Tax Report #958

New York State Bar Association

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July 8, 1999

The Hon. Jonathan Talisman
Deputy Assistant Secretary, Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, N.W.,
Room 1330 MT
Washington, D.C. 20220

Dear Secretary Talisman:

Enclosed is a report of the New York State Bar Association, Tax Section, discussing its support of the proposal in the Administration's Fiscal Year 2000 Budget to amend the "control" test in Section 368(c) of the Internal Revenue Code of 1986, as amended.

The majority of our Executive Committee supports the inclusion of a "value" standard in the definition of "control" for purposes of Section 368, thereby conforming the requirements of Section 368(c) with those provided in Section 1504(a)(2) and Section 1504(a)(4). We believe that such an amendment is necessary to deal with a number of recent transactions that have sought to capitalize on the inadequacies of the current definition through the issuance of low vote/high value stock of the Company. We recognize, however, that changing the "control" definition will not prevent a number of arguably "aggressive" transactions

with similar economic effect. For this reason, as well as others explained in the report, a significant minority of our Committee do not agree with this approach. Nevertheless, the majority supports co-ordination of the ownership requirements for Sections 351, 368, 332, 338 and 1502.

We would be pleased to discuss the report with you at your convenience.

Very truly yours,

Harold R. Handler
Chair

Enclosure

cc: Joseph M. Mikrut, Esq.

I. Introduction.

This report[1] discusses the provision of the Clinton Administration's Fiscal 2000 Budget Proposal (the "Budget Proposal") that would conform the "control" test contained in Section 368(c) to the Section 1504(a)(2) ownership test (the "Control Proposal"). Under the Control Proposal, "control" in Section 368(c) would be defined to require ownership of at least 80 percent of the total voting power and at least 80 percent of the value of a corporation's stock.

The conclusions of this report are:

- A majority of the Committee believes the control test of Section 368(c) should be amended to include a value requirement, in addition to the present voting power requirement. A significant minority of the Committee, however, believes that the control test should not be changed.

- Although adding a value requirement to the control test would prevent perceived abuses effected in some recently publicized divisive and acquisitive transactions, this amendment would not be completely effective in preventing transactions with similar economic consequences.

- Under a revised Section 368(c) control test, the second prong of the current Section 368(c) test, requiring ownership of at least 80 percent of the number of shares of each class of nonvoting stock, should be eliminated.

- A majority of the Committee supports an 80 percent vote and value requirement. However, a significant minority of the Committee believes that, if a value requirement is added, 50 percent should be the minimum required level of value ownership.

- In defining value under the amended Section 368(c) test, preferred stock described in Section 1504(a)(4) should not be taken into account.

- If the control test in Section 368(c) is amended, transition relief similar to that provided in connection with other recent changes of longstanding statutory provisions should be provided.

II. Background.

A majority of the Committee supports the amendments to the control definition in Section 368 because of recent transactions that have sought to capitalize on the inadequacies of the current definition. As explained below, there is a significant minority that disagrees with this

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[1] This report was prepared by the Reorganizations Committee (the "Committee"). The principal authors of this report are Saba Ashraf and Jonathan Kushner. Helpful comments were received from Harold R. Handler, Robert Jacobs, Richard Reinhold, David Rievman, Robert Rothman, Michael Schler, Jodi Schwartz and Daniel Shefter.

approach. In any event, the Committee believes that if this amendment is to be adopted, the collateral consequences of that amendment must be carefully considered.

We have reached this conclusion despite our general view that "piecemeal" amendments to a complex series of statutory provisions frequently lead to inconsistencies. This is particularly true in the case of the "organization" and "reorganization" provisions of Subchapter C of the Internal Revenue Code. They are a complex and vital series of provisions that have existed, more or less with the same overall structure, for at least 75 years. It has been our experience that adjustments to any one of these provisions necessarily leads to inconsistencies and difficulties which can be determined only after the fact. One need only look at the various definitions in Section 368 to realize that amendments made individually over a period of years have contributed to an incoherent statutory structure. If there is an effort to deal with a perceived abuse, and we agree that corrective legislation may be appropriate, the Administration, and Congress, should rationalize these provisions as well. A rationalization effort was attempted 14 years ago in the report of Senate Finance Committee Staff on Subchapter C Revision Bill of 1985, 99th Cong., 1st Sess. p. 47, S. Prt. (May 1985). Such a major reworking of the statutory structure is not completely necessary. For example, a less ambitious revision of the definitions of Section 368 would be a welcome proposal. In any event, the collateral effects on other aspects of the Code must be carefully studied.

