a Creditor Transaction is part of the plan of reorganization, including the nature and amount of the obligation being repaid or exchanged (e.g., whether the amount or timing of the payment is extraordinary as opposed to a recurring payment made in the ordinary course of business), the specificity in the taxpayer's written plan of reorganization, and safeguards that ensure that boot is earmarked for permissible uses (e.g., maintenance of minimum cash balances at least equal to the unexpended boot or segregation of the boot in a special account).[40] We believe that the Service can apply these factors as variable filters to ensure that a payment is adequately connected to the D Reorganization. We note that

[40] We note that the segregation of boot in a separate account may be viewed as providing a stronger level of protection for the government as compared to the maintenance of a minimum cash balance. In certain circumstances, a requirement that Distributing maintain a segregated account could cause it to maintain an amount of cash equal to the sum of its normal cash balances and the amount in the segregated account. However, given that cash is inherently fungible, it likely is true that, where Distributing has a sophisticated treasury function, its overall cash balance likely will be managed taking into account amounts in a segregated account. In such case, a requirement that Distributing maintain a segregated account may have little or no incremental effect and thus may simply impose additional administrative costs. We do not reach a firm conclusion on which method of "earmarking" is most appropriate and note that different methods could be imposed in different fact patterns.

Revenue Procedure 2018-53 applies an additional filter, the business reasons for the delay, potentially to extend the Time-Based Limits. The facts of the Case Studies are intended to address common commercial situations and, as a result, we do not believe that a justification for the delay is necessary. Moreover, in most instances the reasons for the delay are outside of Distributing's control and the externality dictating the timing is self-evident.

While there are different, reasonable approaches to this exercise, we believe that the following PLR guidelines for Creditor Transactions would address most of the cases in a reasonable manner:

- We recommend 12 months as the general Time-Based Limit. While Revenue Procedure 2018-53's general six-month limit may be achievable in some cases, 12 months would generally allow for a more orderly transaction in most cases (e.g., those involving an extraordinary payment).[41] During this time, if desired by the Service, Distributing could be required to earmark the boot in some fashion. A high degree of specificity in the plan of reorganization (e.g., specific identification of the debt to be repaid) does not seem necessary.[42] As discussed below, however, depending upon the nature and/or amount of the obligation being repaid or exchanged within 12 months, additional safeguards may be necessary to address the concerns discussed above.[43]

- We recommend that certain Creditor Transactions outside of 12 months should be treated as part of the plan of reorganization as long as additional safeguards are required. We suggest this category should be limited to 18 months.

- We recommend that the PLR guidelines preserve the ability for taxpayers to seek PLRs that do not meet the safe harbor guidelines on a case-by-case basis depending upon compelling business circumstances.

These general guidelines could also be adopted for Shareholder Transactions involving the distribution of boot, with certain special considerations for Shareholder Transactions that involve the delayed distribution of Controlled stock.

B. Case Studies

In each of this Report's Case Studies, Distributing is a widely held, publicly traded corporation and the common parent of an affiliated group of corporations filing a consolidated federal income tax return. Distributing intends to separate one of its business lines through the contribution of the

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[41] Generally, an extraordinary payment is one not made in the ordinary course of business either because it is unusually large in amount or the timing of the payment has been accelerated.

[42] We recommend that taxpayers be entitled to, and in some cases required to (e.g., if there is a plan to use boot to satisfy a contingent liability of Distributing), identify alternative Creditor Transactions or Shareholder Transactions if the circumstances are such that the original plan may not be fulfilled (e.g., a contingent liability does not materialize, Distributing is not able to negotiate the repayment of Distributing Debt, or the stock market is not conducive to a share repurchase).

[43] Thirty days is unrealistic for most Creditor Transactions; that feature of the Revenue Procedure 2018-53 guidelines should be eliminated.

business line to a domestic Controlled in a D Reorganization in exchange for specified § 361 Consideration (the "**Contribution**"), followed by the tax-free distribution of the stock of Controlled in a Spin-off. The Spin-off was first publicly announced in January of 2020, and the Distribution is expected to occur in September of 2020. Prior to the announcement of the Spin-off, Distributing had not announced or entered into any agreement to execute any transaction that could be considered a "similar transaction" to the Spin-off.

Case Study 1: Repayment of Debt within 12 Months of the Spin-off

Distributing uses boot received in the Contribution to repay a significant third-party promissory note (or bonds) within 12 months of the Spin-off. Alternatively, Distributing makes a large payment on its commercial paper balance.

This Creditor Transaction involves a significant payment and is completed within a reasonable timeframe. These facts seem clear that the payment is part of the plan of reorganization, and there is little concern that the boot can be used as a discretionary fund for normal business operations. In these circumstances, it seems sufficient that the repayment of debt is generally delineated in the plan of reorganization and, potentially (if desired by the government), that Distributing earmarks the boot in some fashion. We do not believe it is necessary to require higher specificity (e.g., specific identification of the debt to be repaid). We recognize that, where a significant debt obligation is satisfied pursuant to its terms within 12 months, one may question whether Distributing has effectively retained the boot and used it for general corporate purposes (i.e., the payment of customary expenses). In contrast, if Distributing calls (or tenders for) the debt prior to maturity, it is clearer that the retention of the boot was for the specific use to which it was ultimately applied. However, there is nothing in the tax law that interprets the plan of reorganization limitation to mean that only debt repayments that would not occur but for the Spin-off satisfy the requirements of section 361(b). Also, there is no policy reason why a taxpayer should have to incur additional friction costs to repay debt that is not otherwise coming due instead of debt that can be repaid pursuant to its terms without additional costs.

We believe, however, that the amount of debt being repaid, and the nature of the repayment transaction, should be relevant. In cases where the Creditor Transaction is made in the ordinary course of business (e.g., the amount repaid is consistent with amounts typically paid on a recurring basis and the payment is not accelerated), additional requirements to establish the requisite connection between the D Reorganization may be necessary. For example, Creditor Transactions that involve ordinary course expenses (see Case Study 4) or contingent liabilities (see Case Study 5) may raise a concern that the boot is serving as a corporate discretionary fund and, therefore, more should be needed to establish these payments are indeed part of the plan of reorganization.

Case Study 2: Repayment of Debt 18 Months after the Spin-off

Distributing uses boot received in the Contribution to repay a third-party promissory note (or bonds) due 18 months after the Spin-off.

The longer time frame in Case Study 2 presents the possibility that the boot can be used as a discretionary fund for general corporate purpose and not as part of the plan of reorganization. Despite the timing, however, we believe that this Creditor Transaction should satisfy the plan of

reorganization limitation provided that adequate safeguards are put into place. In particular, it seems appropriate that the plan of reorganization specifically identify the debt to be repaid. In addition, any boot that will not be expended within 12 months should be earmarked for the specified use. This could be accomplished through maintenance of a minimum cash balance, but (if desired by the government) the more stringent requirement of placing the funds in a segregated account may be appropriate to ensure that such dedicated funds are not available (directly or indirectly) to fund general corporate expenses. Under these conditions, we believe Case Study 2 should satisfy the requirements of section 361(b)(3).

In light of the substantial connection between the reorganization and the payment and the inability to use the boot for discretionary purposes due to the use of one or more earmarking mechanisms, we believe that 18 months is a reasonable period for ruling purposes and is consistent with historic practice.

Case Study 3: Payment of Ordinary Course Liabilities Within 12 Months of the Spin-off

> Distributing uses boot received in the Contribution to repay ordinary course liabilities (which were in existence at the time of the Spin-off) within 12 months.

As a general matter, the payment of ordinary course liabilities that are economically attributable to the period prior to the Spin-off should be permissible under section 361.[44] However, unlike in Case Study 1, the payment of ordinary course liabilities, even if significant in the aggregate, raises a question as to whether such payments are truly pursuant to the plan of reorganization or whether the boot was effectively retained for discretionary use in the payment of general corporate expenses. As a general matter, we believe that these types of payments should be viewed as pursuant to the plan of reorganization because the Spin-off represents Distributing's last chance to access Controlled's assets to satisfy the liabilities. Nevertheless, because the relationship to the Spin-off is less obvious than an extraordinary debt repayment, we recommend that taxpayers be required to provide a plan of repayment of ordinary course liabilities that is specific as to both timing and a reasonably estimated range of amounts. Further, we recommend that safeguards be employed to assure that the boot is earmarked for this purpose (i.e., Distributing should maintain a cash balance at least equal to the unexpended boot, or, alternatively, the boot should be segregated in a special account). We do not believe that the PLR guidelines need to allow taxpayers to pay ordinary course liabilities beyond the 12-month period after the Spin-off.

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[44] To be clear, this concept is not the same as accrual in a tax accounting sense; rather it is intended to denote obligations that are attributable to actions undertaken prior to the Spin-off and thus exist (even if they are contingent) at the time of the Spin-off. For example, state tax liabilities that are attributable to the pre-Spin-off portion of the year in which the Spin-off occurs should be eligible for repayment, notwithstanding that those liabilities generally do not accrue until the end of the year for tax accounting purposes. We believe it is appropriate for ruling standards to provide that obligations for ordinary course liabilities (e.g., salaries) that are economically attributable to post-Spin-off periods should not be permitted to be repaid pursuant to section 361 (because, for example, such liabilities could not be assumed under section 357).

