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Report No. 1491
March 4, 2024

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The Honorable William M. Paul
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The Honorable Daniel I. Werfel
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Internal Revenue Service
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Re: Report No. 1491 - Report on Procedural Guidance for Private letter Rulings on Divisive reorganizations: Issues Related to Section 361 Exchanges

Dear Ms. Aron-Dine and Messrs. Werfel and Paul:

I am pleased to submit Report No. 1491 of the Tax Section of the New York State Bar Association, which discusses the procedural guidance for private letter rulings on divisive reorganizations.

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,

Jiyeon Lee-Lim
Chair

Enclosure

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Report No. 1491

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

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

ISSUES RELATED TO SECTION 361 EXCHANGES

March 4, 2024

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Appendix: 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* (Report No. 1436, Mar. 13, 2020)

I. INTRODUCTION

This report (the "**Report**")[1] of the New York State Bar Association Tax Section makes recommendations for procedural guidance for private letter rulings ("**PLR**s") addressing certain significant 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[2] (a "**Spin-off**").[3][4] We recently have learned that the Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**Service**") are reconsidering certain PLR positions that are critical to effecting Spin-offs, including for Spin-offs that have been in the planning stages for many months without notice of a reconsideration. Assuming our understanding of the potential changes is correct, we have significant concerns about their negative impact on Spin-offs.

Public companies undertake Spin-offs to separate operating businesses and accomplish critical business objectives. As part of a successful separation, each of Distributing and Controlled must adopt its own optimal capital structure. The optimal capital structure typically requires that Distributing reduce its outstanding debt in light of the separation of value and earnings in the Spin-off. Section 361 provides that Distributing may use Controlled stock or securities (or other property received from Controlled) to repay Distributing's creditors on a tax-free basis, allowing for the establishment of the desired capital structure.

In light of the complexity involved with planning and executing a Spin-off and the potential for significant tax to Distributing and its shareholders, Spin-offs often are executed only after the

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[1] The drafters of this Report were Michael J. Cardella, Chelsea E. Garber, Lulu Ma, Joshua Micelotta, David M. Rievman, Jodi J. Schwartz, Karen Gilbreath Sowell, and Thomas F. Wood. Substantial contributions were made by William D. Alexander, Andrew Carlon, Robert Cassanos, Erin Cleary, Marc A. Countryman, Tijana J. Dvornic, Pamela Lawrence Endreny, Lucy W. Farr, Meyer H. Fedida, Lawrence M. Garrett, Edward E. Gonzalez, Josh M. Holmes, Minjae John Jo, David E. Kahen, Michael Kliegman, Adam Kool, Jiyeon Lee-Lim, Vadim Mahmoudov, Michael T. Mollerus, Kara L. Mungovan, Richard M. Nugent, Sonali Parikh, Andrew S. Park, Deborah L. Paul, Arvind Ravichandran, Yaron Z. Reich, Stuart L. Rosow, Alexander Saffi, Michael L. Schler, David H. Schnabel, Patrick E. Sigmon, Ansgar A. Simon, Eric B. Sloan, Lena Smith, Linda Z. Swartz, Jonathan R. Talansky, Joseph Toce, Andrew R. Walker, Davis J. Wang, Gordon E. Warnke, Tatsuro T. Yamamura, and Sara B. Zablotney. This Report reflects solely the views of the New York State Bar Association Tax Section and not those of the New York State Bar Association's Executive Committee or its House of Delegates.

[2] 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.**").

[3] In a typical Spin-off, a corporation ("**Distributing**") distributes to its shareholders and/or security holders 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 "**Divisive Reorganization**"). A section 355 distribution may take the form of a pro rata distribution to shareholders, a distribution in redemption of shares, or a distribution in liquidation of Distributing. This Report generally refers to all forms of section 355 distributions as "Spin-offs" for ease of reading.

[4] This Report follows New York State Bar Ass'n Tax Section, Report No. 1436, *Report on Procedural Guidance for Private Letter Rulings on Divisive Reorganizations: Revenue Procedure 2018-53 and Plan of Reorganization Issues* (Mar. 13, 2020) addressing certain issues related to the repayment or assumption of Distributing debt, as well as distributions of cash or other property to shareholders and delayed distributions of Controlled stock to Distributing's shareholders (the "**Prior Report**"). While this Report does not address the same issues as the Prior Report, we continue to believe that the recommendations in the Prior Report are appropriate and, therefore, attach it for ease of reference.

taxpayer receives a PLR. Even if a PLR is not sought, the PLR guidelines developed by Treasury and the Service, while not law, often have the effect of defining the parameters of what taxpayers and practitioners understand to be acceptable for a Spin-off. Accordingly, changes to well understood standards should be made with notice and discussion, as Spin-offs are typically planned and executed over a lengthy time frame (often multiple years), and any such changes can disrupt the success of Spin-offs. As a matter of sound administration, and to permit taxpayers to plan effectively for business-driven Spin-offs (e.g., to avoid confusion and uncertainty), whatever standards are chosen by Treasury and the Service, we recommend that an announcement be made so that all taxpayers are aware of any proposed new standards, ideally with an opportunity for comment and dialogue in light of the role that PLR guidelines play in the area of Spin-offs.

As a substantive matter, we believe that the PLR guidelines should be designed and applied in a manner that permits taxpayers to achieve optimal capital structures for Distributing and Controlled so long as (i) the transaction format undertaken is consistent with the Code's prescribed formats for tax-free treatment, and (ii) the overall effect achieved is consistent with identified policies underlying the Code's limitations. Assuming this is the case, the PLR guidelines should take into account commercial and market challenges and realities and avoid creating artificial distinctions between economically similar transaction formats because such distinctions merely increase the costs of implementing bona fide business transactions without any policy upside.

Part II of this Report contains a summary of our principal recommendations. Part III provides the relevant background for assessing PLR guidelines in this area, including an overview of the statutory language of section 361(b) and (c), the legislative history to section 361(c), the standards under Revenue Procedure 2018-53[5] and a summary of the guiding principles underlying those standards (as discussed in the Prior Report), and market considerations for executing a Debt-for-Equity Exchange (defined below). Part IV compares the Direct Issuance Model with the Intermediated Exchange Model (each defined below) for executing Debt-for-Equity Exchanges and Debt-for-Debt Exchanges (defined below) and makes recommendations for the continued utilization of the Direct Issuance Model. Part V comments on the timing for executing Debt-for-Equity Exchanges and certain mechanical tweaks to allow smaller placements of Controlled stock. Part VI addresses issues with respect to retained equity of Controlled, including the need for Backstop Retention Rulings (defined below) that offer needed certainty that the Spin-off that is the subject of a PLR is tax-free. Finally, Part VI addresses certain questions regarding the treatment of a pension plan as a "creditor" for purposes of section 361(b)(3).

II. SUMMARY OF RECOMMENDATIONS

1. We recommend that Treasury and the Service make an announcement with a description of changes to ruling guidelines it is considering, with a request for comments that would be considered before these important PLR standards are modified.

2. We recommend that the Service continue to rule favorably with respect to the Direct Issuance Model. If our recommendation to retain the Direct Issuance Model is not adopted and Treasury and the Service return to the Intermediated Exchange Model, we

[5] 2018-43 I.R.B. 667.

recommend that published guidance articulate precise timing and other requirements for implementing the exchange.

3. We recommend that the period of time afforded to complete Debt-for-Equity Exchanges be extended to 18 months.

4. We recommend that the utilization of "dribble out" mechanics in Debt-for-Equity Exchanges be allowed, regardless of whether the Treasury and the Service adopt the Direct Issuance Model or the Intermediated Exchange Model.

5. We recommend that the prior practice of granting Backstop Retention Rulings be continued to provide taxpayers certainty that their Spin-off qualifies.

6. We recommend that the Service continue to apply its historic ruling standards for purposes of evaluating "retentions" within the meaning of section 355(a)(1)(D)(ii).

7. We recommend that a pension plan be respected as a "creditor" of Distributing to the extent of the Underfunded Amount (defined below) for purposes of section 361(b)(3), and that payments in satisfaction of the Underfunded Amount to the pension plan be treated as distributions in pursuance of the plan of reorganization under section 361(b)(3). For this purpose, we suggest that the Service calculate the Underfunded Amount utilizing the ABO Method (defined below).

III. RELEVANT BACKGROUND FOR ASSESSING RULING GUIDELINES

There are numerous requirements under section 355 to limit qualifying transactions to those that effect a true separation of two operating businesses.[6] Below we review the relevant provisions at issue in this Report.

A. Section 361(b)

Under section 361(b), if Distributing receives "boot" (i.e., money or property other than Controlled stock or securities) from Controlled as part of a Divisive Reorganization, Distributing generally does not recognize gain as long as the boot is distributed "in pursuance of the plan of reorganization."[7] 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

[6] The New York State Bar Association Tax Section has submitted several reports on topics related to section 355. *See generally* Prior Report; N.Y. ST. BA. ASS'N, TAX SEC., Rep. No. 1356 *Report on Proposed Regulations under Section 355 Concerning the Device Prohibition and Active Trade or Business Requirement* (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., Rep. No. 1342, *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* (Apr. 12, 2016) (similar); N.Y. ST. BA. ASS'N, TAX SEC., Rep. No. 1292, *Report on the Role of the Step Transaction Doctrine in Section 355 Stock Distributions: Control Requirement and North-South Transactions* (Nov. 5, 2013) (examining, *inter alia*, the requirement that Distributing possess section 368(c) control of Controlled prior to the Spin-off).

[7] Section 361(b)(1)(A).

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.[8]

B. Section 361(c)

Under section 361(c), a corporation which is a party to a reorganization does not recognize gain or loss upon the distribution to its shareholders of "qualified property" in pursuance of the plan of reorganization.[9] "Qualified property" is defined as (i) any stock in (or right to acquire stock in) the distributing corporation or obligation of the distributing corporation, or (ii) any stock in (or right to acquire stock in) another corporation which is a party to the reorganization or an obligation of another corporation which is such a party if such stock (or right) or obligation is received by the distributing corporation in the exchange.[10]

Section 361(c)(3) further provides that, for purposes of section 361(c), "any transfer of qualified property by the corporation to its creditors in connection with the reorganization shall be treated as a distribution to its shareholders pursuant to the plan of reorganization." Taken together with section 361(a), in the context of a Divisive Reorganization, section 361(c)(3) permits Distributing to receive Controlled stock or securities tax-free (pursuant to section 361(a)) and to dispose of such stock or securities tax-free to its creditors in connection with the reorganization in a "**Debt-for-Equity Exchange**"[11] or "**Debt-for-Debt Exchange**," respectively. Unlike the receipt and distribution of "other property or money" to creditors pursuant to section 361(b)(3), the receipt and transfer of stock or securities of Controlled to creditors may be undertaken tax-free regardless of the basis of assets transferred to Controlled in the Divisive Reorganization.

C. Background to the Enactment of Section 361(c)(3) in 1988

The question of whether property received from the transferee or acquiring corporation in an acquisitive reorganization could be transferred in a tax-free manner to creditors of the transferor corporation pursuant to the plan of reorganization was considered (and rejected) in *Minnesota Tea*.[12] In *Minnesota Tea*, a corporation engaged in a retail grocery business ("**Minnesota Tea**") transferred its assets to another corporation ("**Grand Union**") in exchange for shares of Grand Union stock and cash. The cash received by Minnesota Tea was promptly transferred to the shareholders of Minnesota Tea, who used the cash to repay debts of Minnesota Tea that they had assumed in connection with the transaction.[13] Although not directly at issue in the case, *Minnesota*

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[8] For background on the net basis limitation under section 361(b)(3), *see* Prior Report at 9, n.35.