The Control Proposal would conform the Section 368(c) control test, currently used to qualify tax-free incorporations, distributions, and reorganizations, to the Section 1504(a)(2) ownership test, currently used to determine affiliation, tax-free liquidations, and qualified stock purchases. Under current Section 368(c), control means the ownership of stock possessing (i) at least 80 percent of the total combined voting power of all classes of stock entitled to vote and (ii) at least 80 percent of the total number of shares of all other classes of stock in the corporation.[2] By contrast, Section 1504(a)(2) requires the ownership of stock possessing (i) at least 80 percent of the total voting power of the stock of the corporation and (ii) at least 80 percent of the total value of the stock of the corporation. Under the Control Proposal, control under Section 368(c) would be defined as the ownership of stock possessing (i) at least 80 percent of the total voting power and (ii) at least 80 percent of the total value of the corporation's stock. For this purpose, stock would not include nonparticipating "pure" preferred stock that satisfies the requirements of Section 1504(a)(4).

The Treasury Department explains the Control Proposal is needed because the current Section 368(c) control test is too easily manipulated by allocating voting power among the shares of a corporation, and that the absence of a value component enables corporations to retain technical control of a corporation while "selling" a significant amount -- or substantially all -- of

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[2] The IRS has interpreted this second test as requiring ownership of at least 80 percent of the total number of shares of each class of nonvoting stock. Rev. Rul. 59-259, 1959-2 C.B. 115.

its value.[3] The Treasury Department explains that while the ability to manipulate control has been present since the provision was enacted, there has been a proliferation of recent transactions that resemble sales but appear to qualify under tax-free provisions.

III. Proliferation of recent transactions.

A. Divisive reorganizations.

Much has been written about recent transactions involving recapitalizations reallocating voting power prior to a spinoff.[4] As discussed in the description of the provisions in the Budget Proposal prepared by the Staff of the Joint Committee on Taxation,[5] these recent transactions involve the public offering of the stock of a controlled corporation representing less than 20 percent of the voting power but greater -- and in some cases far greater -- than 20 percent of the value of its stock, i.e., the stock issued in the public offering has voting rights disproportionately low compared to the underlying value of the stock. The parent corporation retains ownership of stock in the controlled corporation representing at least 80 percent of the voting power, but significantly less than 80 percent of the value of the stock of the controlled corporation, i.e., the stock retained by the parent corporation has voting rights disproportionately high compared to the underlying value of the stock. The controlled corporation conveys part or all of the offering proceeds to the parent corporation.[6] After the public offering of the stock of the subsidiary, the

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3 *General Explanations of the Administration's Revenue Proposals* 130 (Feb. 1999) (hereinafter "*Administration's General Explanation*").

4 See, e.g., Robert Willens, *New IRS Ruling Focuses Attention on "Control" in Section 355 Transactions*, 89 J. TAX'N 5 (July 1998); Todd Maynes, *Getting Out the Vote: The Use of Voting Rights in Tax Planning*, 73 TAXES 813 (Dec. 1995); Lee A. Sheppard, *Retained Value in Spinoffs and Other Questions*, 65 TAX Notes 398 (Oct. 24, 1994); Martin D. Ginsburg & Jack S. Levin, MERGERS, ACQUISITIONS, AND BUYOUTS, ¶ 1003.1 (Oct. 1998 Edition).

5 Staff of the Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal* 220 (Feb. 22, 1999) (hereinafter "*Joint Committee Description*").

6 The transfer of cash to the parent corporation can be accomplished by the controlled corporation's use of the public offering proceeds to repay previously existing intercompany debt to the parent corporation. Alternatively, in a divisive reorganization qualifying under Sections 368(a)(1)(D) and 355, the controlled corporation can distribute the public offering proceeds tax-free to the parent corporation under Section 361(b) if the parent corporation distributes the cash to the parent's shareholders or uses the cash to pay parent's creditors.

parent corporation distributes all of the retained stock to the parent's shareholders in a transaction intended to qualify for tax-free treatment under Section 355.[7], [8]

B. Acquisitive reorganizations.

Current Section 368(c) also plays a role in acquisitive reorganizations. The Joint Committee Description states that in certain reorganization transactions, the transferor transfers appreciated property in exchange for a stock interest that shares in little, if any, of the economic growth potential of the property the transferor formerly owned. This economic interest now belongs to the other party to the transaction (the acquirer). Instead, the transferor's stock interest reflects the economic value (including cash) contributed by the acquirer as part of the transaction.[9]