Case Study 4: Payment of Contingent Liabilities That Are Attributable to the Pre-Spin-off Period

> Distributing uses boot received in the Contribution to repay contingent liabilities, which were attributable to events occurring before the Spin-off but are uncertain as to the fact of liability or to the amount and timing of payment.

In its current form, Revenue Procedure 2018-53 does not apply to Creditor Transactions involving contingent liabilities of Distributing.[45] We believe that the Service should provide explicit PLR guidelines for these types of payments. For contingent liabilities that are recurring and are typically repaid in similar amounts in the ordinary course of business (e.g., recurring product liability claims), it seems appropriate for PLR purposes to require that contingent liabilities be repaid within 12 months and to treat them much like Case Study 3—i.e., require a plan of repayment that is specific as to both timing and a reasonably estimated range of amounts, and earmark the boot for this purposes (e.g., maintenance of a minimum cash balance or a segregated account). Moreover, due to the contingent nature of the liabilities, a taxpayer should be required to specify alternate uses for the boot in the event that the contingency does not occur.[46]

In addition, where there is a significant contingent liability that is non-recurring (e.g., a large settlement payment for a pending lawsuit), it seems appropriate to extend the time for payment to 18 months. Consistent with Case Study 2, and in light of the substantial connection between the reorganization and the repayment and the inability to use the boot for discretionary purposes due to earmarking (including, if the government determines it necessary, a segregated account), we believe that 18 months is a reasonable period in these circumstances for ruling purposes.[47]

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[45] Revenue Procedure 2018-53 definitionally applies only to Distributing Debt, which is limited to debt instruments other than contingent payment debt instruments subject to Treasury Regulation section 1.1275-4. *See* Rev. Proc. 2018-53, section 3.01.

[46] For example, the plan of repayment could identify alternate debts to be retired or provide that excess amounts will be distributed to shareholders if the contingency does not materialize.

[47] Special consideration should be given to the treatment of post-Spin-off indemnity payments by Controlled to Distributing on account of fixed or contingent liabilities attributable to pre-Spin-off periods. We note that, in the PLR setting, the Service has routinely applied the *Arrowsmith* relation-back doctrine with respect to post-Spin-off indemnification, tax sharing, and similar payments between Distributing and Controlled. *See, e.g.*, PLR 201649012 (June 6, 2016) (indemnification for contingent liabilities); PLR 201524005 (Feb. 24, 2015) (indemnification for contingent liabilities);*see also Arrowsmith v. Comm'r*, 344 U.S. 6 (1952); Rev. Rul. 2002-1, 2002-1 C.B. 268; Rev. Rul. 83-73, 1983-1 C.B. 84. Under the relation-back principle, these types of payments are generally characterized as payments of boot by Controlled to Distributing immediately before the Spin-off. Although PLRs are usually silent on this point, the prevailing view among tax practitioners is that this boot should be treated as having been paid to a creditor of Distributing (i.e., the claimant on the liability for which Distributing is indemnified) pursuant to the plan of reorganization, even though in most cases Distributing will have paid the liability out of its own funds before it receives the actual payment from Controlled and payment may occur long after the Spin-off.

Case Study 5: Distributing Repurchases Stock or Makes an Extraordinary Distribution

Distributing uses boot received in the Contribution to repurchase stock or to make an extraordinary dividend distribution.

This Shareholder Transaction should be analyzed similarly to Case Studies 1 and 2. If extraordinary payments are made within 12 months of the Spin-off, it seems sufficient that the repurchases are reasonably described in the plan of reorganization (e.g., estimated timing and a reasonable range of amounts) and the government may wish to require that Distributing will earmark funds at least equal to the unexpended boot. Where the repurchases are not extraordinary in nature or extend beyond 12 months, the boot should be earmarked for this purpose.

Specific to stock repurchases, it should not be relevant whether the repurchase plan was previously authorized, as authorization is not the same as a commitment to repurchase. Also specific to repurchases, special consideration may be appropriate if market conditions are such that repurchasing stock within the safe harbor period is not in the interests of Distributing and its shareholders. In this case, additional time may be necessary, or an alternative plan to use the boot should be allowed.[48]

Case Study 6: Distributing Makes Ordinary Course Dividend Payments Within 12 Months of the Spin-off

Distributing uses boot received in the Contribution to pay its regular quarterly dividends.

With respect to Shareholder Transactions, the Code simply contemplates that Distributing is a conduit for the transfer of boot from Controlled to Distributing's shareholders. As such, Distributing should be able to pay dividends whether or not declared prior to the Spin-off. We note that using boot to pay ordinary course post-Spin-off dividends does not raise the concern about parity with section 357 that is present in the context of the payment of ordinary course expenses economically attributable to post-Spin-off periods.

The Shareholder Transaction in Case Study 6 should be analyzed similarly to Case Study 3, insofar as it raises the same question as to whether the payments were truly in connection with the reorganization. Because the relationship of these dividends to the Spin-off is less obvious than it is in the case of an extraordinary Shareholder Transaction, we recommend that taxpayers be required to provide a plan for regular dividend payments that is specific as to both timing and a reasonably estimated range of amounts. Further, the boot used for such dividend payments should be earmarked for this purpose.

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[48] *See* Rev. Rul. 2003-55, 2003-22 I.R.B. 961 (wherein an unanticipated deterioration of market conditions prevented Distributing from completing the IPO that motivated the distribution; the Service concluded that the business purposes requirement was still satisfied because the intent to do IPO was present at the time of the distribution). Moreover, it should be acceptable to identify multiple alternative uses, particularly in light of the contingent nature of the transaction (e.g., identifying different debts to be repaid depending on the amount of the contingency that materializes).

Case Study 7: Distributing Distributes Retained Controlled Stock to Shareholders or Creditors

> Distributing distributes at least 80%, but less than all, of the Controlled stock to Distributing's shareholders in one or more distributions. The remainder is later distributed in one or more distributions to Distributing's shareholders or to creditors in exchange for Distributing Debt.

In this Shareholder Transaction, as long as it is clear that the distributions will be effected pursuant to an integrated plan, each distribution should be treated as part of the tax-free Spin-off. In the context of Case Study 7, we believe it is appropriate to require Distributing's plan of reorganization to specify the proposed timing for the distributions with reference to a specific period or events and to require that the retained Controlled stock be disposed of, in any event, within two years following the Spin-off. Case Study 7 implicates the second concern that seems to underlie the Service's concerns discussed above, namely that, because the Controlled stock has a speculative value, Distributing could receive an inappropriate benefit. There are capital markets considerations, however, that must be considered in determining appropriate PLR guidelines. First, where Distributing holds more than 10% of Controlled's stock, Distributing will be considered an "insider" under Securities and Exchange Commission rules and will be subject to certain reporting requirements and other restrictions on any sales, in addition to the general prohibition on trading based on any material non-public information; consequently, Distributing will generally be subject to blackout periods prohibiting dispositions of Controlled stock for some period prior to quarterly earnings releases or before significant corporate events (e.g., 60-90 days). Furthermore, additional contractual lockup periods may be imposed by third-parties (e.g., underwriters) that further limit Distributing's ability to dispose of its Controlled stock. Thus, in the 12 months following a Spin-off, Distributing may be prohibited from disposing of Controlled stock for an aggregate period of 6 months or longer. Second, we understand that, following a Spin-off by a public company, it generally takes two or three full quarters before the Controlled stock begins to trade at its fully distributed value.[49]

V. DEBT ALLOCATION LIMITATIONS IN CREDITOR TRANSACTIONS

A. Relevant Policy Considerations for Developing Ruling Guidelines for Debt Allocation Limitations in Creditor Transactions

One of the main foundations of Revenue Procedure 2018-53 is the notion that, in the context of Creditor Transactions, section 361 is intended to facilitate the allocation of historic Distributing liabilities between Distributing and Controlled and should not be a vehicle for increasing the aggregate liabilities of Distributing and Controlled (i.e., the Debt Allocation Principle). Several aspects of Revenue Procedure 2018-53 appear intended to serve as "guardrails" for this fundamental policy objective. For example, although Revenue Procedure 2018-53 sets forth a detailed representation governing when eligible debt may be incurred, it also goes on to specify that Distributing Debt that does not meet the requirements of this representation can still be

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[49] *See, e.g.*, PLR 201851005 (Sept. 24, 2018); PLR 201835001 (Aug. 31, 2018).

assumed or satisfied if the taxpayer establishes that, based on all the facts and circumstances, the borrowing and the assumption or satisfaction of the Distributing Debt results in an allocation of historic Distributing Debt between Distributing and Controlled.[50] Similarly, Revenue Procedure 2018-53 requires the taxpayer to submit a representation that the Distributing Debt that will be assumed or satisfied will not exceed Distributing's historic average debt levels.[51] In addition, Revenue Procedure 2018-53 provides that Distributing Debt that is assumed or satisfied will not be replaced with previously committed borrowing, other than borrowing in the ordinary course of business pursuant to a revolving credit agreement or similar arrangement. [52]

While Revenue Procedure 2018-53 goes to great lengths to limit the availability of PLRs to Creditor Transactions that are consistent with the Debt Allocation Principle, we believe that any guidance in this area ought to reflect a further guiding principle: the Service's advance ruling practice should not draw distinctions between economically similar transactions absent countervailing policy considerations or a clear, contrary mandate in the Code (the "**Economic Parity Principle**"). It is true that the principal Code provisions governing Creditor Transactions, sections 357 and 361, are form-driven rules that often result in very different tax consequences for transactions that are economically equivalent. As a general matter, taxpayers may freely elect to structure a reallocation of Distributing Debt as an assumption of that debt by Controlled (subject to section 357, including the section 357(c) basis limitation), a repayment of that debt using the distributed proceeds of a newly incurred borrowing by Controlled (subject to section 361(b), including the section 361(b)(3) basis limitation), or an exchange of newly issued Controlled securities in retirement of the Distributing Debt (subject to section 361(c), with no basis limitation). Similarly, Distributing may not on a tax-free basis receive Controlled securities in a D Reorganization, sell them for cash, and use that cash to repay its outstanding debt, notwithstanding that Distributing may, without incurring any tax cost, exchange those very same Controlled securities for its outstanding debt. However, these statutory distinctions are fully within the purview and discretion of Congress.