[9] Section 361(c)(1).

[10] Section 361(c)(2)(B).

[11] In a Debt-for-Equity Exchange, it is typically the case that the Controlled stock transferred to creditors is held by Distributing after the Spin-off (such stock, the "**Remainder Shares**").

[12] *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938).

[13] *Id*. at 610.

Tea came to stand for the proposition that a transferor corporation recognized gain with respect to property (be it stock or securities of the acquiring corporation, cash, or other boot) received in the reorganization if such property were used to satisfy liabilities of the transferor corporation.

For more than half a century, *Minnesota Tea* prevented the tax-free repayment of creditors of the transferor corporation in a reorganization (whether acquisitive or divisive) with stock, securities, or property received from the transferee corporation. In 1986, however, Congress for the first time attempted to overrule *Minnesota Tea*. Pursuant to the Tax Reform Act of 1986 (the "**1986 TRA**"), section 361(a) was amended to provide broadly that "[n]o gain or loss shall be recognized to a transferor corporation which is a party to a reorganization on any exchange of property pursuant to the plan of reorganization."[14] This general nonrecognition rule was not limited to the receipt of stock or securities of the transferee corporation and did not require the transfer of property to creditors, shareholders, or any other specific party as a condition to tax-free treatment (only that the exchange of property occur pursuant to the plan of reorganization). Additionally, section 361(b) was revised to provide that the basis of property (other than stock or securities of another corporation which was a party the organization) received by the transferor corporation in a reorganization would be the fair market value of such property, and to provide that no gain or loss would be recognized by the transferor corporation in the reorganization on *any disposition*, pursuant to the plan of reorganization, of stock or securities of another party to the reorganization that were received by the transferor corporation in the reorganization. In other words, the transferor corporation (e.g., the distributing corporation in a Divisive Reorganization) would not recognize gain or loss on the receipt of any property in the reorganization, would not recognize gain or loss on the disposition of stock or securities of the transferee corporation (e.g., the controlled corporation), and would take a fair market value basis in any other property received, and so would not recognize gain or loss on a disposition of such property either. Although not as directly presented as current section 361(c), the 1986 TRA's changes to section 361 effectively repealed the *Minnesota Tea* doctrine.

The amendments made by the 1986 TRA presented numerous technical challenges and unintended consequences.[15] As a result, two years later, Congress made additional amendments to section 361 as part of the Technical Corrections Act of 1988 (the "**1988 TCA**"), including the enactment of section 361(c)(3) in its current form. These amendments retained the repeal of *Minnesota Tea*, allowing Controlled stock and securities to be transferred to creditors on a tax-free basis.

The relevant legislative history for section 361(c)(3)'s enactment in 1988 is minimal. The relevant committee reports largely restate the rule ultimately reflected in the statute, providing that "the transfer of qualified property by a corporation to its creditors in satisfaction of indebtedness is treated as a distribution pursuant to the plan of reorganization" and noting, in a footnote, that "[t]hese amendments are not intended to affect the treatment of any income from the discharge of

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14 Section 361(a) (1986), prior to amendment by P.L. 100-647.

15 *See* H.R. Rep. No. 100-795, at 371 (1988) ("The 1986 Act made a series of amendments to the reorganization provisions attempting to conform those provisions with changes made by the 1984 Act. However, numerous technical problems with the 1986 amendments have arisen. The bill responds to these technical problems with a complete revision of the 1986 amendments.").

indebtedness arising in connection with a corporate reorganization."[16] The committee reports also explicitly state that the revisions were intended to overrule *Minnesota Tea*.[17]

Furthermore, the legislative reversal of *Minnesota Tea*, first in 1986 and then as reaffirmed in 1988, had broad applicability to all types of reorganizations (both acquisitive and divisive) involving corporate-level asset transfers. The fact that these rules were intended, in large part if not predominantly, to address acquisitive reorganizations has served to obscure their underlying policy motives in the context of Debt-for-Debt Exchanges and Debt-for-Equity Exchanges in Divisive Reorganizations. As discussed above and below, notwithstanding the limited legislative history, in the context of Divisive Reorganizations, section 361(c)(3), like and together with section 361(b)(3), has come to be understood to permit Distributing to achieve an appropriate allocation of historic debt between Distributing and Controlled without gain recognition.[18]

D. Revenue Procedure 2018-53

Revenue Procedure 2018-53 sets forth the Service's current procedures for taxpayers requesting PLRs that no gain or loss will be recognized to Distributing upon Distributing's receipt in a Divisive Reorganization of Controlled stock, Controlled securities or other debt obligations, and money or other property (such consideration received, "**Section 361 Consideration**"), and the transfer of Section 361 Consideration to a creditor in satisfaction of Distributing's debt obligations under section 361(b)(3) and (c)(3) (a "**Creditor Transaction**").

Revenue Procedure 2018-53 requires the taxpayer to submit various information that describes the Distributing debt to be assumed or satisfied, the Section 361 Consideration that will be transferred to creditors in satisfaction of Distributing debt, and the transactions that will implement the assumption of Distributing debt by Controlled debt or Distributing's receipt (and distribution to creditors) of Section 361 Consideration in satisfaction of Distributing debt.[19] The taxpayer is also required to submit information and analysis establishing that "(1) any assumption of Distributing Debt by Controlled will be consideration received by Distributing in the Divisive Reorganization, and (2) any distribution of [Section] 361 Consideration by Distributing to its creditors in satisfaction of Distributing [d]ebt will be in connection with the plan of reorganization."[20]

The standard representations in Revenue Procedure 2018-53 include, among others, representations that (i) Distributing is in substance the obligor of the Distributing debt that will be

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16 *See* S. Rep. No. 100-445, at 393 n.104 (1988); H.R. Rep. No. 100-795, at 372 n.99 (1988). *See also* Staff of J. Comm. on Taxation, 100th Cong., Description of the Technical Corrections Act of 1988 (H.R. 4333 and S. 2238) 385 (JCS-10-88) (Comm. Print 1988).

17 S. Rep. No. 100-445, at 393 (1988); H.R. Rep. No. 100-795, at 372 (1988).

18 *See also* Prior Report, at 18-20.

19 Rev. Proc. 2018-53, section 3.03.

20 *Id.*

assumed or satisfied;[21] (ii) the holder of such Distributing debt will not hold the debt for the benefit of Distributing, Controlled, or any related person;[22] and (iii) such Distributing debt is "historic" debt that was incurred prior to certain landmark dates set forth in the revenue procedure.[23] If Distributing incurred the Distributing debt later than those specified dates, Revenue Procedure 2018-53 requires the taxpayer to "establish that, based on all the facts and circumstances, the borrowing and the assumption or satisfaction of [Distributing debt] will result in an allocation of historic Distributing [d]ebt between Distributing and Controlled or an exchange of historic Distributing [d]ebt for Controlled stock."[24]

Accordingly, Revenue Procedure 2018-53 further reflects an apparent policy focus of section 361(b)(3) and (c)(3) of permitting an allocation of historic Distributing debt in Divisive Reorganizations. Notably, while Revenue Procedure 2018-53 does seem to make clear the importance of allocating Distributing debt (and of more generally establishing the various components necessary for the Service to provide an advance ruling on a section 361(c)(3) exchange), it does not set forth a particular mechanic that taxpayers must use in effectuating Debt-for-Debt or Debt-for-Equity Exchanges (and in fact initially created some potential confusion in this regard, as discussed below). The two most prevalent types of structures for effectuating these exchanges—"traditional" intermediated exchanges and so-called "direct issuance" transactions—are discussed below in Part IV.

E. Key Principles from Prior Report

While this Report addresses issues that were not discussed in the Prior Report, we believe that the principles and context for PLR guidelines articulated in the Prior Report are a helpful and appropriate framework for analyzing the issues addressed herein. Below, we summarize the key principles relevant to Creditor Transactions from the Prior Report, as they relate to section 361. These principles form the basis for our recommendations in this Report.

As discussed in the Prior Report, section 361 generally permits Distributing and Controlled to adopt the optimal capital structures for each company according to their own business judgment, while also imposing certain requirements (such as the plan of reorganization limitation) and form-based limitations that must be complied with to achieve a tax-free result in Creditor Transactions. We continue to believe that 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 (i) the transaction format undertaken is consistent with the Code's prescribed formats for tax-free treatment, and (ii) the overall effect achieved is consistent with identified policies underlying the Code's limitations. As discussed in the Prior Report, there are three guiding

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21 *Id.* section 3.04(1).

22 *Id.* section 3.04(3).

23 *Id.* section 3.04(4). For a more detailed discussion of these representations, *see* Prior Report.

24 Rev. Proc. 2018-53, section 3.04(4).

principles which appear to animate the standards provided in Revenue Procedure 2018-53 and provide a reasonable approach to administering the PLR program.[25]

First, any time-based rules for administering the plan of reorganization limitation should be rooted in a level of connectivity between the Spin-off and the Creditor Transaction that ensures that (i) Distributing cannot inappropriately convert boot into a discretionary fund, such that a distribution to creditors is effectively funded out of operating cash flows generated in the ordinary course of business, and (ii) with respect to distributions of Remainder Shares or retained securities to creditors, Distributing cannot, in effect, speculate on the value of Controlled stock or securities over time.

Second, with respect to Creditor Transactions, as discussed above, 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**").

Third, where the Debt Allocation Principle is satisfied, the mechanics used to effectuate the Creditor Transaction should have diminished importance and the form of the transaction generally should be respected, provided that the form is consistent with the requisite transactional pattern permitted by section 361. In these cases, rather than applying step transaction or similar "anti-abuse" principles to impose artificial constraints on commercial transactions that otherwise meet the policy objectives of section 361, the Service's advance ruling practice should refrain from drawing distinctions between economically similar transactions absent countervailing policy considerations or a clear, contrary mandate in the Code (the "**Economic Parity Principle**").[26]

F. Considerations for Executing a Debt-for-Equity Exchange

Debt-for-Equity Exchanges are extremely complicated to execute, requiring sophisticated corporate finance judgment and decision-making from planning stages through ultimate execution. As discussed below, we understand that there are significant non-tax considerations underpinning both the amount of debt to be retired and the timing of the exchange. We believe that an acknowledgement of these business and market realities is important to sound tax administration. The summary below as it relates to non-tax legal or regulatory restrictions or market practice is based on our experience and extensive diligence with experts in relevant areas.

1. Corporate Finance Considerations in Planning a Debt-for-Equity Exchange

In the planning stages of a public Spin-off, a company's treasury and corporate finance functions, in conjunction with its financial advisors, will determine the appropriate amount of leverage for each of Distributing and Controlled. As part of that determination, it may be decided

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[25] *See* Prior Report, at 8-11.