The basic facts of one well publicized transaction illustrate the application of these rules: Acquirer causes two subsidiaries to be formed -- a first tier subsidiary, whose preferred stock Acquirer will own, and a second-tier subsidiary, whose preferred stock is owned by the first-tier subsidiary and whose common stock is owned directly by Acquirer. The preferred stock of the second-tier subsidiary owned by the first-tier subsidiary represents 80 percent of the voting power of the second-tier subsidiary. Although the common stock of the second-tier subsidiary owned by Acquirer has only 20 percent of the voting power of the second-tier subsidiary, this common stock owned by Acquirer represents the potential for all the growth of the second-tier subsidiary (in excess of dividends paid on the preferred stock owned by the first-tier subsidiary). Acquirer transfers a large amount of cash to the first-tier subsidiary. The second-tier subsidiary is merged, in a transaction intended to qualify for tax-free treatment under Section 368(a)(2)(E),

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7 The multi-class stock arrangement is designed to enable the spinoff to satisfy the control immediately before requirement of Section 355(a)(1)(A) and the distribution of control requirement of Section 355(a)(1)(D). Section 355(a)(1)(A) requires the distributing corporation to distribute stock of a corporation that it controls immediately before the distribution. Section 355(a)(1)(D) requires the distributing corporation to distribute all the stock of the subsidiary, or at least an amount of stock of the subsidiary constituting control of the subsidiary (and it is established that the retention of any stock in the subsidiary was not in pursuance of a plan having as one of its principal purposes the avoidance of tax).

8 Upon the happening of certain specified events (such as the transfer by the parent corporation of the high-vote stock, or an anniversary of the spinoff), the high-vote stock may lose the disproportionately high vote, so that the controlled corporation once again has one class of voting stock outstanding. We understand the IRS will grant a favorable ruling in a Section 355 transaction involving a tiered voting structure (where elimination of the tiered voting structure would reduce the voting power of the high-vote stock below 80 percent) only if the taxpayer represents there is no plan, intention, or formal or informal understanding to change the controlled corporation's capital structure to eliminate the tiered voting structure, or to vote within five years to change the voting structure after five years. See, e.g., PLR 9836019 (June 8, 1998).

9 *Joint Committee Description* 221-22.

with and into Target, with Target surviving. Because the first-tier subsidiary's preferred stock in the second-tier subsidiary has 80 percent of the voting power of the second-tier subsidiary, the first-tier subsidiary has the requisite control of the second-tier subsidiary required to engage in the reverse subsidiary merger.[10] In the merger, the Target shareholder receives voting common stock of Acquirer's first-tier subsidiary. To provide the former Target shareholder with greater control over the cash held by Acquirer's first-tier subsidiary, the first-tier subsidiary places the cash into a wholly-owned LLC, whose sole manager is the former Target shareholder.

IV. Adding a value component to the Section 368(c) test.

A. Foundation of tax-free incorporation and reorganization rules.

To analyze whether the Section 368(c) control test should be conformed to the Section 1504 test, it is necessary to examine the policy underlying each of these tests. The ownership test required for affiliation seeks to ensure that sufficient unity exists between two corporations to treat them as one for tax purposes. The foundation for Section 1504 is the premise that where there is sufficient connection between two entities, they may be viewed as a single entity for tax purposes.[11] The current ownership test for affiliation was added to the Code in 1984 and replaced a test similar to the current Section 368(c) control test. The 1984 amendment reflected Congress's concern that corporations were filing consolidated returns in circumstances in which a parent had little or no interest in the underlying equity value of a subsidiary, and corporations, in essence, were "buying the tax losses" of other corporations.[12]

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10 For a transaction to qualify under Section 368(a)(2)(E), the target shareholders must receive stock of a corporation (the "controlling corporation") which, before the merger, was in control of the merged corporation. In addition, under Treas. Reg. §1.368-2(j)(3)(ii), the controlling corporation must control the surviving corporation immediately after the transaction. For these purposes, control is defined in Section 368(c).

11 When the consolidation statue was amended in 1954, the House Ways and Means Committee referred to the ability of corporations that "operate as economic units, to report their income for tax purposes as a single taxpayer." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 87 (1954). See also *Erie Lighting Co. v. Commissioner*, 93 F.2d 883, 884-85 (1st Cir. 1937) (the purpose of the affiliation provisions "was to enable corporations under one management to make a consolidated return as though they were a unit in transacting business"); *Pioneer Parachute Co. Inc. v. Commissioner*, 162 F.2d 249, 251 (2d Cir. 1947) (referring to an "economic unity" and a "single business enterprise").