On the other hand, in the case of administrative guidance such as revenue procedures governing the Service's ruling guidelines, we do not believe it is sound administrative policy to create additional, artificial distinctions between economically equivalent transactions. Accordingly, with respect to Creditor Transactions, section 361 should be administered in a manner that minimizes differential treatment of economically equivalent Creditor Transactions that satisfy both the Debt Allocation Principle and the explicit statutory terms and conditions of the applicable nonrecognition provision (section 361(b) or (c)).

In certain instances, the PLR guidelines in Revenue Procedure 2018-53 deviate from the Economic Parity Principle. As an example, assume that Distributing A wishes to allocate $100X of its historic debt to a newly formed Controlled A that it intends to distribute in a Spin-off. Distributing A engages a financial institution to purchase $100X of its historic debt on the open

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[50] Rev. Proc. 2018-53, section 3.04(4).

[51] *Id.*, section 3.04(5). The historic average is determined based on Distributing's third-party debt outstanding as of the close of the eight fiscal quarters preceding the date of board approval for the Spin-Off.

[52] *Id.*, section 3.04(7).

market, and, thereafter, Distributing A retires that debt from the intermediary in exchange for Controlled A securities. Assume that Distributing B wants to pursue the same type of transaction in a Spin-off of its own newly formed Controlled B, but it discovers that the cost for a financial institution to purchase its historic debt on the open market is prohibitively high. As an alternative, Distributing B issues $100X of new debt to a financial institution and uses the proceeds to repay $100X of its historic debt. Distributing B then retires the new debt in exchange for Controlled B securities. Both transactions, in form, satisfy the requirements of section 361. Furthermore, each transaction effects a reallocation of $100X of the distributing corporation's historic debt to its controlled corporation, in accordance with the Debt Allocation Principle.

Nevertheless, as discussed further below, while Distributing A may be able to satisfy the requirements of Revenue Procedure 2018-53, Distributing B will not be able to make all requisite representations. Although Revenue Procedure 2018-53 does provide taxpayers with the opportunity to explain why a representation may be unnecessary or inapplicable in the taxpayer's particular circumstances, this ad hoc approach is burdensome to administer, injects unnecessary uncertainty into the planning of significant business transactions, and ultimately can result in disparate treatment of similarly situated taxpayers. Our recommendations below aim to address these concerns, effectively limiting the application of step transaction principles in these circumstances where the overall result is consistent with the policies underlying section 361 and the form of the transaction is consistent with its permitted transactional patterns.[53]

This principle is particularly relevant to Creditor Transactions in which a debt-for-debt exchange is effectuated as an "intermediated" exchange of Controlled securities for either "old and cold" or recently issued Distributing Debt. If a transaction satisfies the Debt Allocation Principle, but the idiosyncrasies in the capital markets necessitate an intermediary, the Service should not abandon the Economic Parity Principle in service of step transaction or similar principles that have a limited role in this context. Subject to the limitations and qualifications discussed below, including the addition of a minimum or safe harbor period of time during which an intermediary must hold and bear the risk of Distributing Debt, we believe that the form of a Creditor Transaction should not be recast or recharacterized where the result of the transaction is permitted by and in accordance with the Debt Allocation Principle and the formal requirements of section 361. In these circumstances, there is no abuse for the step transaction doctrine to remedy.

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[53] In this regard, we note that the Service often declines to apply step transaction principles in the context of subchapter C's nonrecognition rules where the chosen form of a transaction and the resulting tax consequences are consistent with the underlying policies of the relevant Code provision. *See, e.g.*, Revenue Ruling 2003-51, 2003-1 C.B. 938; Revenue Ruling 2001-46, 2001-2 C.B. 321; Revenue Ruling 98-27, 1998-1 C.B. 1159. Of particular relevance is Revenue Ruling 2017-9, 2017-21 I.R.B. 1244 (May 3, 2017), the Service's most recent articulation of the step transaction doctrine's proper role in the context of corporate nonrecognition transactions. There, the Service explained that "[t]he treatment of a transaction generally follows the taxpayer's chosen form unless: (1) there is a compelling alternative policy; (2) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise-applicable Code provisions; or (3) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions."

B. Intermediated Exchanges

Revenue Procedure 2018-53 requires the taxpayer to submit a representation that "[t]he holder of Distributing Debt that will be assumed or satisfied will not hold the debt for the benefit of Distributing, Controlled, or any Related Person" (the "**No Benefit Representation**").[54] For this purpose, a collateral benefit received by Distributing from an arrangement with an intermediary (e.g., by reason of the intermediary's facilitation of an exchange of § 361 Consideration for Distributing Debt) will not be treated as an intermediary holding Distributing Debt for the benefit of Distributing, Controlled, or a Related Person.[55] Thus, it is clear that the Not for the Benefit Of Representation is not intended as an impediment to rulings on traditional intermediated debt-for-debt and equity-for-debt exchanges.

If an intermediary acquires Distributing Debt from any person that will be satisfied with § 361 Consideration, Revenue Procedure 2018-53 requires the taxpayer to submit the following additional representations:

- The intermediary will not acquire Distributing Debt from Distributing, Controlled, or any Related Person (the "**Direct Acquisition Representation**").[56]

- Neither Distributing, nor Controlled, nor any Related Person will participate in any profit gained by the intermediary upon an exchange of § 361 Consideration; nor will any such profit be limited by agreement or other arrangement (the "**Profit Participation/Limitation Representation**").[57]

- The value of the § 361 Consideration received by the intermediary in satisfaction of the Distributing Debt will not exceed the amount to which the holder is entitled under the terms of the Distributing Debt (the "**Consideration Entitlement Representation**").[58]

Revenue Procedure 2018-53 also provides that the taxpayer should describe any co-obligation, guarantee, indemnity, surety, make-well, keep-well, or similar arrangement, including additional security, provided to the intermediary by Distributing, Controlled, or any Related Person for risk of loss with respect to the Distributing Debt.[59] In addition, Revenue Procedure 2018-53 requires the taxpayer to submit "information and analysis to establish that, under general principles of tax law, the transactions (including any exchange facilitated by an intermediary) should not be recast,

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[54] Rev. Proc. 2018-53, section 3.04(3). A "Related Person" is any person related to Distributing or Controlled within the meaning of section 267(b) or section 707(b)(1). *Id.*, section 3.04(2).

[55] *Id.*, section 3.04(3).

[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] *Id.*

recharacterized, or otherwise treated as one or more transactions that would not qualify under the relevant provisions of the Internal Revenue Code of 1986."[60]

Case Study 8: Intermediated Exchange Following Historic "5/14" Standard

> Distributing incurred $500X of debt in March of 2015, in the form of SEC-registered, publicly traded notes that qualify as Distributing Debt under Revenue Procedure 2018-53 (the "**Distributing Notes**"). The Distributing Notes will mature in March of 2030.
>
> In the Contribution, Distributing contributes assets to Controlled in exchange for Controlled stock and securities. In connection with the Spin-off, Distributing engages a financial institution to purchase Distributing Notes in the open market (the "**Financial Institution**"). No sooner than five days following the Financial Institution's purchase of Distributing Notes, Distributing and the Financial Institution enter into an agreement to exchange the Financial Institution's purchased Distributing Notes for the Controlled securities issued in the Contribution (the "**Exchange Agreement**"). The Financial Institution is required to exchange the Distributing Notes for an implied price equal to the fair market value of the Distributing Notes on the date the Exchange Agreement is signed.[61] Ten days after the Exchange Agreement is executed, Distributing transfers the Controlled securities to the Financial Institution in exchange for the Financial Institution's purchased Distributing Notes. It is expected that the Financial Institution will subsequently sell the Controlled securities to third-party investors for cash and Distributing and Controlled are required to provide Financial Institution with such information as is necessary or appropriate to facilitate the marketing of the Controlled Securities.

As noted above, Revenue Procedure 2018-53 clarifies that the No Benefit Representation is satisfied notwithstanding that Distributing receives some "collateral benefit" from an intermediary, including any benefit from an orderly and facilitated exchange of Distributing Debt for § 361 Consideration. We commend the Service for adopting this sensible approach, which is entirely consistent with the overarching policy objective of permitting taxpayers to reallocate historic Distributing liabilities between Distributing and Controlled. However, we recommend that the Service clarify certain aspects of Revenue Procedure 2018-53 as applied to a typical intermediated exchange such as Case Study 8.