[26] For a more detailed discussed of the Debt Allocation Principle and the Economic Parity Principle, *see* Prior Report, at 18-20.

that a certain amount of Distributing debt needs to be retired with Controlled equity in order to optimize the parties' respective capital structures (e.g., to avoid overleveraging Controlled while also retiring an appropriate amount of Distributing debt). The retained stake is then sized to achieve the targeted amount of deleverage pursuant to one or more Debt-for-Equity Exchanges. Once Distributing commits to undertaking a Debt-for-Equity Exchange, it must disclose its intention to execute the transaction in Securities and Exchange Commission ("**SEC**") filings prior to completion of the Spin-off. In addition, a public commitment to execute the Debt-for-Equity Exchange within a specified period of time is required to obtain the credit ratings benefit for the expected de-levering.

Thus, the Debt-for-Equity Exchange is embedded into the Distributing's plan of reorganization at the outset of the Spin-off. While unexpected conditions may end up delaying the anticipated timing of the Debt-for-Equity Exchange, these developments rarely alter the initial decision to undertake a Debt-for-Equity Exchange. Furthermore, the goal of the Debt-for-Equity Exchange is simply to retire the pre-determined amount of debt. While Distributing has an incentive to dispose of the Remainder Shares at a price that will enable it to meet its deleveraging target, this is fully consistent with the purpose of the Debt-for-Equity Exchange.

In addition, as a practical matter, most public companies would not want to hold onto a minority stake in Controlled for any period of time. This is due to complexities associated with financial statement reporting and accounting considerations, including under the Financial Accounting Standards Board (FASB) 2018 revised minority equity investment accounting standards. Because (i) the Remainder Shares constitute less than 20% of the outstanding stock of Controlled, and (ii) Distributing is subject to the voting restrictions set forth in Appendix B of Revenue Procedure 96-30,[27] Distributing does not qualify for the equity method of accounting with respect to the Remainder Shares. Thus, for financial accounting purposes, Distributing is required to recognize book income (or loss) to reflect changes in the fair market value of the Remainder Shares for each quarter that it continues to hold the Remainder Shares. This mark-to-market on the Remainder Shares results in undesirable profit and loss volatility for which Distributing obtains no benefit or credit for purposes of calculating its earnings per share. Specifically, because the market is aware of the temporary nature of Distributing's ownership of the Remainder Shares, it discounts any reported appreciation in the value of the shares. Furthermore, Distributing's continued ownership of the Remainder Shares is also undesirable from Controlled's perspective, because the market will undervalue Controlled in anticipation of the planned disposition of a large block of Controlled shares. Thus, Distributing would not retain *any* shares in Controlled unless there is a compelling need to right-size the capital structure of Distributing and Controlled, as described above.

Therefore, absent (i) market considerations that practically limit the windows in which an offering of the Remainder Shares can be executed (described in greater detail in Part III.F.2 below), and (ii) concerns with disposing of the Remainder Shares in a manner that is inefficient and value

[27] 1996-1 C.B. 696, *modified*, Rev. Proc. 2013-32, 2013-28 I.R.B. 55, *and superseded*, Rev. Proc. 2017-52, 2017- 41 I.R.B. 283. Specifically, Distributing is required to vote the Remainder Shares in proportion to the votes cast by Controlled's other shareholders. The other requirements under Appendix B of Revenue Procedure 96-30 are discussed in Part VI.A.2, *infra*.

destructive (described in greater detail in Part III.F.3 below), Distributing would seek to dispose of the retained stake immediately after the Spin-off.

2. Market Restrictions on Controlled Stock Offerings

Following a Debt-for-Equity Exchange, the relevant investment bank involved in the transaction (the "**Bank**") will as soon as possible sell the Controlled shares it receives to investors in either a "marketed offering" (pursuant to which the shares are sold in an SEC-registered offering, with the Bank acting as the underwriter) or a "block trade" (in which the Bank sells the shares for its own account). A marketed offering is often preferred for various reasons, including timing constraints associated with a block trade and the fact that the securityholder choosing to sell its shares through a block trade generally accepts a discount to the current market price. However, there are various market considerations that make it impracticable to execute a securities offering (and therefore, a Debt-for-Equity Exchange) on certain "closed" dates over the course of a year.

As an initial matter, Distributing is subject to *de facto* "lock-up" periods during which market practice dictates a waiting period before further disposing of Controlled shares. Specifically, the Bank will typically advise Distributing to wait a period of approximately 90 days after a Spin-off before a subsequent disposition of Controlled shares. In addition, in the event all of the Remainder Shares cannot be disposed of in an initial Debt-for-Equity Exchange, Distributing and Controlled will often agree to a contractual lock-up for a similar period of time following the initial Debt-for-Equity Exchange. These waiting periods are to allow for Controlled to report one quarter of earnings and the market to absorb the prior disposition of Controlled stock.[28]

Another significant limitation stems from the strict SEC restrictions that are imposed on public companies with respect to material non-public information ("**MNPI**"). MNPI is information that (i) a reasonable investor would find important in making an investment decision, and (ii) is not available to the general public.[29] Specifically, companies and their insiders who are in possession of MNPI are prohibited from trading on the basis of such MNPI until it is disclosed to the public (e.g., Distributing and the Bank could not execute a Debt-for-Equity Exchange while in possession of MNPI regarding Controlled). Accordingly, for each fiscal quarter, there is a blackout period during the last two weeks of a quarter and through the second trading day after the quarterly earnings release, during which securities offerings cannot occur absent certain exceptions. Earnings are typically released two weeks after quarter end; thus, this blackout period generally spans a period of approximately 30 days a quarter, or 120 days a year. This restriction applies to MNPI regarding both Distributing and Controlled. As such, if Distributing and Controlled have

[28] As discussed in greater detail in Parts III.F.3 and V.B, *infra*, there is typically a period of market volatility following a disposition of a large block of Controlled stock. Distributing is advised to wait for this volatility to settle before further approaching the market.

[29] While this is a customary definition of MNPI, "materiality" is not typically defined in SEC regulations. This conventional definition is formed through multiple sources (e.g., statutes, guidance, court opinions and regulations, including Rule 405 under the Securities Act of 1933, as amended, and Rule 12b-2 of the Securities and Exchange Act of 1934, as amended).

different quarter ends, as is often the case, the amount of closed windows during the 12-month period after the Spin-off can be doubled.[30]

In addition to the foregoing, in each calendar year, the following are days on which an equity offering is imprudent (and thus customarily avoided) due to the market volatility that can be caused by such announcements: (i) the 16 days on which the Federal Reserve meets (eight meetings a year for two days each);[31] (ii) the eight days on which the Federal Reserve releases minutes for such meetings (three weeks after the date of the relevant meeting/policy decision); (ii) the 12 days on which the Bureau of Labor Statistics releases its monthly employment report;[32] and (iii) the 12 days on which the Bureau of Labor Statistics releases its monthly consumer performance index report.[33] Finally, there are holidays on which the stock exchanges are closed.[34]

The "closed windows" described above are depicted in the below sample calendar, which assumes for ease of illustration that Distributing is a calendar year taxpayer with March 31, June 30, September 30, and December 31 quarter ends. The calendar does not take into account lock-up periods or other potential closed windows arising from instances in which (i) Controlled has a different quarter end from Distributing, or (ii) Distributing or Controlled is in possession of other MNPI (e.g., regarding a potential acquisition). Taking such additional windows into account, it is often the case that there are as many (or more) "closed" dates than there are "open" dates in a calendar year.[35]

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[30] A blackout period can be shortened if Controlled or Distributing, as applicable, "cleanses" its MNPI by disclosing such information outside the course of its ordinary earnings cycle. However, this requires the company to prepare and disclose preliminary "flash" financial statements, an undertaking that is costly, time intensive, and impractical in light its already existing disclosure requirements.

[31] *See* Federal Open Market Committee, Meeting calendars, statements, and minutes (2019-2024), https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm (last visited Feb. 27, 2024).

[32] *See* U.S. Bureau of Labor Statistics, Schedule of Releases for the Employment Situation, https://www.bls.gov/schedule/news_release/empsit.htm (last visited Feb. 27, 2024).

[33] *See* U.S. Bureau of Labor Statistics, Schedule of Releases for the Consumer Price Index, https://www.bls.gov/schedule/news_release/cpi.htm (last visited Feb. 27, 2024).

[34] *See* New York Stock Exchange, Holidays and Trading Hours, https://www.nyse.com/markets/hours-calendars (last visited Feb. 27, 2024).

[35] In addition, companies that have completed an IPO within a one-year period are required to file a Form S-1 to execute an equity offering. In contrast with a Form S-3 filing, this process requires approval or receipt of a "no review" letter from the SEC in order to proceed with a Debt-for-Equity Exchange of such company's stock. This SEC review process may take several weeks, further eating into any open windows.

Sample Calendar of Closed Windows

January 2024						
S	M	T	W	T	F	S
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	31			

February 2024						
S	M	T	W	T	F	S
				1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29		

March 2024						
S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

April 2024						
S	M	T	W	T	F	S
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30				

May 2024						
S	M	T	W	T	F	S
			1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30	31	

June 2024						
S	M	T	W	T	F	S
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30						

July 2024						
S	M	T	W	T	F	S
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	31			

August 2024						
S	M	T	W	T	F	S
				1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	31

September 2024						
S	M	T	W	T	F	S
1	2	3	4	5	6	7
8	9	10	11	12	13	14
15	16	17	18	19	20	21
22	23	24	25	26	27	28
29	30					

October 2024						
S	M	T	W	T	F	S
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30	31		

November 2024						
S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30

December 2024						
S	M	T	W	T	F	S
1	2	3	4	5	6	7
8	9	10	11	12	13	14
15	16	17	18	19	20	21
22	23	24	25	26	27	28
29	30	31				

	Earnings Release (estimated)
	Blackout Period
	Open Window
	Federal Reserve Meetings
	Release of Federal Reserve Minutes
	Bureau of Labor Statistics Employment Reports
	Consumer Price Index (CPI) Releases
	NYSE and SEC Holidays

3. Market Performance of Controlled Stock

Sometimes, unanticipated company-specific developments, industry-specific developments, macroeconomic forces (e.g., volatile markets, interest rate changes, etc.), or a combination of these factors will result in Controlled equity underperforming as compared to expectations at the time the Spin-off was planned and when it was executed. Under these circumstances, it is inadvisable to execute a Debt-for-Equity Exchange until market conditions improve or Controlled performance aligns more closely with projections, and the already limited windows described above are further constricted.

As described more in Part V.B below, market volatility and underperformance of Controlled's stock price may be further exacerbated if the shares are sold in the market as a large block. It is common for this positive supply shock to result in a temporary reduction in Controlled's share price. In stable markets, the price rebounds fairly quickly; however, when markets are volatile, the stock price may recover more slowly. Such longer-term disruption to Controlled share prices means that a 12-month period to complete the Debt-for-Equity Exchange may present unreasonable challenges in the face of practical economic and business considerations.