12 The Senate Floor Discussion of the 1984 changes illustrates the concern:

> The law is generally intended to permit two corporations to file a consolidated return if one corporation owns and controls at least 80 percent of the other. Unfortunately, the law, as written, is more generous than that. Taxpayers have been using creative capital structures so as to be eligible for consolidation in situations not appropriate for consolidation and to avoid consolidation in situations when it should not be avoided. Taxpayers have been filing consolidated returns in instances where one owns less than 30 percent in value of the other. As a result, corporations with

A principal reason for providing nonrecognition treatment for incorporations and acquisitive reorganizations is that the shareholders involved do not actually realize the value of their investments because they do not dispose of them, but continue them in a new form.[13] The rationale for the incorporation and acquisitive reorganization rules is that no tax should be imposed on a transaction that is merely a conversion to a new form of the previous participation in an enterprise. The control requirement helps ensure that the shareholders maintain the requisite continuing interest. For example, in a Section 351 incorporation, the control requirement helps ensure the transferors have a significant interest in the transferee corporation. In a Section 368(a)(1)(B) reorganization or a reverse triangular merger under Section 368(a)(2)(E), the requirement that the acquiring corporation control the target corporation immediately after the acquisition helps ensure the target shareholders have a significant continuing indirect interest in the target. In a forward triangular merger under Section 368(a)(2)(D) or a parenthetical Section 368(a)(1)(C) reorganization, the requirement that the parent corporation control the acquiring corporation helps ensure the target shareholders have a significant continuing indirect interest in the corporation that acquires the target's assets.[14]

With respect to divisive reorganizations, the rationale for tax-free treatment is similar, i.e., no tax should be imposed on a transaction that is merely a new form of a previous participation in an enterprise. Unlike an acquisitive reorganization, where the new form results from a combination of businesses, in a divisive reorganization the new form results from a separation. After a spinoff, the shareholders own stock of two corporations conducting the businesses formerly conducted -- directly and indirectly -- by the distributing corporation. Tax-free treatment is permitted for a divisive transaction only if it separates what are essentially divisions of a single business enterprise.

> substantial taxable incomes have been taking advantage of the consolidated return rules to use the tax losses of other corporations. In essence, the former are buying tax losses of the latter.

Senate floor amendment to H.R. 2163, 130 Cong. Rec. 8654 (Apr. 11, 1984). It should be noted that the change in the ownership test by the Deficit Reduction Act of 1984 was also motivated by concerns that the previous definition allowed taxpayers too much electivity as to whether to consolidate or deconsolidate.

13 Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 Yale L.J. 90, 117 (1977).

14 This concept of a continuing interest by the shareholders is incorporated in the Code in other ways besides the control requirement. For example, in a Section 368(a)(1)(B) reorganization, the target shareholders must receive solely voting stock, and in a Section 368(a)(1)(C) or Section 368(a)(2)(E) reorganization only a small amount of boot is permitted. The concept of a continuing interest is also reflected in the continuity of interest and continuity of business enterprise doctrines, which were developed in case law and later incorporated in Treasury Regulations.

The concept of continuity of ownership underlying the tax-free incorporation and acquisitive reorganization rules would seem to require a significant continuity in ownership of the underlying value of an entity, and not simply voting power.[15] Similarly, the notion that a divisive reorganization is a separation of divisions of a single enterprise would seem to require a significant ownership by the distributing corporation in the value of the distributed subsidiary. Under current Section 368(c), a shareholder can control a subsidiary by owning a small amount of nonparticipating high-vote stock.[16] For purposes of control, a continuity of ownership should require more than just voting power—it should also require a significant participation in the upside and downside of the enterprise. For this reason, a majority of the Committee believes Section 368(c) should include a value requirement.[17]

However, a significant minority of the Committee believes that the control test has provided flexibility to taxpayers for many years, and should not be changed in response to certain potentially inappropriate transactions, which should be dealt with in other more direct ways. The minority believes it does not make sense for Congress to focus in a piecemeal manner on this particular discontinuity, because there are so many other discontinuities in Subchapter C to address, there are other ways to deal with the recent publicized transactions, and, as discussed below, changing the definition of control will not necessarily prevent transactions with similar economic consequences.