As a threshold matter, it is unclear what types of arrangements could potentially run afoul of the No Benefit Representation in the first instance, and what types of benefits are merely "collateral benefits" in an intermediated exchange. We believe that a typical intermediated exchange should easily satisfy the No Benefit Representation, but additional guidance on the exact contours of this representation would be helpful.

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[60] *Id.*, section 3.04(8).

[61] The fair market value of the Distributing Notes is determined by the Financial Institution and Distributing, bargaining at arm's length.

Case Study 8 closely follows the facts of several PLRs issued by the Service prior to the publication of Revenue Procedure 2018-53. In those PLRs, the Service routinely sanctioned use of the so-called "5/14" standard to establish an intermediary's status as a "creditor" of Distributing participating as a principal in the debt-for-debt or equity-for-debt exchange.[62] In effect, the Service required the intermediary to take on meaningful risk for a minimum period of time (i.e., five days of price/event risk and fourteen days of execution and credit risk) as a condition to ruling that the form of the exchange would be respected and not recast or recharacterized under a step transaction, agency, or similar theory.[63]

Revenue Procedure 2018-53 does away with the 5/14 standard.[64] At the same time, Revenue Procedure 2018-53 supplants it with a series of new representations (i.e., the Direct Acquisition Representation, the Profit Participation/Limitation Representation, and the Consideration Entitlement Representation) that seem to be aimed at substantiating the intermediary's status as a creditor of Distributing. In most intermediated exchanges, there is likely to be significant overlap between these new representations and the information required to establish that the transaction should not be recast or recharacterized.[65] The Service should consider combining or consolidating these aspects of Revenue Procedure 2018-53.

As an initial matter, many of the new representations, in their current form, will be difficult or impossible to satisfy in almost all typical intermediated exchanges. Where, as in Case Study 8, a particular tranche of Distributing Debt is trading above face value, whether due to a decrease in interest rates or an improvement in Distributing's financial condition or credit rating, the amount needed to repurchase the debt from an economically rational holder, including an intermediary, will always exceed the face value of the debt.[66] It is hard to perceive a sound policy reason for limiting PLRs to situations where Distributing Debt is trading at or below par. Further, even if the

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[62] *See, e.g.*, PLR 201613008 (Mar. 25, 2016); PLR 201601001 (Sept. 30, 2015); PLR 201308002 (Oct. 25, 2012); PLR 201232014 (Feb. 16, 2012); PLR 201216023 (Jan. 19, 2012); PLR 200802009 (Oct. 5, 2007).

[63] We understand that the 5/14 standard originated in market practice that was analyzed and blessed by the Service in the section 108 context. *See, e.g.*, TAM 8815003 (Dec. 11, 1987) (debt-for-debt); TAM 8738003 (May 22, 1987) (debt-for-stock); TAM 8735006 (May 18, 1987) (debt-for-stock). In each of these technical advice memoranda, the Service respected the form of a debt-for-stock or debt-for-debt exchange where an underwriter acquired debt of a corporation in anticipation of exchanging that debt for new debt or stock issued by the corporation. In each case, the Service concluded that the underwriter was respected as a principal and not treated as the agent of the corporate debtor because, among other reasons, there was no agreement between the corporation and the underwriter evidencing an intention to create an agency relationship, the corporation did not appear to have any power to control the underwriter, no third party could look to the corporate debtor for performance or damages on any contract entered into by the underwriter with the third party, and the underwriter had the economic burdens and benefits of ownership with respect to the debt it had acquired.

[64] *See, e.g.*, Emily L. Foster, "Guidance on Leveraged Spinoff Rulings Designed for Flexibility," 161 Tax Notes 386 (Oct.15, 2018) (in public remarks at an American Bar Association conference, Robert Wellen, Associate Chief Counsel (Corporate), stated that "[o]ne of the significant purposes of this [procedure] is to turn off the 5-14 idea").

[65] *See* Rev. Proc. 2018-53, section 3.04(8).

[66] More generally, where a debt is not due and is not callable, the holder is not "entitled" to receive any amount on the date that a debt is retired pursuant to an agreement between the holder and the issuer. Thus, the representation is either meaningless or inconsistent with a broad category of Creditor Transactions.

Distributing Debt were trading at levels near its face value, no commercially reasonable intermediary would agree to bear the risk and friction costs associated with acquiring and holding the Distributing Debt, and the related § 361 Consideration received from Distributing, without receiving some economic compensation. Typically, one component of the compensation received by an intermediary is a favorable exchange ratio for the Distributing Debt that it acquires and exchanges for Controlled stock and/or securities. In this regard, it appears that Revenue Procedure 2018-53 expresses a preference for alternative forms of compensation for intermediaries, such as fee-based payments in cash. We are unable to identify any basis for limiting the types of compensation that may be received by intermediaries, particularly when such distinctions elevate the significance of mechanics and result in disparate treatment of similarly situated taxpayers. Accordingly, we recommend that the Consideration Entitlement Representation be removed or, at a minimum, modified to require only that the exchange be effected on an arm's length basis (including arm's length compensation for the intermediary, regardless of its form).

The Profit Participation/Limitation Representation similarly presents challenges in Case Study 8. The terms of an exchange agreement almost always cap the price at which the intermediary may sell the Distributing Debt back to Distributing, which appears to be an "agreement or arrangement" that limits the profit of the intermediary and thus violates the Profit Participation/Limitation Representation. An example of a situation where Distributing, Controlled, or a Related Person will participate in any profit gained by the intermediary upon the exchange of § 361 Consideration, and the policy concerns that this representation is intended to address, would also be helpful.

In addition, we believe that the addition of an alternative bright-line rule or safe harbor for intermediated exchanges, along the lines of the 5/14 standard, would materially benefit both taxpayers and the Service. The 5/14 standard gained widespread use and acceptance by taxpayers, their advisors, and the Service over the years, and it has become increasingly understood and accepted by the financial markets. In contrast to this widely understood, bright-line standard, as currently drafted, Revenue Procedure 2018-53 appears to require a case-by-case evaluation without any clear standards to apply to the particular facts. This ad hoc approach creates uncertainty for taxpayers and the Service alike without meaningfully advancing any policy goal and should be reconsidered. Unless the Service takes a different approach, many taxpayers will be forced to choose between an advance ruling process with minimal guidance on acceptable structures or undertaking significant transactions with financing restrictions and frictions costs that may be much more burdensome than what is available to similarly situated taxpayers pursuing PLRs. Likewise, the Service will be placed in the difficult position of evaluating and blessing (or rejecting) a huge variety of financing structures and arrangements on a case-by-case basis.

Nor do we believe that step transaction or similar common law principles should broadly apply to intermediated exchanges in which the intermediary is exposed to some real measure of risk, provided the other requirements of Revenue Procedure 2018-53, which help ensure that PLRs are only available for Creditor Transactions involving an allocation of historic debt, are otherwise satisfied. The Service's ruling practice should respect the form of the transaction when that form is entirely consistent with the policies of section 361. As discussed above, transactions otherwise

in accord with the policies underlying a particular Code provision should not be recast or re-ordered under step transaction principles.[67]

The inclusion of a bright-line standard is also fully consistent with, and meaningfully advances, the Service's goal of developing a consistent and comprehensive approach to analyzing Creditor Transactions. Given the widespread acceptance of the 5/14 standard, we recommend that the Service expressly incorporate such a standard into any subsequent guidance in lieu of (or as an alternative to) the new representations for intermediated exchanges in Revenue Procedure 2018-53. However, we acknowledge that any reasonable bright-line test or safe harbor could, if appropriately tailored, also provide certainty to taxpayers and permit the Service to administer the PLR program equitably and efficiently.

Case Study 9: Direct Issuance by Distributing to Financial Intermediary

> On the same day as the Distribution, or shortly before that date, Distributing issues $500X of debt to the Financial Institution in exchange for $500X of cash (the "**Distributing Directly-Issued Debt**"). Distributing uses the proceeds from the issuance of the Distributing Directly-Issued Debt to repay other outstanding third-party debt of Distributing.
>
> In the Contribution, Distributing contributes assets to Controlled in exchange for Controlled stock and securities. At least five days following the issuance of the Distributing Directly-Issued Debt, Distributing and the Financial Institution enter into an agreement to exchange the Distributing Directly-Issued Debt for Controlled securities issued in the Contribution (the "**Direct Exchange Agreement**"). Ten days after the Direct Exchange Agreement is executed, Distributing transfers the Controlled securities to the Financial Institution in exchange for the Distributing Directly-Issued Debt. It is expected that the Financial Institution will subsequently sell the Controlled securities to third-party investors for cash.

The transaction in Case Study 9 does not satisfy the explicit requirements of Revenue Procedure 2018-53 because the Distributing Directly-Issued Debt was acquired by an intermediary, the Financial Institution, directly from Distributing, in violation of the Direct Acquisition Representation.[68] Although the Service has previously ruled favorably on section 361 exchanges involving so-called "direct issuances" of Distributing Debt to intermediary investment banks,[69] Revenue Procedure 2018-53, on its face, appears to foreclose the possibility of obtaining a PLR in these circumstances.