IV. SECTION 361 EXCHANGES – "DIRECT ISSUANCE" MECHANICS

As discussed further below, practical and economic considerations of well-functioning capital markets make it unwieldy and usually impracticable for Distributing itself to exchange Controlled equity or securities directly with preexisting holders of Distributing debt, particularly in the case of a longer-term and illiquid indebtedness. An ordinary course holder of Distributing debt, in practice, is almost always unfamiliar with the strictures of section 361(c) and, more importantly, unwilling or uninterested in swapping the Distributing debt for a very different investment in the debt or equity of Controlled. In general, the Controlled debt received by Distributing for use in a Debt-for-Debt Exchange will be long-term debt so as to constitute a security which may be received by Distributing tax-free under section 361(a), but the Distributing debt satisfied with Controlled securities need not be (and, in any event, the two companies will often have different credit profiles).[36] With respect to Debt-for-Equity Exchanges, historic Distributing debtholders are typically lending institutions or fixed-income investors that may not even be able to swap their Distributing debt for Controlled stock. For these reasons, taxpayers wishing to avail themselves of section 361(c) in the context of Divisive Reorganizations typically need to seek out financial intermediaries to facilitate a desired Debt-for-Equity or Debt-for-Debt Exchange. In recognition of this practical and economic reality, the Service has studied and developed standard approaches to give effect to section 361(c) in the Divisive Reorganization setting.

As discussed above, establishing the appropriate capital structure for Distributing and Controlled is a critical component of a successful Spin-off, and reducing Distributing's leverage

[36] Conceivably, Controlled debt could be short-term debt that does not qualify as a "security" if Distributing had sufficient basis in the assets transferred to Controlled to qualify for tax-free treatment under section 361(b). However, Debt-for-Debt Exchanges and Debt-for-Equity Exchanges are typically only undertaken when Distributing has insufficient basis to qualify under section 361(b). Where Distributing does have sufficient basis, almost universally, Distributing will prefer to receive cash (rather than Controlled debt) to the extent of that basis, which receipt is tax-free if the cash is paid to creditors of Distributing.

to account for the loss of earnings and value in the Spin-off generally is essential. Distributing, of course, is in the best position to manage its own liability portfolio and should be able to do so without artificial limits and costs associated with outsourcing this activity to a third party. This reality was the underpinning for the more recent model of executing a Debt-for-Debt Exchange or Debt-for-Equity Exchange, the "**Direct Issuance Model**." We understand that the Direct Issuance Model was developed and adopted after a thorough study by Treasury and the Service of the Code provisions, the practical implications, and the capital markets implications of the Intermediated Exchange Model, defined below.

A. Direct Issuance Model

Under the Direct Issuance Model, Distributing issues debt ("**Refinancing Debt**") directly to one or more Banks. The credit agreement evidencing the Refinancing Debt (the "**Credit Agreement**") appears in a form typical of other third-party borrowings; the agreement provides for an interest rate, has a defined maturity date, and contains customary terms.

At least one day after the Refinancing Debt issuance, Distributing and the Bank enter into an exchange agreement, whereby Distributing agrees to transfer a specified number of Remainder Shares (or Controlled securities) to the Bank (or an affiliate thereof, on behalf of the Bank) in payment of the Refinancing Debt (the "**Exchange Agreement**"). Any accrued and unpaid interest on the Refinancing Debt also is payable by Distributing upon closing. Following execution of the Exchange Agreement, Distributing delivers the Remainder Shares (or Controlled securities) to the Bank in payment of the Refinancing Debt. Distributing then uses the proceeds of the Refinancing Debt to repay its historical Distributing debt, the same outcome as with the Intermediated Exchange Model.[37]

The Service's ruling practice on the Direct Issuance Model has vacillated over the years. Prior to Revenue Procedure 2013-3,[38] the Service issued several favorable PLRs blessing the Direct Issuance Model.[39] Several of these PLRs also make clear that the Debt-for-Debt or Debt-for-Equity Exchanges using the Direct Issuance Model therein were effectuated consistent with the timing and ordering of the 5/14 Standard, defined below.[40] In other words, the issuance of Refinancing Debt to the financial intermediary would occur at least five days prior to the exchange

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[37] In the Direct Issuance Model, Distributing may use an amount of cash equal to the proceeds of the Refinancing Debt to retire Distributing debt either concurrently with or within a short period following the Debt-for-Debt Exchange or Debt-for-Equity Exchange, or the debt repayment may take longer, depending upon the maturities of the relevant historic debt. During the time prior to use, Distributing will deposit and use the cash in its general accounts or may place it in a segregated account or an escrow account that secures the Refinancing Debt. *See* Prior Report, Part V.G.

[38] 2013-1 I.R.B. 113, *superseded,* Rev. Proc. 2014-3, 2014-1 I.R.B. 111.

[39] *E.g.*, PLR 201339001 (Apr. 4, 2013); PLR 201330002 (Aug. 14, 2012); PLR 201308002 (Oct. 25, 2012); PLR 201228033 (Apr. 11, 2012); PLR 201232014 (Feb. 16, 2012); PLR 201132009 (May 9, 2011); PLR 201129005 (Apr. 13, 2011).

[40] *E.g.*, PLR 201308002; PLR 201232014; PLR 201129005.

agreement's signing and at least 14 days prior to the exchange of the Refinancing Debt for the Remainder Shares (or Controlled securities).

In Revenue Procedure 2013-3, the Service indicated that it would no longer rule regarding whether sections 355 and 361 would apply to Distributing's distribution of Controlled stock or securities "in exchange for, and in retirement of, any putative debt of the distributing corporation if such distributing corporation debt is issued in anticipation of the distribution" (the "**Direct Issuance No-Rule**").[41] Following the adoption of the Direct Issuance No-Rule, which appeared in each annual Revenue Procedure setting forth "no-rule" areas until 2017,[42] through the issuance of Revenue Procedure 2018-53, the Service did not issue any PLRs addressing Direct Issuance Model transactions.

Revenue Procedure 2018-53 altered the landscape of the Service's advance ruling policies as it relates to the Direct Issuance Model.[43] On the one hand, Revenue Procedure 2018-53 requires the taxpayer to represent that that any financial intermediary which receives Section 361 Consideration in satisfaction of Distributing debt must not have acquired the Distributing debt from Distributing, Controlled, or any other related person (the "**Direct Acquisition Representation**"). On the other hand, Revenue Procedure 2018-53 contains some implicit support for the appropriateness of the Direct Issuance Model where the effect is a reallocation of historic Distributing debt between Distributing and Controlled. As noted above, Revenue Procedure 2018-53 limits Distributing's ability to use Section 361 Consideration to satisfy Distributing debt incurred too close in time to the distribution. Nevertheless, a taxpayer may receive a favorable ruling with respect to recently incurred Distributing debt if it establishes that, based on all the facts and circumstances, the satisfaction of such 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.[44] One way in which this requirement may be satisfied is by using the proceeds of the recently incurred Distributing debt to repay historic Distributing debt that was not recently incurred.[45] The ability to demonstrate that the debt effectively satisfied or assumed is historic debt, even if the debt legally satisfied with Section 361 Consideration is itself newly or relatively newly

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41 Rev. Proc. 2013-3.

42 *See* Rev. Proc. 2017-3, 2017-1 I.R.B. 130, *superseded*, Rev. Proc. 2018-3, 2018-1 I.R.B. 130; Rev. Proc. 2016-3, 2016-1 I.R.B. 126, *superseded*, Rev. Proc. 2017-3, 2017-1 I.R.B. 130; Rev. Proc. 2015-3, 2015-1 I.R.B. 129, *superseded*, Rev. Proc. 2016-3, 2016-1 I.R.B. 126; Rev. Proc. 2014-3, 2014-1 I.R.B. 111, *superseded,* Rev. Proc. 2015-3.

43 The Direct Issuance No-Rule above was also removed in the 2018 edition of the "no-rule" list. Rev. Proc. 2018-3, 2018-1 I.R.B. 130, *superseded*, Rev. Proc. 2019-3, 2019-1 I.R.B. 130.

44 Rev. Proc. 2018-53, section 3.04(4).

45 *Id.* The revenue procedure includes an explicit reference to Revenue Ruling 79-258, 1979-2 C.B. 143, in which Controlled's assumption of newly issued Distributed debt in a Divisive Reorganization was not subject to section 357(b) because the proceeds of the newly issued Distributing debt had been used to repay historic debt of Distributing.

issued, reflects a logic that would seemingly permit the Direct Issuance Model as well, at least where historic debt is ultimately repaid by Distributing with the proceeds from its new issuance.[46]

This sensible and logical extension of Revenue Procedure 2018-53's view of historic debt was reflected in the Service's advance ruling practice following the issuance of the revenue procedure. In recent years, the Service has consistently provided favorable rulings with respect to Divisive Reorganizations involving historic debt reallocations effectuated through the Direct Issuance Model.[47]

Because of the meaningful efficiencies of the Direct Issuance Model as compared to traditional intermediated exchanges, as discussed below, and with the benefit of PLRs, the Direct Issuance Model has become the predominant market standard for Debt-for-Debt Exchanges and Debt-for-Equity Exchanges.

B. Intermediated Exchange Model and Historic 5/14 Standard

Before the Service issued Revenue Procedure 2018-53, taxpayers typically effectuated these exchanges in accordance a model in which the Bank would act as an intermediary for Distributing to buy historic Distributing debt, with Distributing then using the Controlled equity or securities to repay the historic debt owned by the Bank (the "**Intermediated Exchange Model**"). Specifically, after the intermediary Bank purchased Distributing debt, after at least five days of holding the purchased Distributing debt, the Bank and Distributing would enter into an agreement to exchange the purchased Distributing debt for Remainder Shares or Controlled securities, with the applicable exchange ratio priced in accordance with the fair market value of the Distributing debt on the day the exchange agreement was signed. The actual exchange of Distributing debt for Remainder Shares or Controlled securities would occur at least 14 days following the intermediary Bank's purchase of Distributing debt (the "**5/14 Standard**").

The theory underlying the 5/14 Standard seemed to be that these periods of ownership were sufficient to demonstrate (at least for the Service's ruling purposes) that the intermediary Bank was a true creditor that held Distributing debt for tax purposes, bearing five days of price and event risk and nine days of overall execution and credit risk. If an event occurred calling into question Distributing's continued vitality as a going concern, the financial intermediary would bear the cost of that downturn. To the extent this event occurred within five days of the intermediary's purchase of Distributing debt, the intermediary would be free to cut its losses and sell the Distributing debt to another party.

There is no direct Code section or Treasury Regulation out of which the 5/14 Standard developed; section 361(c)(3) states only that qualified property must be transferred to a "creditor" of Distributing. Rather, the 5/14 Standard was developed by practitioners in the 1980s in the

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46 *See* Prior Report (Case Study 9: Direct Issuance by Distributing to Financial Intermediary).

47 *E.g.*, PLR 202345008 (Nov. 21, 2022); PLR 202330002 (May 1, 2023); PLR 202322006 (Mar. 6, 2023); PLR 202224002 (Dec. 28, 2021); PLR 202139006 (July 6, 2021). Notably these newer PLRs involving the Direct Issuance Model also seem to reflect, at least in certain instances, sequencing tighter than the 5/14 Standard as well. *E.g.*, PLR 202330002 (exchange agreement entered into at least one day after issuance of Distributing debt); PLR 202224002 (exchange agreement entered into one day after Direct Issuance).

context of swaps of equity to retire debt that were intended to avoid cancellation of indebtedness income under then-prevailing law. Several of these transactions were the subject of technical advice memoranda ("**TAMs**") issued in 1987.[48] To avoid taxable income under the law at the time, the debtor was required to exchange its stock for its debt; a retirement of the debt for cash would not receive the same favorable treatment. Taxpayers structured these transactions as an acquisition of debt from an intermediary in exchange for the taxpayer's own newly issued stock. Accordingly, the Service faced the issue of whether the taxpayer in each TAM was respected as using its stock to purchase taxpayer debt from the intermediary that held the taxpayer debt on its own behalf. Alternatively, the Service considered characterizations that could cause this treatment to not be respected. Namely, if the intermediary were treated as an agent of the taxpayer in purchasing taxpayer's bonds on behalf of the taxpayer, or if the purchase of taxpayer debt by the intermediary and the subsequent exchange were effectively integrated through the step transaction doctrine, then the taxpayer would not be respected as exchanging its stock for its debt.