B. Preventing disguised sale transactions.

The Control Proposal addresses the Administration's concern that the absence of a value component to the control test enables corporations to retain control of a corporation while "selling" a significant amount -- even substantially all -- of the value of the "controlled"

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15 Cf. Treas. Reg. §1.368-1(e)(1)(i), relating to continuity of interest. "Continuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization." (Emphasis added.)

16 The high-vote stock could be preferred stock. The preferred stock could satisfy the requirements of Section 1504(a)(4), and thus be similar to debt, and nevertheless count towards control for purposes of the current Section 368(c) test. See the discussion of Section 1504(a)(4) stock below.

17 We note that if the Section 368(c) control test is amended, collateral effects would need to be considered. For example, amending the Section 368(c) control test would affect the operation of Section 368(a)(2)(C), which governs the transfer of assets or stock after a reorganization to a subsidiary of the acquiring corporation. In the course of considering this issue, Congress might consider permitting reorganizations in which assets or stock are directly transferred to a second-tier or lower-tier subsidiary of the acquiring corporation. In any event, the IRS would need to reconsider the definition of a "qualified group" in Treas. Reg. §1.368-1(d)(4)(ii), which is relevant to the effect on continuity of business enterprise of transfers of assets after a reorganization. In addition, Congress and the IRS should evaluate the effect of amending the Section 368(c) control test on provisions outside subchapter C that use or cross reference Section 368(c).

corporation.[18] Although other factors contribute to the transactions the Treasury views as sale-like, the separation of vote from value is an important feature of these transactions. As discussed below, although amending the Section 368(c) control test to include a value requirement would prevent many of these transactions, the amendment would not prevent all of them. Nevertheless, a majority of the Committee believes that because the control element is a feature of the untoward transactions, particularly the acquisitive reorganization type of transactions, the control definition should be amended to require value ownership.

The recent, highly publicized divisive transactions typically involve the public offering of the stock of a controlled corporation representing less than 20 percent of its voting power but more -- typically far more -- than 20 percent of the value of the stock of the controlled corporation. The parent corporation retains ownership of stock in the controlled corporation representing at least 80 percent of the voting power, but significantly less than 80 percent of the value of the stock of the controlled corporation. The controlled corporation conveys part or all of the offering proceeds to the parent corporation. After the public offering of the stock of the subsidiary, the parent corporation distributes all of the retained stock to the parent's shareholders in a transaction intended to qualify as tax-free spinoff under Section 355.

An amendment to the Section 368(c) control test to conform to the Section 1504 test would prevent the tax-free distribution of the stock of the controlled corporation in the above scenario, because the distributing corporation would not "control" the "controlled corporation" immediately before the spinoff as required by Section 355(a)(1)(A), nor would the distributing corporation distribute "control" as required by Section 355(a)(1)(D). However, the amendment would not prevent other transactions with a similar economic effect. For example, prior to a spinoff, the controlled corporation could borrow substantial funds and distribute the cash to the parent corporation.[19] After the cash distribution, the parent corporation could distribute the stock of the controlled corporation tax-free under Section 355. After the spinoff, the formerly controlled corporation effects a substantial public offering, representing more than 20 percent of its value.[20] This transaction accomplishes a result similar to the pre-spinoff public offering,

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18 *Administration's General Explanation* 130.

19 The distribution might qualify as a dividend separate from the spinoff, which would not result in tax in a consolidated group unless it creates an excess loss account under Treas. Reg. § 1.1502-19. Alternatively, the cash might be used to repay a previously existing intercompany debt. Or, in the case of a divisive reorganization qualifying under Sections 368(a)(1)(D) and 355, the controlled corporation might distribute the cash tax-free to the parent corporation under Section 361(b) if the parent corporation distributes the cash to the parent's shareholders or uses the cash to pay the parent's creditors.

20 The only limitation on the size of a post-spinoff public offering is Section 355(e), which can impose a tax on the distributing corporation if the public offering represents 50 percent or more of the vote or value of the controlled corporation.

without using high vote, low vote classes of stock.[21] In fact, the Tax Section commented on an aspect of this concern at the time Section 355(e) was under consideration,[22] suggesting that disproportionate allocation of debt was the major problem that needed to be addressed in the Anti-"Morris Trust" proposed legislation.