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[67] *See, e.g.*, Rev. Rul. 2017-9, 2017-21 I.R.B. 1244.

[68] *See* Rev. Proc. 2018-53, section 3.04(3).

[69] *See, e.g.*, PLR 201835001 (Aug. 31, 2018); PLR 201330002 (Jul. 26, 2013); PLR 201339001 (Apr. 4, 2013); PLR 201308002 (Oct. 25, 2012); PLR 201228033 (Apr. 11, 2012); PLR 201232014 (Feb. 16, 2012); PLR 201216023 (Jan. 19, 2012); PLR 201132009 (May 11, 2011); PLR 201129005 (Apr. 13, 2011).

Consistent with the Debt Allocation Principle, the net effect of the transaction in Case Study 9 is a $500X reduction in the historic debt of Distributing and a $500X increase in the debt of Controlled. This is exactly the result—a reallocation of historic Distributing liabilities between Distributing and Controlled—that section 361 and Revenue Procedure 2018-53 are intended to facilitate on a tax-free basis. Because the proceeds of the Distributing Directly-Issued Debt are fully "purged" by the payment to existing creditors of Distributing, Distributing does not experience an increase in its free cash, and the transaction does not resemble a sale by Distributing of Controlled securities. In these circumstances, the taxpayer should not be forced to incur the incremental frictions costs associated with an intermediated exchange of "old and cold" debt.[70]

Adopting an otherwise flexible advance ruling policy for traditional intermediated exchanges of § 361 Consideration for Distributing Debt, while at the same time excluding debt such as the Distributing Directly-Issued Debt from the PLR process, draws an artificial distinction between two economically equivalent transactions, based solely on the mechanical steps required to consummate the exchange. While it is true that a traditional intermediary may require compensation for its role in excess of what is required in an exchange effectuated through a direct issuance, it is difficult to see how or why those incremental friction costs could justify this disparate treatment of otherwise similarly situated taxpayers. We acknowledge the Service's concerns with transactions that might be perceived to call into question whether an intermediary is, in substance, the holder of Distributing Debt, and whether Distributing is, in substance, the obligor. Nevertheless, we believe that a better manner of addressing this concern would be to provide a safe harbor or other bright-line test for determining whether debt and a holder thereof will be respected as such, potentially similar to the 5/14 standard or other standard adopted with respect to intermediated exchanges generally, as discussed above.

Accordingly, we recommend that section 3.04(3) of Revenue Procedure 2018-53 be revised to provide that, to the extent Distributing Debt is acquired from Distributing, Controlled, or a Related Person, the taxpayer should submit an alternative representation to the effect that the proceeds received by Distributing, Controlled, or a Related Person will be used to repay historic Distributing Debt.[71]

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[70] A traditional intermediated exchange involving historic debt of Distributing will often result in much higher friction costs for taxpayers than the mechanic described in Case Study 9 because Distributing, unlike an intermediary, may be able to prepay or call its own debt pursuant to the terms of the debt, or because particular Distributing debt may not be traded in a well-developed market that an intermediary could easily access. This is especially true for companies with mostly longer-term debt outstanding, since the intermediary may need to pay a large premium to acquire existing debt in the market, and that cost will ultimately be borne by Distributing as an economic matter. This problem is exacerbated if holders of the debt know that the intermediary needs to acquire the debt over a relatively short period of time and use this as leverage to extract an even larger premium.

[71] Where the facts are the same as in Case Study 9, except that Distributing retains the proceeds of the Distributing Directly-Issued Debt and uses the cash for general corporate purposes, the net effect of the transaction would be a $500X increase in the debt of Controlled and a $500X increase in Distributing's free cash—a result at odds with the Debt Allocation Principle. Although the form of the transaction complies with the literal language of section 361(c), neither the Direct Acquisition Representation nor the alternative proposed representation described above is satisfied, and we believe that a PLR should not be available absent unusual circumstances that the taxpayer would need to demonstrate and explain to the Service.

C. Other Creditor Transactions Involving Recently Issued Distributing Debt

As a general matter, Revenue Procedure 2018-53 requires the taxpayer to submit a representation that "Distributing incurred the Distributing Debt that will be assumed or satisfied (a) before the request for any relevant ruling is submitted and (b) no later than 60 days before the earliest of the following dates: (i) the date of the first public announcement (as defined in § 1.355-7(h)(10)) of the [D] Reorganization or a similar transaction, (ii) the date of the entry by Distributing into a binding agreement to engage in the [D] Reorganization or a similar transaction, and (iii) the date of approval of the [D] Reorganization or a similar transaction by the board of directors of Distributing."[72] For Distributing Debt incurred at a later time, the taxpayer generally must establish that the borrowing and the assumption or satisfaction of the new Distributing Debt will result in an allocation of historic Distributing Debt between Distributing and Controlled or an exchange of historic Distributing Debt for Controlled stock—for example, by demonstrating that the new Distributing Debt is "replacement debt" for historic Distributing Debt under the principles of Revenue Ruling 79-258, 1979-2 C.B. 143 (the "**Refinancing Exception**"), or by establishing that the proceeds of the new Distributing Debt are to be used in Controlled's business.[73]

Case Study 10: Distributing Commercial Paper

> Distributing routinely borrows under an ongoing commercial paper program (the "**Commercial Paper Program**"). Borrowings under the Commercial Paper Program are generally unsecured obligations of Distributing with maturity dates ranging from a few weeks to twelve months. In the ordinary course of its business, as borrowings under the Commercial Paper Program come due, Distributing draws additional amounts under the Commercial Paper Program to repay the maturing amounts. In the twelve months prior to January 2020 (i.e., the announcement of the Spin-off), Distributing maintained borrowings under the Commercial Paper Program with an aggregate principal amount of at least $500X. Following the announcement of the Spin-off, Distributing continues to borrow under the Commercial Paper Program to repay existing borrowings and to fund general corporate expenses. At the time of the Spin-off, Distributing has an outstanding balance under the Commercial Paper Program of approximately $500X.
>
> In the Contribution, Distributing contributes assets to Controlled in exchange for the stock of Controlled and other § 361 Consideration (e.g., Controlled securities and/or cash proceeds from a new third-party borrowing by Controlled). Distributing uses $500X of the § 361 Consideration to repay then-outstanding borrowings under the Commercial Paper Program.

Based on the provisions of Revenue Procedure 2018-53, we believe that the Service would properly rule favorably on the transaction in Case Study 10. All borrowings under the Commercial Paper Program should qualify as Distributing Debt, irrespective of their relatively short maturities. As discussed above, although the specific borrowings that are repaid with § 361 Consideration were incurred well after the announcement of the Spin-off, all of those borrowings should be

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[72] Rev. Proc. 2018-53, section 3.04(4).

[73] *Id.*

eligible for the Refinancing Exception because they were used to pay off other debt that was incurred prior to the announcement of the Spin-off (or a "chain" of borrowings and reborrowings ultimately used to refinance debt that was incurred prior to the announcement of the Spin-off). Importantly, the net effect of this transaction is a $500X reduction in the historic debt of Distributing and a $500X increase in the debt of Controlled. Thus, the transaction effects a reallocation of historic Distributing liabilities between Distributing and Controlled and does not increase Distributing's free cash, consistent with the Debt Allocation Principle.

D. Related Party Issues

Revenue Procedure 2018-53 requires the taxpayer to submit a representation that "[n]o holder of Distributing Debt that will be assumed or satisfied is a person related to Distributing or Controlled within the meaning of section 267(b) or section 707(b)(1) ("**Related Person**")."[74] Alternatively, Revenue Procedure 2018-53 permits a Related Person that holds Distributing Debt to receive § 361 Consideration in satisfaction of such Distributing Debt if the Related Person that receives the § 361 Consideration uses that consideration to satisfy a non-contingent debt instrument[75] that is held by a person other than a Related Person (the "**Subsequent Purge Requirement**").[76]

In effect, the Subsequent Purge Requirement requires an internal creditor that receives § 361 Consideration from Distributing to "re-purge" that consideration in satisfaction of external debt held by one or more third parties. This approach is consistent with the Debt Allocation Principle.[77] As described further below, within a consolidated group, the Subsequent Purge Requirement also may be viewed as an application of the intercompany transaction rules of Treasury Regulation section 1.1502-13.

Case Study 11: Repayment of Consolidated Related Party Debt with Subsequent Purge to External Creditors

In 2015, Distributing borrowed $500X from Domestic Sub, a wholly-owned member of Distributing's consolidated group (the "**Internal Distributing Borrowing**"). Domestic

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[74] Rev. Proc. 2018-53, section 3.04(2).

[75] A debt instrument is "non-contingent" if it is not a contingent payment debt instrument subject to Treasury Regulation section 1.1275-4. *See* Rev. Proc. 2018-53, section 3.01.

[76] Rev. Proc. 2018-53, section 3.04(2).