To arrive at its ultimate conclusion that the former characterization was more appropriate, the Service discussed the ordering of steps used to consummate the exchange. In particular, each TAM involved a situation in which (i) the intermediary (an underwriter) first acquired the taxpayer's bonds, (ii) thereafter, the taxpayer and the intermediary entered into an exchange agreement and determined the relevant pricing for the exchange, and (iii) after the exchange, the intermediary sold the stock received in the exchange. The TAMs specified the dates on which the relevant steps would occur (although such steps are redacted in the published guidance).[49] Ultimately, in its analysis in each TAM, the Service relied on the "salient economic realities" that were accomplished through the exchange mechanics. Notably, based on the facts, the Service stated that the intermediary acquired the taxpayer's bonds "for its own account prior to execution of the exchange agreement" and that the intermediary "ran the risk, however minimal, that [t]axpayer would not execute the stock-for-debt agreement and acquired whatever benefit that ownership of the bonds provided." Moreover, the Service explained that the intermediary bore the upside and downside of gain and loss associated with the subsequent stock sale. In sum, the Service rejected the "principal-agent" theory and concluded that the intermediary held taxpayer's debt on its own behalf and purchased and sold taxpayer stock on its own behalf (in other words, as "an independent party acting for its own account").

Based on the mechanics for the exchanges addressed (and, presumably, the ordering and time periods between steps) in the TAMs, the 5/14 Standard was developed as an analogous and similar mechanic that established to the Service's satisfaction that the intermediary Bank was economically exposed to the Distributing debt such that it would be treated as a creditor for purposes of section 361(c)(3). Prior to the issuance of Revenue Procedure 2018-53, the Service issued many rulings addressing transactions implementing exchanges in accordance with the Intermediated Exchange Model and the 5/14 Standard and, accordingly, this mechanism became common market practice and came to be understood and accepted by the Service, taxpayers, and

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48 TAM 8738003 (May 22, 1987); TAM 8735007 (May 18, 1987); TAM 8735006 (May 18, 1987).

49 TAM 8738003 specified that the intermediary acquired Distributing debt between three days and four-and-a-half months before the exchange agreement was signed. Moreover, it was widely known within the practitioner community that all of these transactions adhered to the 5/14 Standard.

tax advisors.[50] The establishment of a *de facto* safe harbor (at least for ruling purposes) obviated the need for case-by-case analyses of whether an intermediary assumed sufficient risk. The representations required under Revenue Procedure 2018-53 do not contain any specific periods of time required for an intermediary's holding of Distributing debt. Thus, Revenue Procedure 2018-53 instead effectively replaced the *de facto* ruling standard that was the 5/14 Standard with the looser guidelines discussed above. We understand that the Service has blessed intermediated exchange structures with even tighter sequencing in recent years.[51]

C. Comparison of the Direct Issuance Model and Intermediated Exchange Model

Under the Direct Issuance Model, Distributing does its own liability management, using the cash from the Refinancing Debt to repay its historic debt in the most efficient manner. In contrast, in an Intermediated Exchange Model, Distributing's liability management will be dictated by which Distributing debt the Bank is willing and able to buy. The Direct Issuance Model is particularly useful in the fairly common situation where Distributing's historic debt funding consists of longer-term debt that cannot be retired efficiently, or at all, in a traditional intermediated exchange. For example, Distributing often can retire its term loan at par with no penalty, while an intermediary will have to negotiate to buy Distributing's debt at a premium.

Distributing will also bear the friction costs associated with an Intermediated Exchange Model transaction, resulting in a loss of value to Distributing and its shareholders, with the value going to the debtholders and the Bank. The compensation paid to the Bank intermediary, whether in fee-based cash payments or a favorable exchange ratio, is generally much greater under the Intermediated Exchange Model, where the Bank intermediary's role in the transaction is greatly expanded relative to the Direct Issuance Model. The Bank intermediary has little leverage when buying Distributing debt, and the debtholders have all the negotiating power and may be able to extract a significant premium from the intermediary. Further, the bank intermediary takes on significantly more exposure (i.e., in terms of price, credit, and execution risk) in an Intermediated Exchange Model transaction than a Direct Issuance Model transaction, where the Refinancing Debt exists only for a few days. Nonetheless, as discussed below, the Bank in a Direct Issuance Model transaction takes on sufficient credit risk to be considered a creditor of Distributing.

The incremental friction costs that accompany an Intermediated Exchange Model transaction can be greater depending on the type of debt that Distributing seeks to retire. Bonds generally include substantial call protection, making it more expensive for the Bank to purchase sufficient amounts of the outstanding bonds on the market. Term Loan B loans, a type of term loan financing often extended by non-bank lenders and which have less amortization (and thus a greater bullet payment at maturity) than their Term Loan A brethren, almost always have call protection

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[50] *E.g.*, PLR 201613008 (Dec. 21, 2015); PLR 201601001 (Sept. 30, 2015); PLR 201542004 (July 15, 2015); PLR 201308002 (Oct. 25, 2012); PLR 201232014 (Feb. 16, 2012); PLR 201216023 (Jan. 19, 2012); PLR 200802009 (Oct. 5, 2007).

[51] *E.g.*, PLR 202139006 (July 6, 2021) (only stating that the exchange agreement "will not be entered into any earlier than the day after the day on which the Banks acquire the Distributing Exchange Debt" to be exchanged for Controlled securities and/or stock; this ruling also contains a possible Direct Issuance mechanic); PLR 202223004 (Dec. 17, 2021) (Distributing debt satisfied in debt exchanges "will have been purchased on the open market by various investment banks . . . at least one day before the date of the of the [debt exchanges].").

and a prepayment premium. In such cases, we understand the prepayment premium, together with the Bank fees, frequently fall between 1% and 3% of the principal amount of the debt acquired. For non-investment grade issuers, which may have issued debt that trades in illiquid markets, such costs may be greater. Compared to a Direct Issuance Model transaction, an Intermediated Exchange Model transaction can often thus place an already disadvantaged Distributing at an even greater disadvantage.

Timing restrictions accompanying Intermediated Exchange Model transactions can also considerably increase associated costs. For example, assume that Distributing is targeting retiring its most expensive debt, which is due in six months. In an Intermediated Exchange Model transaction, Distributing's timing with respect to disposition of the Remainder Shares (or retained Controlled securities) will be influenced by the Service's PLR guidelines, black-out dates, and market and other forces. That timing, in the majority of cases, is unaffected by and may fail to correspond with timing considerations with respect to the scheduled debt retirement. In this example, if circumstances dictate that Distributing dispose of the Remainder Shares (or Controlled securities) prior to the due date of the targeted debt, the Bank must generally acquire the debt at some premium. If the transaction were instead in the Direct Issuance Model, the Distributing could issue the Refinancing Debt to the Bank now (i.e., six months prior to the historic Distributing debt's maturity date), the parties could then effectuate the Debt-for-Equity Exchange, and Distributing could use the cash to repay the debt at maturity in six months' time. While it is theoretically possible that the disposition of the Remainder Shares (or Controlled securities) could coincide with the maturity date of the targeted debt, it is rather unlikely.

D. The Direct Issuance Model Satisfies the Statutory Language and Policy of Section 361

Section 361(c) accords tax-free treatment to distributions of qualified property to shareholders or creditors so long as such distributions are in pursuance of the plan of reorganization. Thus, a Debt-for-Debt Exchange or Debt-for-Equity Exchange satisfies the plain language of the statute only if the Bank is a "creditor" of Distributing. The Service has indicated it may be rethinking its practice of providing favorable rulings on the Direct Issuance Model because of concerns that the step transaction doctrine applies to disregard the Refinancing Debt as transitory, such that the transaction should be viewed as a sale of the Remainder Shares (or Controlled securities) by Distributing for cash (i.e., the Refinancing Debt proceeds). We understand the Service may be drawing a distinction between the Direct Issuance Model, where the Bank is the creditor that is repaid with the Remainder Shares (or Controlled securities) and the Refinancing Debt is used to refinance historic Distributing debt, and the Intermediated Exchange Model, where the Remainder Shares (or Controlled securities) are exchanged for outstanding historic Distributing debt.

For the following reasons, we do not believe the step transaction doctrine should be employed to disregard the Refinancing Debt. As an initial matter, Revenue Ruling 2017-9[52] articulates the boundaries of application of the step transaction doctrine. As stated in the ruling,

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[52] 2017-21 I.R.B. 1244.

the default is that the tax treatment follows the taxpayer's chosen form and the step transaction doctrine applies only if:

> (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.

In the Direct Issuance Model, in form, Distributing repays the Refinancing Debt with the Remainder Shares (or Controlled securities), and the proceeds of the Refinancing Debt are used to repay historic Distributing debt. As discussed above in Part III.E and in the Prior Report, section 361 is intended to facilitate the establishment of the appropriate capital structure for each of Distributing and Controlled and not function as a pathway to increase aggregate debt.[53] The appropriate capital structure may involve adding leverage to Controlled and Distributing's use of the cash, in the case of section 361(b)(3), or the value of Controlled stock or securities, in the case of section 361(c)(3), to repay its historic debt in accordance with the Debt Allocation Principle. In a Debt-for-Equity Exchange, debt is not reallocated from Distributing to Controlled, but aggregate liabilities decrease when Distributing uses the value of the Controlled stock to retire its debt.[54] In either case, aggregate debt across Distributing and Controlled does not increase as a result of a Debt-for-Debt Exchange or Debt-for-Equity Exchange.[55] This principle is furthered regardless of whether the Direct Issuance Model or the Intermediated Exchange Model is used. Under the standards described in Revenue Ruling 2017-9, there is no discernible reason why the form of the Direct Issuance Model should not be respected as a Debt-for-Debt Exchange or Debt-for-Equity

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53 *See* Prior Report, at 10.

54 It may be debated whether debt reduction is tantamount, or at least corollary, to a general policy of debt allocation, and the legislative history provides limited guidance as to the drafters' motivations.

55 So long as Distributing does not replace the Distributing debt that is satisfied with the proceeds of the Refinancing Debt with a "previously committed borrowing," Distributing may undertake transactions to increase debt above pre-Spin-off levels. In setting that standard, the Service did not require that Distributing abstain wholly from borrowing additional amounts. As stated in the Prior Report, we believed that the "previously committed" standard "[struck] a reasonable balance" without foreclosing possible development of a standard to address non-committed replacement borrowings. Prior Report, at 34. Nevertheless, viewing a Debt-for-Equity Exchange in isolation and setting aside other actions by Distributing to re-lever (which the Service does not prohibit), aggregate liabilities are reduced.

If the Service were interested in bolstering the "previously committed" standard through additional representations or otherwise, they might consider narrowing the universe of permissible anticipated debt replacements related to and soon after the Spin-off, while still allowing for business-based exceptions (e.g., in addition to precluding certain "previously committed" borrowings, the narrower standard also might preclude a planned borrowing that does not address post-distribution business-based capital needs, where Distributing is not exposed to significant post-distribution market risk prior to the borrowing). However, as discussed in the Prior Report, the authors continue to believe that potentially abusive transactions involving post-Spin-off re-leveraging are relatively rare.