A substantial minority of the Committee observes that the real source of potential concern is the cash received by the distributing corporation, as if the distributing corporation sold the subsidiary's stock.[23] If the distributing corporation's receipt of cash is perceived to be a problem, it should be dealt with directly, and not by an amendment to the control requirement, that will not be completely effective.[24]

An amendment to the Section 368(c) control test could have a more pronounced effect on acquisitive transactions. For example, a key feature of the acquisitive transaction described earlier in this report is that the first-tier subsidiary controls the second-tier subsidiary (and the target), so that the reorganization can qualify under Section 368(a)(2)(E), notwithstanding that the common stock of the second-tier subsidiary owned directly by the Acquirer represents the future economic growth potential of the second-tier subsidiary. An amendment to the Section 368(c) control test to include a substantial value requirement would require the first-tier subsidiary to have substantial ownership of the value of the second-tier subsidiary. That change should prevent the described transaction from qualifying under Section 368(a)(2)(E).

A significant minority of the Committee believes the control element is not the key feature that makes the above described acquisitive transaction controversial. They point out that this transaction frustrates the intent of the reorganization provisions because the Target

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21 Even if the control test is amended to include an 80 percent value requirement, a partial sale-like effect can be achieved with a pre-spinoff public offering by the controlled corporation, provided the pre-spinoff public offering represents 20 percent or less of the vote and value of the controlled corporation's stock.

22 See New York State Bar Association Tax Section Report #907 dated July 2, 1997.

23 Cf. *Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970) (dividend to seller prior to the sale of its subsidiary's stock recharacterized as sales proceeds).

24 Some commentators suggest the device requirement of Section 355(a)(1)(B) is the more relevant concern here. The presence of a large amount of cash can be evidence of device under Treas. Reg. §1.355-2(d)(2)(iv). Despite the guidelines concerning device provided in Treas. Reg. §1.355-2(d), the device standards remain difficult to apply. See *Pulliam v. Commissioner*, 73 TCM 3052 (1997) (IRS unsuccessfully argued that a sale of 49 percent of a subsidiary's stock after its spinoff was a device). Furthermore, the primary purpose of the device requirement is to prevent shareholders from converting dividends to capital gain, which is not the concern raised by the Treasury with respect to recent transactions. Consequently, the device requirement may not be an appropriate tool to deal with disguised sale transactions.

shareholder, in effect, receives cash, represented by the Target shareholder's common stock interest in the first-tier subsidiary, which has transferred cash (provided by Acquirer) to a wholly-owned LLC, whose sole manager is the former Target shareholder. They suggest that a more direct way to deal with this transaction is to attack it under a substance over form or similar judicial doctrine.

C. Second prong of the current Section 368(c) test.

Current Section 368(c) generally ignores the ownership of the value of the stock of a corporation. However, the IRS's interpretation of the second prong of the test, requiring ownership of at least 80 percent of the total number of shares of each class of nonvoting stock of the corporation, mandates ownership value continuity. In Rev. Rul. 59-259, 1959-2 C.B. 115, in ruling that the control definition of Section 368(c) requires ownership of at least 80 percent of the total number of shares of each class of nonvoting stock, as opposed to ownership of 80 percent of the number of all nonvoting shares of stock, the IRS explained:

> [P]ercentage ownership of the number of non-voting shares outstanding, as contrasted to percentage ownership of each class of non-voting shares, is ordinarily of no significance and can lead to results which are inconsistent with the statutory scheme and clear congressional purpose. Ownership of large numbers of non-voting shares in a multi-class stock structure would not necessarily assure, in itself, the continuation of substantial proprietary interests in modified corporate forms as contemplated by the statute. See Section 1.368-1 of the Income Tax Regulations.

Amending the control test to require value ownership would achieve the desired continuation of a proprietary interest. If the Section 368(c) control test is changed to require a minimum ownership of value, the second prong of the current test should be eliminated because it would be redundant.

V. Level of ownership required.

A majority of the Committee supports the 80 percent vote and value requirement set forth in the Control Proposal. In the majority's view, for incorporations and acquisitive reorganizations, the necessary continuing interest is ensured by an 80 percent vote and value requirement. In particular, the majority observes that in the paradigm tax-free reorganization, a direct merger of the target corporation into the acquiring corporation, the target shareholders have a direct stock interest in the corporation that succeeds to the target corporation's assets. It is that direct stock interest in the acquiring corporation that is the basis for tax-free treatment. By contrast, in an acquisitive stock reorganization (a Section 368(a)(1)(B) reorganization or a reverse triangular merger under Section 368(a)(2)(E)) or in a triangular asset reorganization (a forward triangular merger under Section 368(a)(2)(D) or a parenthetical Section 368(a)(1)(C) reorganization), the target shareholders do not have a direct stock interest in the corporation that holds the target corporation's assets after the reorganization. The target shareholders have a stock interest in a controlling corporation, and the controlling corporation has a stock interest in