[77] It is also consistent with the Service's historic ruling practice regarding the application of sections 361(b) and (c) to related-party creditors of Distributing. The Service has previously ruled that internal creditors may, in certain circumstances, be acceptable recipients of property under section 361(b)(3). *See, e.g.*, PLR 201851005 (Sept. 24, 2018); PLR 201601001 (Sept. 30, 2015) (Ruling 6); PLR 201409002 (Nov. 22, 2013). The Service has also previously ruled, in a number of contexts, that internal creditors may be acceptable recipients of qualified property for purposes of section 361(c)(3). *See, e.g.*, PLR 201352007 (Aug. 30, 2013); PLR 201232014 (Feb. 16, 2012).

Sub has $1,000X of outstanding debt held by third-party creditors (the "**External Subsidiary Borrowing**").[78]

In the Contribution, Distributing contributes assets to Controlled in exchange for the stock of Controlled and other § 361 Consideration (e.g., Controlled securities and/or cash proceeds from a new third-party borrowing by Controlled). Following the Distribution, Distributing uses $500X of the § 361 Consideration to repay the Internal Distributing Borrowing. Shortly thereafter, Domestic Sub uses that consideration to repay a corresponding portion of the External Subsidiary Borrowing.

Domestic Sub's repayment of the External Subsidiary Borrowing satisfies the Subsequent Purge Requirement and the Debt Allocation Principle. The net effect of the transaction in Case Study 11 is a $500X reduction in the historic external debt of the Distributing group and a $500X increase in the debt of Controlled. Facilitating this type of transaction on a tax-free basis is appropriate because it effects a reallocation of historic Distributing liabilities between Distributing and Controlled. There is no increase in the total amount of free cash held by the Distributing group, and the transaction does not resemble a sale of stock of Controlled.

This result also seems consistent with the intercompany transaction rules of Treasury Regulation section 1.1502-13. The statutory requirement to purge boot received in an intercompany section 361 transaction could be viewed as an attribute of the boot, in which case that requirement arguably should be administered on a single-entity basis per the attribute redetermination rule of Treasury Regulation section 1.1502-13(c)(1)(i). Under this view, in order for Distributing to be able to receive the boot tax-free under section 361(b), Domestic Sub must in turn purge the boot that it received in the intercompany debt repayment to a creditor that is not a group member.[79]

The same approach should apply with respect to a series of multiple intercompany loans among Distributing affiliates, such as back-to-back on-loans of a subsidiary's external borrowing proceeds. The Subsequent Purge Requirement should be revised to clarify this treatment. For example, assume that another direct or indirect wholly-owned subsidiary member of Distributing's consolidated group ("**Domestic Sub 2**") is the obligor on the External Subsidiary Borrowing and holds a $500X intercompany receivable from Domestic Sub (the "**Domestic Sub Intercompany Debt**"). Distributing uses $500X of § 361 Consideration to repay the Internal Distributing Borrowing; in turn, Domestic Sub uses the § 361 Consideration to repay the Domestic Sub Intercompany Debt, and Domestic Sub 2 ultimately uses that consideration to repay the External

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[78] The Internal Distributing Borrowing may or may not be an "on-loan" of a portion of the proceeds from the External Subsidiary Borrowing.

[79] *See* Treas. Reg. § 1.1502-13(j)(4) (applying a single-entity analysis to successive intercompany transactions).

Subsidiary Borrowing, all pursuant to the plan of reorganization. In this scenario, both the Debt Allocation Principle and the formal requirements of section 361 are satisfied.[80]

Case Study 12: Refinancing of Distributing Debt Due Prior to the Contribution with Related Party Borrowing; No Subsequent Purge by Related Creditor

> In June of 2020, following the announcement of the Spin-off and as part of the plan of reorganization, Distributing borrows $500X from Foreign Sub, a wholly-owned foreign subsidiary of Distributing (i.e., a new Internal Distributing Borrowing from Foreign Sub). Certain outstanding publicly traded debt of Distributing, incurred several years prior to the announcement of the Spin-off, is scheduled to mature in July of 2020. Distributing uses the proceeds of the Internal Distributing Borrowing to repay that debt (which otherwise qualifies as Distributing Debt) when it matures.
>
> In the Contribution, Distributing transfers assets to Controlled in exchange for stock of Controlled and $500X of cash proceeds from a new third-party borrowing by Controlled. Following the Distribution, Distributing uses that cash to repay the Internal Distributing Borrowing. Foreign Sub retains the proceeds and uses the cash for general corporate purposes (or transfers the cash to another Distributing affiliate to use for such purposes).

Case Study 12 highlights interesting sequencing issues under section 361 and the Subsequent Purge Requirement. The literal language of section 361(b) simply requires the boot received in a D Reorganization to be used to repay Distributing's creditors. While the facts of Case Study 12 satisfy the literal language of the statute, they do not satisfy the Subsequent Purge Requirement because the actual cash received in the Contribution and used to repay the Internal Distributing Borrowing is not subsequently purged by Foreign Sub.

On balance, we believe that the Service should rule favorably on Case Study 12 for two reasons. First, Distributing does, in fact, distribute the boot received to its creditor, Foreign Sub, and thus is in literal compliance with the section 361(b). Second, the series of transactions as a whole is in compliance with the Debt Allocation Principle because its net effect is the allocation of Distributing Debt to Controlled.[81] In effect, Case Study 12 is similar to Case Study 9, with Foreign Sub being substituted for Financial Intermediary. In these circumstances, we think the Subsequent Purge Requirement should yield, consistent with our overall view that step transaction principles should not be applied in a manner to create artificial distinctions where no identifiable

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[80] Assume that the facts are the same as in Case Study 11, except that Domestic Sub retains the proceeds from the repayment of the Internal Distributing Borrowing and uses the cash for general corporate purposes (or transfers the cash to another Distributing affiliate to use for such purposes). The statutory text of section 361(b) and (c) does not explicitly require that a creditor receiving § 361 Consideration be unrelated to Distributing, and section 361 is generally administered on a separate-entity basis (e.g., the section 361(b)(3) basis limitation). However, unlike in Case Study 11, the net effect of this transaction is a $500X increase in the debt of Controlled and a $500X increase in the Distributing group's free cash. Accordingly, consistent with the Subsequent Purge Requirement, Treasury Regulation section 1.1502-13(c), and the Debt Allocation Principle, we do not believe the Service should be willing to issue a PLR in these circumstances.

[81] Controlled (rather than Distributing) ultimately will bear the economic burdens associated with servicing and repaying the $500X of debt used to fund the boot payment.

policy interest is served thereby (in this case, a distinction between a third-party lender and a related-party lender where the proceeds of the loan are used to repay historic Distributing Debt as part of the plan of reorganization).

To clarify that the Service would rule favorably on transactions similar to Case Study 12, we would propose that an additional prong be added to section 3.04(2) of Revenue Procedure 2018-53 as an alternative to the Subsequent Purge Requirement. This additional prong would provide that satisfaction of Distributing Debt held by a Related Person is a permissible use of § 361 Consideration if the taxpayer establishes that the proceeds from that debt were or will be used to repay otherwise qualifying Distributing Debt held by one or more unrelated parties.

Case Study 13: Liquidation of Subsidiary Debtor or Other Debt Assumption and Purge to External Creditors

> As in Case Study 11, Domestic Sub has $1,000X of outstanding debt held by third-party creditors (i.e., the External Subsidiary Borrowing). Unlike in Case Study 11, Domestic Sub does not hold any Distributing Debt. Domestic Sub converts to a limited liability company in anticipation of the Spin-off and prior to the repayment of the External Subsidiary Borrowing.
>
> In the Contribution, Distributing transfers assets to Controlled in exchange for § 361 Consideration that includes boot. Following the Distribution, Distributing contributes $500X of the § 361 Consideration to Domestic Sub (now a disregarded entity). Shortly thereafter, Domestic Sub uses that consideration to repay a corresponding portion of the External Subsidiary Borrowing.

We believe that the Service is and should be willing to provide a PLR for this transaction. As a result of the deemed liquidation of Domestic Sub, Distributing becomes the section 381 successor of Domestic Sub in a transaction described in section 332 and should be able to purge § 361 Consideration by repaying historic third-party debt of Domestic Sub. In this scenario, Distributing replaces Domestic Sub as the obligor under the External Subsidiary Borrowing, and the holder of that debt therefore becomes a creditor of Distributing.

On balance, the result should be the same if Distributing repays third-party debt that it has assumed from a subsidiary in a transaction that caused a "significant modification" of the debt under Treasury Regulation section 1.1001-3 (e.g., where the debt is not assumed in a section 381 transaction).[82] Although such an assumption results in a technical satisfaction and reissuance of the debt for federal income tax purposes, and although the assumed debt is quickly repaid,[83] the transaction is nevertheless in accordance with the Debt Allocation Principle because it effects a

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[82] *See* Treas. Reg. § 1.1001-3(e)(4)(i).

[83] *See Arthur L. Kniffen v. Comm'r*, 39 T.C. 553 (1962); Rev. Rul. 78-330, 1978-2 C.B. 147.

reallocation of historic Distributing liabilities between Distributing and Controlled and does not increase Distributing's free cash.[84]

Case Study 14: Contribution to Consolidated Subsidiary and Purge to External Creditors

> The facts are the same as in Case Study 13, but Domestic Sub does not convert to a limited liability company and remains the obligor on the External Subsidiary Borrowing. Following the Distribution, Distributing contributes to Domestic Sub $500X of the § 361 Consideration received in the Contribution, and Domestic Sub promptly uses that consideration to repay a corresponding portion of the External Subsidiary Borrowing.