Exchange and, instead, characterized as a sale of the Remainder Shares (or Controlled securities) to the Bank.[56]

Second, treating the transaction as a prepaid forward contract for the Remainder Shares (or Controlled securities)—where, in effect, Distributing is treated as receiving the Refinancing Debt proceeds in advance of (but still in exchange for) Controlled stock or securities—does not best characterize a Debt-for-Equity Exchange using the Direct Issuance Model. In the Prior Report, we stated our belief that, with respect to exchanges of Distributing debt in the context of a Divisive Reorganization, the form of the transaction generally should be respected where such form is consistent with the policies underlying, and the transactional patterns permitted by, section 361.[57] Distributing's sale of Controlled stock or securities to the Bank is not one such pattern.

The Direct Issuance Model is a streamlined, but economically equivalent, update of the Intermediated Exchange Model. The transaction does not resemble a sale of Controlled stock or securities because Distributing is required to purge the borrowing proceeds by using such proceeds to pay its existing creditors.[58] Consistent with the Economic Parity Principle, we continue to believe that mechanical improvements, purely intended to eliminate artificial timing constraints and reduce transaction costs, do not justify treating the Direct Issuance Model differently than the Intermediated Exchange Model. While it is not the Service's mandate to reduce a taxpayer's transaction costs, ruling policy should not be revised in a manner that will inflate such costs where the end result is unchanged and the underlying policy is not violated.

Further, a sale characterization must contend with authorities supporting treatment of the Refinancing Debt as a refinancing of Distributing's historical debt. In Revenue Ruling 79-258,[59] in the first step of a transaction intended to qualify under sections 368(a)(1)(D) and 355, a corporation (P) desired to transfer one of two businesses in which it was engaged to a newly formed subsidiary (S), in exchange for stock and the assumption of liabilities related to the transferred business. One such liability was a portion of a long-term debt owed to an insurance company. The insurance company creditor refused to absolve P of its primary liability with respect to that portion of the debt owed to it. P executed a new loan, which S subsequently assumed, and P used the borrowing proceeds to repay the same portion of the insurance company debt. The Service ruled that section 357(b) did not apply to the assumption and that the new debt and its transfer to S was in substitution, and analogous to the assumption, of the insurance company debt that related to the

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56 We also note that, in a variety of other subchapter C contexts, Treasury and the Service have often respected the form of transaction steps that might otherwise be recharacterized under a traditional step transaction analysis where such a recharacterization would not advance relevant policy objectives. As just two prominent examples, *see* Treas. Reg. §§ 1.368-2(k) (turning off recharacterization principles in the case of certain post-reorganization transfers), 1.368-2(m)(3)(ii) (so-called "F in a bubble" rule).

57 *See generally* Prior Report.

58 Revenue Procedure 2018-53 also requires that Distributing represent that it 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," another safeguard intended to preclude a circuitous route to a synthetic sale. Rev. Proc. 2018-53, section 3.04(7).

59 1979-2 C.B. 143.

transferred business. At bottom, the ruling sanctions the substitution of one creditor with another creditor in connection with a Divisive Reorganization, treating the new debt as a continuation of the existing debt.[60]

Throughout the Code, there are numerous examples of newly incurred debt to refinance an existing debt being treated as a continuation of the refinanced debt.[61] For example, Treasury Regulation section 1.707-5(c) treats a refinancing debt as the original partner or partnership debt where proceeds of the refinancing debt are allocable to payments discharging such original debt.[62] The section 707 regulations do not require that the refinancing debt extend the term of the original debt or that the refinancing debt remain outstanding for a specified period of time, or that the proceeds of the refinancing debt be used immediately to repay the original debt. Consistent therewith, we do not believe that either (i) the Refinancing Debt's short lifespan or (ii) Distributing's repayment of historic Distributing debt with Refinancing Debt proceeds after retirement of the Refinancing Debt is fatal to treating the Refinancing Debt as the appropriate surrogate of the historic Distributing debt. We acknowledge that the longer the time period between the issuance of the Refinancing Debt and the repayment of historic Distributing debt, the more attenuated the characterization of the transaction as a refinancing of the historic Distributing debt. Accordingly, it may be worthwhile considering certain safeguards with respect to the use of the Refinancing Debt proceeds (e.g., identifying the specific Distributing debt to be retired or placing the proceeds into escrow pending such repayment). In practice, however, due to closed windows and other timing considerations discussed above, Debt-for-Equity Exchanges typically occur in the latter half of the 12-month period, limiting the instances in which Distributing holds onto the Refinancing Debt proceeds for a significant time.

Lastly, the parties intend that the Refinancing Debt establish a debtor-creditor relationship. Even where an overall plan exists and relevant policy objectives are at stake, the step transaction doctrine is properly invoked to collapse a transaction only where one or more individual steps are meaningless or unnecessary.[63] Although the parties understand that the Refinancing Debt should remain outstanding only for a limited time, each of Distributing and the Bank also intends that the

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[60] It has been noted that Revenue Ruling 79-258 presents a hurdle to outright precluding the Direct Issuance Model. *See* Lee A. Sheppard & Amy S. Elliott, *IRS Indecisive About Leveraged Spinoffs*, 148 Tax Notes Fed. (TA) 1464, 1466 (Sept. 28, 2015).

[61] *See, e.g.*, section 221(d)(1) (defining a "qualified education loan" to include indebtedness used to refinance debt which qualifies as a qualified education loan); section 279(h)(1) (for purposes of section 279, the refinancing of a pre-existing indebtedness is not deemed to be the issuance of a new obligation); section 304(b)(3)(B)(ii) (for purposes of section 304(b)(3)(B)(i), any refinancing of a liability which meets the requirements of that section is also treated as meeting those requirements); section 514(c)(3) (for purposes of section 514, the refinancing of pre-existing indebtedness is not treated as the creation of new indebtedness); Temp. Treas. Reg. § 1.163-8T(e) (for purposes of allocating interest expense among expenditures, to the extent proceeds of any debt are used to repay any portion of an existing debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated).

[62] Treas. Reg. § 1.707-5(c) ("To the extent that the proceeds of a partner or partnership liability (the refinancing debt) are allocable under the rules of § 1.163-8T to payments discharging all or part of any other liability of that partner or of the partnership, as the case may be, the refinancing debt is treated as the other liability for purposes of applying the rules of this section.").

[63] *See, e.g.*, *Esmark, Inc. v. Commissioner*, 90 T.C. 171, 195 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989) (mem).

Refinancing Debt is bona fide indebtedness. We understand the Bank undertakes its customary diligence and, before the loan can be issued, it must receive lending committee approval and the Credit Agreement's terms must be negotiated between the parties. The Credit Agreement is executed, and the Refinancing Debt is extended, at least one day before the parties enter into the Exchange Agreement. There is no guarantee that, after execution of the Credit Agreement and receipt of the loan proceeds, the parties will enter into the Exchange Agreement, whether on the day following the loan issuance or ever. Distributing may allow the Refinancing Debt to remain outstanding and repay it at maturity or prepay it immediately (or at any time prior to maturity) in cash.[64]

From the moment the Refinancing Debt is issued, the Bank is a creditor of Distributing and Distributing is legally obligated to repay the Bank.[65] Notably, at the time the debtor-creditor relationship is established, Distributing is not legally obligated to deliver Controlled stock or securities to the Bank in repayment of the Refinancing Debt, and the Bank is not legally obligated to accept Controlled stock or securities (i.e., Distributing and the Bank have not established a seller-buyer relationship). At the time of issuance, Distributing possesses the full economic benefits and burdens of ownership of the Remainder Shares (or Controlled securities) and unfettered freedom of action with respect to the disposition thereof. The Bank remains a creditor of Distributing when the parties enter into the Exchange Agreement and establish the seller-buyer relationship and until Distributing delivers the Remainder Shares (or Controlled securities) to the Bank in retirement of the Refinancing Debt. The establishment of the debtor-creditor relationship has real legal consequence, and ignoring the Refinancing Debt would undermine its independent significance.

Moreover, a short-term instrument should properly be treated as debt if such instrument bears the hallmarks of debt.[66] The Refinancing Debt is an unqualified obligation of Distributing to pay a prescribed amount to the Bank a set number of days after its issuance. That the Refinancing Debt is actually repaid, even if not pursuant to its terms, is significant. The short-term nature of the Refinancing Debt is not a sufficient rationale for treating the Refinancing Debt as anything other than indebtedness and the Bank other than as a creditor. Some have indicated that Revenue Ruling 2017-9 is distinguishable, that step principles should not be applied in this context solely on the basis of the absence of a binding obligation to do the Debt-for-Equity Exchange at the time that Distributing issues the Refinancing Debt to the Bank, and that broader formulations of the step transaction doctrine (*i.e.*, the mutual interdependence and/or end result tests) should be applied

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64 While the parties may intend to execute the Exchange Agreement on the day following the issuance of the Refinancing Debt, and indeed do in the overwhelming majority of cases, this does not always occur (though, as previously noted, that is the parties' expectation and often at such time, the Exchange Agreement documentation is already in agreed form, aside from pricing).

65 Where Distributing places the borrowing proceeds in escrow as security for the Refinancing Debt during the pendency of the remaining steps of the transaction (as discussed in note 37), there may be arguments contrary to treating the Bank as a creditor of Distributing. For ruling purposes, it would be reasonable for the Service to require that the proceeds of the Refinancing Debt not be held in escrow as security for the Refinancing Debt.

66 *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957) ("The classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof.").

to characterize the transaction. Under this view, because the parties intend and expect that the Refinancing Debt will be exchanged for Remainder Shares after a short period of time, the Refinancing Debt may be disregarded as transitory, with the Bank treated as purchasing Remainder Shares for cash and Distributing treated as using the cash to repay its indebtedness. Any application of the step transaction doctrine, however, should not ignore the substantive role played by the Refinancing Debt; that is, as a mechanism to enable a "transfer of qualified property by the corporation to its creditors" within the meaning of section 361(c)(3), and which engenders the same result as the Intermediated Exchange Model just with fewer implementation and economic frictions and inefficiencies. Thus, applying a broader formulation of the step transaction doctrine to eliminate or curtail the Direct Issuance Model (e.g., by requiring the Refinancing Debt to be outstanding for a longer period of time, or by mandating that only intermediated exchanges are permissible), as a practical matter, would not change the end result.