the corporation that holds the target corporation's assets. In these reorganizations, it is the combination of the target shareholder's stock ownership in the controlling corporation, plus the controlling corporation's stock interest in the subsidiary that holds the target corporation's assets, that provides the continuity that is the basis for tax-free treatment. A majority of the Committee believes a continuity standard similar to the direct merger is achieved only if the controlling corporation owns a high percentage of the vote and value of the subsidiary stock. For this reason, the majority supports an 80 percent vote and value requirement.

A majority of the Committee also believes that an 80 percent vote and value requirement is appropriate for tax-free divisive reorganizations. As indicated previously, an underlying premise for Section 355 is that tax-free treatment is permitted for a divisive reorganization only if it separates what are essentially divisions of a single business enterprise. A subsidiary represents a division only if the distributing corporation owns a substantial percentage of the vote and value of the stock of the subsidiary.[25] For this reason, the Committee majority supports an 80 percent vote and value requirement for the control immediately before requirement of Section 355(a)(1)(A) and the distribution of control requirement of Section 368(a)(1)(D). Similarly, the majority supports an 80 percent vote and value requirement for the indirect active conduct of a trade or business rule of Section 355(b)(2)(A) and the acquisition of control rule of Section 355(b)(2)(D).[26]

A significant Committee minority does not support an 80 percent vote and value requirement for incorporations and acquisitive and divisive reorganizations. In the minority's view, the concerns addressed by Section 1504 and Section 368(c) are not the same. The rationale for the reorganization rules is that no tax should attach to what is merely a continuation of the previous equity participation in a business enterprise. Arguably, less unity should be required to avoid a recognition event in an incorporation or reorganization transaction than should be required to treat two taxpayers as one under Section 1504. Accordingly, if a value requirement is to be added to Section 368(c), ownership of only 50 percent of value should be required.[27]

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25 Cf. Section 332, which allows a tax-free liquidation of a subsidiary into a parent corporation only if the parent corporation owns at least 80 percent of the vote and value of the stock of the subsidiary.

26 Under Section 355(b)(2)(A), the distributing corporation or the distributed subsidiary can satisfy the requirement that it must be engaged in the active conduct of a trade or business if substantially all of its assets consist of stock or securities of a corporation (or corporations) controlled by it (immediately after the distribution) which is (or are) so engaged. Section 355(b)(2)(D) generally provides that the active conduct of a trade or business requirement is not satisfied if control of the corporation conducting the business was acquired within the 5-year period preceding the distribution.

27 Cf. Rev. Proc. 77-37, 1977-2 C.B. 568 (for continuity of interest purposes, the IRS requires 50 percent continuity in value). In the minority's view, it may be appropriate to retain the 80 percent of vote requirement. A 50 percent of value requirement would ensure that abusive transactions are prevented.

The minority suggests that the 1997 legislation attacking *Morris Trust* transactions[28] indicates that 50 percent of vote and value is the appropriate threshold for control for purposes of Section 355. Section 355(e), as enacted in the Taxpayer Relief Act of 1997, provides that a distributing corporation must recognize gain with respect to the stock of a controlled corporation if a spinoff of the controlled corporation is part of a plan (or series of related transactions) pursuant to which one or more persons acquire directly or indirectly stock representing a 50 percent or greater interest in the distributing corporation or any controlled corporation.

One of the purposes for enacting Section 355(e) was to create parity among transactions. However, Congress failed to achieve complete parity, because disparity continues to exist between pre-spinoff transactions and post-spinoff transactions. Under the current statutory structure, a post-spinoff public offering of more than 20 percent of the stock of the controlled corporation will not violate the Section 355(a)(1)(A) control requirement, but a pre-spinoff offering by the controlled corporation of the same amount will prevent a tax-free distribution. To provide similar tax treatment for similar transactions, a significant minority of the Committee supports modification of the definition of control for purposes of Section 355(a)(1)(A) (and other provisions in Section 355) to require ownership of more than 50 percent of vote and value.