Section 361 is generally administered on a separate-entity basis, and compliance with the statutory text of section 361(b) and (c) requires that the § 361 Consideration be distributed or otherwise transferred to a shareholder or creditor of Distributing itself (including a creditor that is related to Distributing). Nevertheless, Treasury Regulation section 1.1502-13 may support a favorable conclusion in Case Study 14, on the grounds that the ability to purge the boot received by Distributing in the intercompany section 361 transaction should be considered an attribute of the boot that attaches to the intercompany contribution to Domestic Sub via application of the successive intercompany transaction rule of Treasury Regulation section 1.1502-13(j)(4), thereby permitting Domestic Sub's repayment of the External Subsidiary Borrowing to satisfy the section 361 purge requirement on a single-entity basis.

E. Reborrowings by Distributing

Revenue Procedure 2018-53 requires the taxpayer to submit a representation that "Distributing will not replace any Distributing Debt that will be assumed or satisfied with previously committed borrowing, other than borrowing in the ordinary course of business pursuant to a revolving credit agreement or similar arrangement."[85] It further provides that, if Distributing is a prospective borrower under a revolving credit agreement or similar arrangement, it should be established that the agreement or arrangement was not entered into, and the amounts of borrowing provided for therein were not increased, in a transaction related to the Spin-off.[86] Revenue Procedure 2018-53 indicates that this representation is intended to establish that the application of section 361 to the transaction is consistent with the purpose of section 361.[87]

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[84] In effect, a favorable outcome in the case of assumed debt is consistent with our conclusion in Case Study 17 below. A favorable result in Case Study 13 also should be reached if a favorable result is reached in Case Study 14 below.

[85] Rev. Proc. 2018-53, section 3.04(7). Although this is arguably implicit in the representation, consideration should be given to whether the representation should be further clarified by explicitly stating that the representation is intended to apply equally to debt issued before the Spin-off and as part of the plan of reorganization.

[86] *Id.*

[87] *Id.*

Case Study 15: Reborrowing Pursuant to Previously Committed Revolving Credit Agreement

> Distributing entered into a revolving credit agreement with third party lenders in June of 2016 (the "**Revolving Credit Agreement**"). Pursuant to the terms of the Revolving Credit Agreement, Distributing is entitled to borrow, and the syndicated group of lenders are required to lend, up to $100X. The Revolving Credit Agreement has a final maturity date of June of 2027 and bears interest at a floating rate based on the Federal Reserve Funds Target Rate plus a specified percentage spread. Amounts borrowed under the Revolving Credit Agreement may be repaid prior to the final maturity date at Distributing's option. Prior to the announcement of the Spin-off, Distributing had previously drawn and repaid amounts under the Revolving Credit Agreement to fund general corporate expenses, but at the announcement of the Spin-off, no amounts were outstanding under the Revolving Credit Agreement.
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> In the Contribution, Distributing transfers assets to Controlled in exchange for the stock of Controlled and other § 361 Consideration (e.g., Controlled securities and/or cash proceeds from a new third-party borrowing by Controlled). Following the Distribution, Distributing borrows under the Revolving Credit Agreement in the ordinary course of business, using the proceeds for general corporate purposes.

Case Study 15 appears to satisfy the requirements of section 3.04(7) of Revenue Procedure 2018-53. Under the facts of this example, Distributing was, prior to the announcement of the Spin-off, and remained following the Spin-off, entitled to draw up to $100X under the Revolving Credit Agreement. Additionally, the Revolving Credit Agreement had been in place well in advance of the announcement of the Spin-off and had been drawn on by Distributing to fund general corporate expenses prior to the Spin-off. Moreover, the new borrowing does not contravene the Debt Allocation Principle. Because the new borrowing is a routine, ordinary course borrowing, there is no concern that Distributing has used section 361 as a vehicle for increasing the aggregate liabilities of Distributing and Controlled.

This showing alone should be sufficient to demonstrate that "the agreement or arrangement was not entered into, and amounts of borrowing provide for therein were not increased, in a transaction related to the [D] Reorganization." We interpret section 3.04(7) as requiring that Distributing not increase the total amount that *may* be borrowed under an existing revolving credit agreement, and not as a requirement that otherwise available amounts under existing revolving facilities not be borrowed. This is a commonsense interpretation of the wording of section 3.04(7), as it would be illogical and presumably unintended to permit a preexisting revolver to be outstanding with undrawn amounts while at the same time prohibiting post-Spin-off borrowings under that revolver. The Service could provide additional certainty by clarifying that a borrowing under a previously arranged revolving facility in the ordinary course of business is not evidence of replacing the debt of Distributing repaid with § 361 Consideration.

Potentially difficult related issues arise in some cases where a post-Spin-off borrowing by Distributing, although not previously committed, was anticipated at the time of a Spin-off. On one hand, it might be said that the Debt Allocation Principle should be relevant at least in some such cases, and that if the new borrowing by Distributing undoes Distributing's de-levering at the time

of the Spin-off, then at least in some cases the overall transaction could be seen to resemble a partial sale by Distributing of Controlled's business. We note that, because the debt replacement representation only applies to "previously committed" borrowings, Revenue Procedure 2018-53 permits a taxpayer to replace Distributing Debt pursuant to an overall plan, provided there is no commitment to undertake the borrowing at the time of the Spin-off. Thus, pursuant to a plan not involving pre-committed financing, Distributing could theoretically borrow after the Spin-off and keep the proceeds for general use in its business, thereby effecting a sale-like result that is inconsistent with the Debt Allocation Principle.

On the other hand, we believe that the replacement of Distributing Debt through a non-committed post-Spin-off borrowing is likely to be a relatively unusual situation. As a practical matter, it is unlikely that Distributing would undertake a borrowing and retain the proceeds without a specific use (i.e., simply as a replacement for Distributing Debt repaid from boot received) due to negative arbitrage. Rather, corporations generally incur new borrowings for a specific purpose. As described above, an ordinary course borrowing does not raise the concern that section 361 has been used to effect a partial sale of Controlled. Similarly, as discussed in Case Study 16 below, this concern is not present where a new borrowing is undertaken for a business purpose that is unrelated to the Spin-off (e.g., to finance an acquisition of a new business that would have been undertaken absent the Spin-off).

Moreover, it seems hard to identify clear principles that would distinguish the cases in which a planned future borrowing by Distributing would lead to abusive results, particularly because the statute itself sets forth no limits on post-Spin-off borrowings by Distributing, without simultaneously preventing ordinary course or extraordinary borrowings that should be permissible or requiring a very intrusive inquiry into complicated capital management matters that the government is not well-positioned to administer effectively. For example, the application of a standard that treats as problematic all post-Spin-off borrowings that are part of the "plan" or would not have occurred but for the Spin-off would create enormous uncertainty in almost any case where a future borrowing is foreseeable at the time of the Spin-off. Accordingly, we believe that a non-committed borrowing potentially could be viewed as problematic only if, at a minimum, (1) the borrowing occurs reasonably shortly after the Spin-off (i.e., so that Distributing is not exposed to significant market risk in the interim), (2) the borrowing is not in the ordinary course of business consistent with historic practices, (3) Distributing cannot demonstrate that the borrowing was not planned in connection with the Spin-off, and (4) there is clear evidence that absent the borrowing Distributing would be under-levered from a capital markets perspective (so that Distributing had a need to replace Distributing Debt that was repaid from boot received).

For these reasons, and in light of the fact that any potentially abusive transactions along the lines discussed above are a very small subset of the broad majority of reborrowing transactions, we agree that the "previously committed" standard strikes a reasonable balance, although we do not foreclose the possibility that an administrable standard could be developed to address a limited set of non-committed replacement borrowings.

Case Study 16: Borrowing Pursuant to Newly Committed Financing After Change in Circumstances

> Following the announcement of the Spin-off but prior to the Spin-off, a business competitor of Distributing ("**Target**") is the target of a hostile takeover offer by another competitor. Target begins an auction process, and Distributing submits a successful bid. To finance its acquisition of Target, Distributing enters into committed financing arrangements with a syndicate of third-party lenders (the "**Committed Financing**"). The Committed Financing is fully committed prior to the Distribution.
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> In the Contribution, which takes place during the pendency of Distributing's acquisition of Target, Distributing transfers assets to Controlled in exchange for the stock of Controlled and cash proceeds from a new third-party borrowing by Controlled. Following the Distribution, Distributing uses that cash to repay other outstanding third-party debt of Distributing. Distributing later borrows pursuant to the Committed Financing and uses the proceeds to acquire Target.

The facts of Case Study 16 do not satisfy the explicit requirements of Revenue Procedure 2018-53 because Distributing has financing commitments entered into following the announcement of the Spin-off and does in fact borrow those amounts following the Spin-off. However, the surrounding facts and circumstances clearly indicate that Distributing's post-Spin-off borrowing pursuant to the Committed Financing does not circumvent the Debt Allocation Principle. Because the Committed Financing is demonstrably independent of the Spin-off plan, Distributing should not be viewed as improperly taking advantage of section 361 to increase the aggregate liabilities of Distributing and Controlled. Accordingly, we believe the Service should be willing to provide a PLR where a post-Spin-off borrowing by Distributing occurs pursuant to a pre-Spin-off financing commitment entered into as a result of changed circumstances that were unanticipated at the time the Spin-off was first announced.