We recommend that the Service remain on its current trajectory and continue to rule favorably with respect to the Direct Issuance Model.[67] For the reasons discussed above, it is most important for Distributing to be able to execute on its liability management exercise without outsourcing this activity to a third party with no leverage to repurchase debt. If there is a concern that the Direct Issuance Model does not cause the Bank to be a creditor of Distributing, we recommend that consideration be given to requiring a 5/14 Standard to the Direct Issuance Model, consistent with the Service's approach prior to the adoption of the former Direct Issuance No-Rule.[68]

If our recommendation to retain the Direct Issuance Model is not adopted and Treasury and the Service return to the Intermediated Exchange Model, taxpayers will need to have precise guidance on the timing for entering into of the Exchange Agreement and other associated issues. In light of the complexity involved with this model, it would be helpful for the Service to confirm that Distributing and the Bank may enter into the Exchange Agreement prior to the Bank's repurchasing of Distributing debt, with no other waiting period imposed.[69] In addition, guidance should include whether the Bank can be a historic "creditor" of Distributing for purposes of section 361(c)(3), such that Distributing can enter into a Debt-for-Equity Exchange with the Bank (e.g., even where the Spin-off was not contemplated at the time of the debt issuance). Detailed guidance is also necessary as it relates to Distributing's issuance of commercial paper or other short-term borrowings ("**Commercial Paper**") (where the proceeds of such Commercial Paper is used by Distributing to perform its own liability management with respect to historic Distributing debt), which the Bank acquires for use in a Debt-for-Debt Exchange or Debt-for-Equity Exchange. Such guidance may cover (i) the minimum term, if any, with respect to such Commercial Paper, (ii) the

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[67] *See, e.g.*, PLR 202151001 (Sept. 24, 2021); PLR 202139006 (July 6, 2021); PLR 202127003 (Apr. 14, 2021).

[68] *See supra* note 40 and accompanying text.

[69] It appears there have been some rulings involving an Intermediated Exchange Model where the 5/14 Standard was not applied. *E.g.*, PLR 202139006 (July 6, 2021) (only stating that the exchange agreement "will not be entered into any earlier than the day after the day on which the Banks acquire the Distributing Exchange Debt" to be exchanged for Controlled securities and/or stock; this ruling also contains a possible Direct Issuance mechanic); PLR 202223004 (Dec. 17, 2021) (Distributing debt satisfied in debt exchanges "will have been purchased on the open market by various investment banks . . . at least one day before the date of the of the [debt exchanges].").

minimum holding period by the Bank with respect to such Commercial Paper, (iii) whether the Bank must be unrelated to the holder(s) of the Commercial Paper, (iv) whether the Bank, as purchaser of the Commercial Paper, is permitted to engage in discussions with Distributing and/or the holder(s) of the Commercial Paper (and to what extent), and (v) whether Distributing must use the proceeds of the Commercial Paper to repay historic Distributing debt before the Bank acquires the Commercial Paper (or executes the Debt-for-Debt Exchange or Debt-for-Equity Exchange).

V. Debt-for-Equity Exchanges – Timing and Alternative Mechanics

A. Timing

As discussed above, the purpose of the Debt-for-Equity Exchange is to properly allocate historic debt between Distributing and Controlled and to enable the parties to put in place an optimal capital structure for both companies. If Controlled stock is trading at a discount, relative to expectations, at the time of any potential subsequent exchange, effecting the Debt-for Equity Exchange at such time could frustrate the purpose of the Debt-for-Equity Exchange because it would not allow for sufficient proceeds and thus result in excessive debt owed by Distributing. It could also undermine the business purposes for the Spin-off itself (e.g., Distributing might not be able to achieve its capital allocation business purposes). The Debt-for-Equity Exchange would not occur but for the Spin-off, and, accordingly, forms a part of the plan of reorganization, regardless of the specific time in which it will occur.

In general, the statutory requirement for the transfer of boot or qualifying property is just that the transfer occur "in pursuance of a plan of reorganization" or "in connection with the reorganization."[70] Sections 361(b) and 361(c) of the Code impose no time limit on the transfer of boot or qualifying property. In several private letter rulings, the Service has allowed Distributing 12 months to transfer Remainder Shares to its creditors or shareholders,[71] or purge any cash or other property received in a Divisive Reorganization.[72] However, as discussed above, there are limited open windows in which a Debt-for-Equity Exchange can realistically be executed within a 12-month period. Accordingly, we believe a 12-month period, in many instances, does not provide

[70] Section 361(b)(1) provides that if Distributing receives any cash or other property in the section 361 exchange, it will recognize gain (if any) with respect to the assets contributed to Controlled, unless the cash or other property is distributed "in pursuance of the plan of reorganization." For this purpose, section 361(b)(3) provides that a transfer by Distributing to its creditors of the money or other property "in connection with the reorganization" will be treated as a distribution to its shareholders in pursuance of the plan of reorganization. In addition, section 361(c)(3) provides that a distribution by Distribution of qualified property to its creditors "in connection with the reorganization" will be treated as a distribution to Distributing's shareholders pursuant to the plan of reorganization for purposes of section 361(c)(1).

[71] *See, e.g.*, PLR 202152010 (Oct. 4, 2021); PLR 202047007 (Aug. 24, 2020); PLR 201839006 (July 2, 2018); PLR 201731004 (Feb 16, 2017).

[72] *See, e.g.*, PLR 201306006 (Nov. 5, 2012) ("Distributing 4 will use all of the Cash Proceeds to repay debt to unrelated third parties within 12 months following Internal Distribution 4."); PLR 201216023 (Jan. 19, 2012) (same); PLR 201132009 (May 9, 2011) (same); PLR 200843011 (July 9, 2008) (same); PLR 200841020 (July 8, 2008) (same); PLR 200823004 (Mar. 3, 2008) (same); PLR 200805010 (Nov. 7, 2007) (same).

a sufficient period of time to effect a Debt-for-Equity Exchange. The Service should recognize the practical frictions and extend the period of time afforded to Distributing to complete its Debt-for-Equity Exchange to 18 months. This additional time is particularly important if the Service is not amenable to the mechanical improvements that can facilitate a more expedient execution of Debt-for-Equity Exchanges (e.g., the Direct Issuance Model discussed above and/or mechanics to allow for smaller placements of Controlled stock, discussed below).

B. Mechanics to Allow for Smaller Placements of Controlled Stock

In a traditional Debt-for-Equity Exchange, Distributing retires the exchange debt held by the Bank in one or more transactions involving a large block of Controlled shares (i.e., the Remainder Shares). As discussed above, following the Debt-for-Equity Exchange, the Bank will sell the Controlled shares to investors in either a marketed offering or a block trade. Subsequently, it is common for the stock price of Controlled to experience a temporary dip as a result of a large tranche of Controlled stock being released into the market. When markets are stable and Controlled is performing in line with market expectations, this reduction in stock price dissipates relatively quickly. However, when markets are volatile or Controlled stock is trading poorly due to other factors, the Controlled stock price generally does not rebound as quickly.[73] The slow recovery of the Controlled stock price, in turn, exacerbates the pre-existing strain on Controlled stock and negative market sentiment with respect to the company. Thus, flooding the market with a large block of Controlled shares in such instances can create a cycle of longer-term disruption to Controlled.

This expected market impact can create significant impediments to an effective and efficient execution of a Debt-for-Equity Exchange. In particular, the Bank is reluctant to participate in a Debt-for-Equity Exchange unless it is able to establish a market price for the Remainder Shares with a reasonable degree of confidence. If there is uncertainty that the entire block of Remainder Shares can be placed in the market (whether due to an underperforming Controlled or uncertain market conditions on a macro level) and Distributing must dispose of the Remainder Shares within a certain period of time, the Debt-for-Equity Exchange must be priced at a significant discount to compensate the Bank for the heightened level of risk involved. This discount, in turn, further deflates the Controlled stock price, resulting in the longer-term detriments to Controlled described above. While this effect could, in theory, be mitigated by executing marketed offerings or block trades in smaller tranches, such an approach is not feasible as a practical matter.[74] Moreover, because the market would have visibility into the timing and pricing of the smaller offerings, the

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[73] In this regard, market research of recent public company marketed offerings demonstrates that companies trading poorly perform significantly worse in the aftermarket as compared to companies trading well prior to the relevant offering. For example, for the period between September 1, 2018, and September 1, 2023, companies trading down 15% or more as compared to the S&P 1500 during the 3-month period prior to the filing date for a secondary offering had negative excess returns of (13%)-(15%) over the 30-90 day period after the filing. In comparison, companies trading between 0%-15% as compared to the S&P 1500 had excess returns between (5%)-2% over the same 30-90 day period.

[74] Specifically, the cost and resources to execute such offerings, which are highly negotiated and require many weeks of contract negotiation and equity marketing (and, in the case of marketed offerings, sizeable involvement by management of Distributing and Controlled), make it highly impractical to execute in a series of smaller offerings.

market reaction would likely be the same as it would be to an announcement of a one-time offering of a larger block of Controlled stock.

As discussed above, there are limited open windows in which a Debt-for-Equity Exchange can realistically be executed within a 12-month period. Thus, to facilitate the timely disposition of Remainder Shares within a prescribed time period and mitigate the negative impact on Controlled, certain mechanical tweaks to the traditional Debt-for-Equity Exchange model have been developed to replicate the effect of smaller Debt-for-Equity Exchanges over time (so-called "**dribble out**" mechanics). Below, we describe the two models that have been developed to implement these dribble out mechanics. While the Service has previously ruled favorably on one or both of these models,[75] we understand that it is now reconsidering its position on these mechanics.

1. Models for Dribble Out Mechanics

As an initial matter, both dribble out models retain the standard features of a traditional Debt-for-Equity Exchange, with the only difference being the introduction of a variable pricing mechanism for the exchange. Below, we describe the specifics of each model (assuming, for ease of discussion, that the Debt-for-Equity Exchange takes the form of a Direct Issuance Model transaction).

a. Model One: Front-End Debt-for-Equity Exchange with True-Up Payment

In the first model, the pricing for the Remainder Shares is determined over a period of time *following* the Debt-for-Equity Exchange. This is effected through the following mechanics:

On Date 1, Distributing issues Refinancing Debt to the Bank, with the proceeds subsequently applied to repay historic Distributing debt. On Date 2, the parties enter into an Exchange Agreement, and pursuant to such agreement, Distributing delivers the Remainder Shares to the Bank in satisfaction of the Refinancing Debt. While the Date 2 exchange is executed using the then-market price for Controlled stock (the "**agreement date price**"),[76] the parties agree to "true-up" the price of the Remainder Shares using the daily volume-weighted average price ("**VWAP**") of Controlled stock over a specified period of time after Date 2 (the "**true-up period**"). Specifically, the Exchange Agreement provides that, on a future settlement date at the end of the true-up period (no more than 12 months after the Spin-off), one party will make a true-up payment to the other, based on the difference between (i) the VWAP of Controlled stock over the true-up period (plus or minus a spread of up to approximately 1%) (the "**reference price**"), and (ii) the agreement date price. During the true-up period, the Bank is not required to sell the Remainder Shares but will typically do so as a principal trading for its own account, in relatively small trades

[75] *See* PLR 202330002 (May 1, 2023); PLR 202244009 (Aug. 11, 2022); PLR 202231004 (May 12, 2022).