However, such a revision to a 50% control test under Section 355 would not achieve complete parity. For example, a spinoff of a 100% subsidiary followed by a public offering of 51 percent of the controlled corporation's stock, although subject to Section 355(e), could still qualify under Section 355(a), but a spinoff preceded by a public offering of 51 percent of the controlled corporation's stock would violate the Section 355(a)(1)(A) control requirement (as revised) and consequently would not qualify under Section 355(e). Furthermore, the majority does not believe that this 50% requirement of Section 355(e) should override the basic principle that Section 355 permits tax-free treatment for a divisive reorganization only if it separates what are essentially divisions of a single enterprise.

In addition, the legislative history for Section 355(e) suggests that the "control" test of Section 368(c) was intended to apply independently of Section 355(e) and that a purpose of the legislation was to ensure that post-spinoff transactions have no effect on whether the distributing corporation controls the controlled corporation immediately before the spinoff as required by Section 355(a)(1)(A).

The House bill does not change the present-law requirement under Section 355 that the distributing corporation must distribute 80 percent of the voting power and 80 percent of each other class of stock of the controlled corporation. It is expected that this

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[28] A *Morris Trust* transaction is a spinoff followed by an acquisitive reorganization involving the distributing or distributed corporation. See *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966). Congress enacted Section 355(e) because it believed that *Morris Trust* transactions resembled corporate level dispositions if new shareholders acquired ownership of a business in connection with a spinoff. H.R. Rep. No. 148, 105th Cong., 1st Sess. 213 (1997); S. Rep. No. 33, 105th Cong., 1st Sess. 139-40 (1997).

requirement will be applied by the Internal Revenue Service taking account of the provisions of the proposal regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80-percent control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80-percent controlled subsidiary, but would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.[29]

Thus, Section 355(e) is arguably imposing a 50% "continuity of interest" requirement on the shareholders of either the distributing or controlled corporation, as opposed to the 80% "control" requirement which addresses the premise that a tax-free divisive reorganization involves the separation of what are essentially divisions of a single enterprise. Thus, the majority believes that there is no justification for importing the 355(e) 50% ownership requirement into the general control tests of Section 368(c).

VI. Preferred Stock.

The Control Proposal would conform the control test of Section 368(c) to the affiliation test in Section 1504. "Pure" preferred stock, as described in Section 1504(a)(4), would not be taken into account in applying the revised Section 368(c) test. Section 1504(a)(4) provides that for purposes of Section 1504(a), the term "stock" does not include any stock that (i) is not entitled to vote, (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (iii) has redemption and liquidation rights that do not exceed the issue price of the stock, and (iv) is not convertible into another class of stock. If Congress adopts an 80 percent vote and value test for Section 368(c), then conformity with Section 1504(a), which treats "pure" preferred stock like debt, would require that Section 368(c) also disregard "pure" preferred stock.

The Committee recognizes that disregarding "pure" preferred stock could permit transactions that are arguably sale-like, even in circumstances in which a majority of the value of the equity is represented by the "pure" preferred stock. A controlled corporation could issue "pure" preferred stock and distribute the proceeds to the parent corporation, and then the parent corporation could distribute the stock of the controlled corporation tax-free under Section 355. Although the ability to engage in this transaction might appear to be undesirable, it follows from the Code treating "pure" preferred stock like debt. As indicated previously, amending the Section 368(c) control test would not prevent a controlled corporation from issuing debt and distributing the proceeds to the parent corporation prior to a spinoff. Similarly, disregarding "pure" preferred stock would permit an acquiring company in a reorganization defined in Section 368(a)(1)(B) to purchase such stock for cash, notwithstanding the "solely for voting stock" requirement. The legislative history should contemplate regulations under Section 1504(a)(4)

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[29] H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 529-30 (1997).

concerning whether the amount of the value of the "pure" preferred stock is so substantial that, in substance, under a debt/equity analysis, the preferred stock is, in fact, the common equity of the issuing company.

VII. Transition rules.

The Control Proposal, if enacted, would be effective for transactions on or after the date of enactment. The current control test of Section 368(c) has been in the Code since the Revenue Act of 1921. Taxpayers have been relying on it for many years in structuring incorporations and reorganizations. Any change of the test would be a fundamental change to Subchapter C. Accordingly, the Committee supports a prospective effective date for any changed rule, and urges the adoption of appropriate transition rules.

Broad grandfather protection would be consistent with recent precedents related to changes in longstanding Code provisions[30] and would ensure that taxpayers who justifiably relied on the current definition of control in Section 368(c) will not be penalized unfairly by a change in the law.

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30 For example, broad transition rules were provided in connection with the enactment of Sections 355(e) and 351(g) by the Taxpayer Relief Act of 1997.