Case Study 17: Reborrowing by Subsidiary of Distributing

> In June of 2020, Domestic Sub enters into a committed financing agreement with a third-party lender (the "**Subsidiary Committed Financing**"). In the Contribution, Distributing receives $500X of cash from Controlled and repays $500X of otherwise qualifying Distributing Debt. Following the Spin-off, Domestic Sub borrows $500X under the Subsidiary Committed Financing. The proceeds are then used by Domestic Sub and other subsidiaries of Distributing to fund general corporate expenses.

The facts above do not clearly fall outside of the scope of Revenue Procedure 2018-53. Section 3.04(7) of Revenue Procedure 2018-53, by its terms, applies only to debt incurred by Distributing, not Distributing's subsidiaries. However, Case Study 17 results in no net decrease in the liabilities of the Distributing group, and it increases Distributing's free cash by $500X. Thus, the economics of this transaction do not comport with the Debt Allocation Principle and are largely similar to a taxable sale of a portion of the stock of Controlled. For this reason, we believe that taxpayers seeking a PLR in circumstances similar to Case Study 17 should be required to provide a more significant showing as to why, in their particular circumstances, the purposes of section 361 would be furthered by affording tax-free treatment to Distributing's receipt of § 361 Consideration.

Accordingly, we recommend that section 3.04(7) of Revenue Procedure 2018-53 be revised to apply to borrowings by both Distributing and its subsidiaries.

F. Post-Spin-off Refinancing of Controlled Debt

Revenue Procedure 2018-53 does not address the ability of Controlled, following the Spin-off, to refinance or otherwise modify any of its securities or other debt obligations that constitute or fund the § 361 Consideration. Nevertheless, taxpayers would benefit from guidance on the permissible scope of transactions that Controlled (or a successor corporation, such as an acquiror in a "Reverse Morris Trust" transaction) is permitted to undertake with respect to Controlled securities or other Controlled debt that is issued to fund § 361 Consideration. In this regard, we note that certain judicially developed doctrines may, in certain circumstances, treat another party as the true obligor of debt legally incurred by a taxpayer.[88]

Case Study 18: Post-Spin-off Refinancing or Assumption of Controlled Debt Issued to Fund Pre-Spin-off Boot Distribution

> In January of 2020, Distributing enters into an agreement with another domestic publicly-traded company ("**RMT Counterparty**") pursuant to which, immediately following the Spin-off, RMT Counterparty will acquire all of the stock of Controlled in exchange for stock of RMT Counterparty (the "**RMT Acquisition**"). Former shareholders of Controlled will own more than 50% of the stock of RMT Counterparty upon consummation of the RMT Acquisition.
>
> Shortly before the Spin-off, Controlled borrows under a term loan and distributes the proceeds to Distributing as part of the consideration in the Contribution. Following the RMT, Controlled is merged with and into RMT Counterparty, and RMT Counterparty legally assumes Controlled's obligations under the term loan (the "**Follow-on Merger**"). RMT Counterparty subsequently refinances the debt in a manner consistent with its existing debt facilities.

We do not believe the Follow-on Merger should cause the Spin-off to be subject to any sort of recast, provided that Controlled would be able to support the debt that it incurred prior to the Spin-off on a standalone basis. This result is consistent with the non-application of step transaction principles to section 355 distributions generally, as prescribed by Revenue Ruling 98-27.[89]

Additionally, we believe that the same result should obtain if there is no Follow-on Merger, and RMT Partner assumes or otherwise accedes to the obligations of Controlled in a transaction in which RMT Partner is not the successor to Controlled under section 381, regardless of whether the assumption triggers a deemed exchange of the assumed debt under section 1001. In our view, Controlled should be respected as the obligor on debt used to fund a boot payment to Distributing

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[88] *See., e.g., Plantation Patterns, Inc. v. Comm'r*, T.C. Memo. 1970-182 (1970); *Waterman Steamship Corp. v. Comm'r*, 430 F.2d 1185 (5th Cir. 1970).

[89] 1998-1 C.B. 1159.

so long as Controlled is able to support the debt, on a standalone basis, at the time of the Spin-off and without regard to any subsequent acquisition or restructuring of Controlled.

The Service should clarify this result and provide guidance regarding what, if any, post-Spin-off limitations apply to debt of Controlled that was used to fund a boot payment to Distributing.

Case Study 19: Post-Spin-off Refinancing or Assumption of Controlled Securities Exchanged for Distributing Debt

> The facts are the same as in Case Study 18, except that, instead of borrowing under a term loan and distributing the proceeds to Distributing, Controlled issues Controlled securities to Distributing as part of the consideration in the Contribution, and Distributing transfers those securities to its creditors in an exchange described in section 361(c). Following the RMT Acquisition, Controlled is merged with and into RMT Counterparty, and RMT Counterparty legally assumes Controlled's obligations under the securities, which remain outstanding and are serviced and repaid in accordance with their terms.

Similar to Case Study 18, we do not believe the Follow-on Merger should cause the Spin-off and the issuance of Controlled securities to be subject to any potential recast. The Follow-on Merger should not prevent the securities from qualifying as "securities" within the meaning of section 361(a) because their assumption by RMT Counterparty does not result in a deemed satisfaction of the securities and a deemed reissuance of "new" debt instruments.[90]

Taxpayers would benefit from guidance regarding what different standards may apply with respect to Controlled debt used to fund a payment of boot to Distributing, as in Case Study 18, as compared to Controlled securities that are issued to Distributing and exchanged for Distributing Debt in a section 361(c) transaction. Additionally, greater clarity regarding what post-distribution transactions do or do not impact an instrument's status as a "security" would be welcome.

G. Boot Required to Be Purged

Revenue Procedure 2018-53 does not address certain situations where it is unclear what property is received by Distributing from Controlled, and whether such property, or fungible replacement property, is required to be paid to shareholders or creditors. Section 361 provides, in several instances, that it is "*the* other property or money received in the exchange" that must be distributed to shareholders or creditors. However, with respect to cash and other economically fungible property, the Service does not appear to require strict adherence to any formalistic interpretation suggested by this language.[91]

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[90] If the Follow-on Merger does not occur, however, and RMT Partner instead assumes the Controlled securities in a transaction that causes a "significant modification" of the debt under Treasury Regulation section 1.1001-3, it is uncertain whether the debt should qualify as securities in the first instance.

[91] As one example, in a number of PLRs, the Service has not strictly traced the actual cash boot received to a permissible use. *See, e.g.*, PLR 201818010 (May 22, 2017) (ruling that, for purposes of determining if there was a qualifying purge as required for nonrecognition treatment under section 361(b), "Distributing will not be required to

Case Study 20: Distributing Receives Short-Term Note from Controlled and Purges Cash Consideration

> In the Contribution, Distributing receives stock of Controlled and a note issued by Controlled with a face amount of $500X, payable 120 days following the Spin-off (the "**Controlled Short-Term Note**"). The Controlled Short-Term Note was issued because, due to the seasonality of Controlled's business, Controlled required additional working capital on hand at the time of the Spin-off. Within 120 days following the Spin-off, Distributing receives $500X from Controlled in repayment of the Controlled Short-Term Note, and it uses that cash to repay otherwise qualifying Distributing Debt pursuant to the plan of reorganization.

This transaction fully comports with the Debt Allocation Principle, in that it effects a reallocation of historic Distributing liabilities between Distributing and Controlled. However, there is technical argument that the property Distributing receives in the Contribution is not $500X of cash, but rather the Controlled Short-Term Note. On a very formalistic reading of the statute, because the Controlled Short-Term Note itself is not transferred to creditors or shareholders of Distributing, Distributing is arguably required to recognize gain under section 361(b) as a result of the receipt of "unpurged" boot in the Contribution.

We believe that any uncertainty surrounding this scenario should and could easily be resolved by the addition of guidance to any successor to Revenue Procedure 2018-53. One fairly straightforward way to address this uncertainty would be to clarify that § 361 Consideration includes cash or other economically fungible property required to be paid by Controlled to Distributing in exchange for the "money, securities or other debt obligations of which Controlled is the obligor, and other property" received by Distributing in the D Reorganization.

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segregate or otherwise trace the cash received from [Controlled as part of the Contribution] and, as such, may use cash from any source"); PLR 201703012 (Sept. 20, 2016) (ruling that "Distributing will not be required to segregate or otherwise trace the cash received from Controlled in the Contribution" in order to attain nonrecognition treatment); PLR 201702035 (Feb. 1, 2016) (ruling that, where "Distributing will not set aside or otherwise segregate the" cash boot, the cash boot will be treated as being distributed pursuant to a plan of reorganization for purposes of section 361(b)(1)(A) and (b)(3)); PLR 201627001 (Jan. 4, 2016) (ruling that a distribution of "an amount of cash equal to or greater than the cash received" from Controlled to Distributing's shareholders or creditors will be sufficient to qualify the receipt of cash boot by Distributing for nonrecognition treatment under section 361(b)(1)(A) by reason of section 361(b)(3)).