[76] The agreement date price is typically the closing price of a share of Controlled stock on the New York Stock Exchange ("**NYSE**") on the date on which Distributing and the Bank enter into the Exchange Agreement.

intended to avoid material market distortions.[77] On the settlement date, if the reference price exceeds the agreement date price, the Bank will make a true-up payment to Distributing in either cash or additional outstanding Distributing debt.[78] Conversely, if the agreement date price exceeds the reference price, Distributing will make a true-up payment to the Bank in cash.[79] However, the Remainder Shares are fully disposed of at the time of the Debt-for-Equity Exchange on Date 2, and there is no circumstance in which such shares would revert to Distributing during the true-up period. Importantly, the determination of the true-up amount is based on an objective measure of Controlled performance over the true-up period and is not determined by reference to the Bank's actual profit or loss from its sales of the Remainder Shares.

b. Model Two: Back-End Debt-for-Equity Exchange following a Measurement Period

In the second model, the pricing for the Remainder Shares is determined over a period of time *preceding* the Debt-for-Equity Exchange. This is effected through the following mechanics:

On Date 1, Distributing issues Refinancing Debt to the Bank, with the proceeds subsequently applied to repay historic Distributing debt. On Date 2, the parties enter into an Exchange Agreement. Pursuant to such agreement, the parties agree to participate in a Debt-for-Equity Exchange at the end of a period beginning on the date of the Exchange Agreement and not to exceed 12 months following the Spin-off (the "**measurement period**"), during which the exchange ratio for the Debt-for-Equity Exchange is established.[80] Specifically, the Bank agrees to acquire the Remainder Shares from Distributing on the settlement date in exchange for an amount of Refinancing Debt equal to the daily VWAP of Controlled stock over the measurement period, plus or minus a spread of up to approximately 1% (the "**exchange value**"). During the measurement period, Distributing pledges the Remainder Shares as collateral to secure the Refinancing Debt, and the Bank has a "right of rehypothecation" that permits the Bank to sell the Remainder Shares in the market.[81] At the end of the measurement period, Distributing will use the

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77 Because these trades represent a small portion of the trading volume of Controlled stock on a given day and the Controlled stock is released into the market over an extended period of time without advance notification to the market, this alleviates the pricing pressure that is otherwise created with a traditional Debt-for-Equity Exchange. In addition, the percentage of the spread on VWAP is not based on the actual prices of these sales but instead would be agreed upon upfront, based on market conditions at the time the Exchange Agreement is executed.

78 The characterization of the true-up payments would relate back to the original Debt-for-Equity Exchange. Thus, to the extent the true-up payment from the Bank is in the form of incremental Distributing debt meeting the requirements of Revenue Procedure 2018-53, this would constitute an additional tax-free exchange of the excess Remainder Shares for Distributing debt in the Debt-for-Equity Exchange. In contrast, Distributing would recognize gain on any cash payment from the Bank.

79 Such a payment would be a non-deductible payment with respect to the excess principal amount of the Refinancing Debt.

80 The Refinancing Debt remains outstanding during the measurement period and Distributing will make interest payments on the Refinancing Debt during such period.

81 If the Bank sells the Remainder Shares held as collateral, it would generally be required to replace such shares with other shares of Controlled stock on or before the end of the measurement period, except to the extent the parties

Remainder Shares to repay the Refinancing Debt. If the exchange value exceeds the principal amount of the Refinancing Debt, the Bank will pay the difference to Distributing in either cash or other outstanding Distributing debt.[82] Conversely, if the principal amount of the Refinancing Debt exceeds the exchange value, Distributing will retire the remainder of the Refinancing Debt with cash.[83] Like the first model, the exchange value is based on an objective measure of Controlled performance over the measurement period and is not based on the Bank's actual profit or loss from its sales of the Remainder Shares.

2. Summary and Recommendation

As discussed above, both dribble out models allow the Bank to sell the Remainder Shares in a manner that ameliorates the harmful impact to Controlled that would likely result from a traditional Debt-for-Equity Exchange. These mechanics are therefore less disruptive to the market and facilitate a more efficient execution of the Debt-for-Equity Exchange. They also have the added benefit of enabling Distributing to complete a Debt-for-Equity Exchange in the period of time required under current Service ruling policy.

Furthermore, both dribble out models satisfy the literal language and principles of section 361(c)—in each model, as with a traditional Debt-for-Equity Exchange, the Remainder Shares are used to repay Distributing debt in a manner consistent with the Debt Allocation Principle and with Distributing's plan of reorganization that includes the Debt-for-Equity Exchange. This is not altered by the presence of variable pricing mechanisms embedded in the Exchange Agreement. While Distributing is effectively exposed to pricing fluctuations in the Remainder Shares for a longer period of time, as discussed below,[84] section 355 expressly permits temporary continued ownership of the Remainder Shares, which necessarily brings with it pricing exposure (both negative and positive). Importantly, neither model facilitates the participation by Distributing in the profit actually realized by the Bank on its sale of the Remainder Shares.[85] Instead, the Bank will endeavor to maximize its own stock sale proceeds and may very well outperform (or could fall short of) the VWAP pricing metric in the Exchange Agreement. Thus, the dribble out mechanics do not create a synthetic sale of the Remainder Shares by Distributing

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agree to offset the replacement value of the shares against the Refinancing Debt. Alternatively, the Bank may borrow Controlled shares in the market to sell during the measurement period. As with the first model, any trades of Controlled stock by the Bank during the measurement period would typically represent a small portion of the trading volume of Controlled stock on a given day so as to avoid market distortions.

82 The payments would be treated as part of the Debt-for-Equity Exchange. Thus, to the extent the Bank makes a payment to Distributing in the form of Distributing debt meeting the requirements of Revenue Procedure 2018-53, this would be treated as part of the tax-free exchange of the Remainder Shares for Distributing debt in the Debt-for-Equity Exchange. Distributing would recognize gain on any cash payment from the Bank.

83 Such a payment would be a non-deductible payment with respect to the excess principal amount of the Refinancing Debt.

84 *See infra* Part VI.A.3.b.

85 As noted above, although the reference price or exchange value incorporates a spread of up to approximately 1%, this spread is not based on the actual prices of the Bank's sales but instead would be agreed upon upfront, based on market conditions at the time the Exchange Agreement is executed.

and should not create an inference that the Bank is acting as Distributing's agent. Instead, the pricing mechanisms simply reflect (i) that under the dribble out models, the Remainder Shares can be (and are) sold by the Bank in smaller blocks over the relevant measurement or true-up period (which, absent the practical considerations noted above, could be done permissibly under the traditional Debt-for-Equity Exchange model), and (ii) the parties' agreement that the appropriate measure of the value of the Remainder Shares delivered in the Debt-for-Equity Exchange must be determined over a commensurate period of time.

Based on the foregoing, we recommend that the Service continue to rule favorably on the utilization of the dribble out mechanics described above in Debt-for-Equity Exchanges, regardless of whether the Debt-for-Equity Exchanges adopt the Direct Issuance Model or the Intermediated Exchange Model.

VI. RETAINED EQUITY

A. Potential Changes to Retention Ruling Practice

Under current Service practice, a taxpayer may receive a favorable ruling regarding a Debt-for-Debt Exchange or Debt-for-Equity Exchange (a "**Subsequent Section 361 Transfer**") following the initial Spin-off distribution of Controlled stock (the "**Initial Distribution**").[86] As discussed above in Part III.D, Revenue Procedure 2018-53 currently provides that a taxpayer may receive a favorable ruling when a Subsequent Section 361 Transfer occurs within 180 days of the Initial Distribution, but we understand that many recent PLRs have permitted longer periods, where sufficient business reasons for the delay were provided.

Under current ruling guidelines, the Service will also issue rulings regarding the impact of Distributing's continued ownership of stock or securities of Controlled that are not disposed of in pursuance of a plan of reorganization (a "**Retention**"). Section 355(a)(1)(D) generally requires that Distributing either (i) distribute all of the stock and securities in Controlled held immediately before the distribution, or (ii) distribute an amount of stock in Controlled constituting "control" within the meaning of section 368(c) (the "**Distribution Requirement**"). In the case of a distribution of less than all of the stock and securities of Controlled owned by Distributing (i.e., a Retention), section 355(a)(1)(D)(ii) further requires Distributing to establish, to the satisfaction of the Secretary of the Treasury (the "**Secretary**"), that the retention of stock or securities in Controlled "was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax" (the "**Non-Avoidance Requirement**").

The degree of statutory discretion granted to the Secretary under the Non-Avoidance Requirement counsels in favor of the Service considering the Non-Avoidance Requirement at the earliest relevant time. While we believe satisfaction of the Non-Avoidance Requirement may be established post hoc (i.e., on examination or later), PLRs regarding Retentions have become

[86] Depending on the context, various provisions of section 361 use slightly different formulations in respect of plans of reorganization. *See*, variously, section 361(c)(1) providing "no gain or loss shall be recognized to a corporation a party to a reorganization on the distribution to its shareholder of property *in pursuance of the plan of reorganization*" (emphasis added), and section 361(c)(3) providing that "any transfer of qualified property by the corporation to its creditors *in connection with the reorganization* shall be treated as a distribution to its shareholders *pursuant to the plan of reorganization*." (emphasis added).

important tools for taxpayers to achieve certainty in advance of executing a Spin-off. Importantly, and as noted above, if any stock or securities are retained and Distributing is unable to satisfy the Secretary that the Non-Avoidance Requirement is satisfied, the entire Spin-off (including the Initial Distribution) is rendered fully taxable at both the corporate and shareholder levels. Given the potential quantum of the exposure, a period of uncertainty regarding the Non-Avoidance Requirement between the Spin-off and resolution on audit is simply untenable to many taxpayers.

In addition to rulings where a Retention is, *ab initio*, expected to occur, taxpayers have customarily also been granted protective rulings regarding the requirements under section 355(a)(1)(D)(ii) in the event that any Subsequent Section 361 Transfer intended to occur in pursuance of the plan of reorganization either becomes unavailable or impractical, or cannot occur within the requisite time period ("**Backstop Retention Rulings**").[87] Backstop Retention Rulings have two separate but related functions. First, such rulings provide confirmation that Subsequent Section 361 Transfers which in form satisfy the requirements of section 361, but which occur outside of the requisite time period permitted by the ruling ("**Delayed Exchanges**"), will not cause a Spin-off, in its entirety, to be taxable through a failure to satisfy the Non-Avoidance Requirement ("**Extended Timing Protection**"). Additionally, a Backstop Retention Ruling will typically describe alternative taxable sales of the Remainder Shares (or Controlled securities) that may occur in the event not all of such stock or securities are disposed of in pursuance of the plan of reorganization. Backstop Retention Rulings confirm that the continued ownership of such stock or securities, and their disposition in taxable transactions, will not prevent a Spin-off from otherwise satisfying the Non-Avoidance Requirement ("**Alternative Transaction Protection**"). The primary goal of both Extended Timing Protection and Alternative Transaction Protection is to preserve the qualification of the Initial Distribution, regardless of whether a subsequent disposition (be it a Delayed Exchange or a taxable sale) is, itself, taxable, and of any Subsequent Section 361 Transfers made within the time limits set out in the PLR.

Given the significant tax risks associated with a Retention (i.e., the taxability of all of a distribution otherwise intended to qualify under section 355), Backstop Retention Rulings provide needed certainty to taxpayers in the event intended Subsequent Section 361 Transfers are not able to be completed in the requisite time period. Importantly, neither Extended Timing Protection nor Alternative Transaction Protection provides any comfort regarding the taxability (or not) of a disposition that occurs outside the requisite time period granted for Subsequent Section 361 Transfers. Taxable sales for which Alternative Transaction Protection is relevant are, it perhaps goes without saying, taxable to Distributing. Likewise, Delayed Exchanges may or may not be taxable, depending upon whether a taxpayer can establish that such transactions nonetheless occur

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[87] As one recent example of such a ruling, *see* PLR 202344013 (Aug. 3, 2023) (transaction step indicating that "[*i*]*f* Distributing retains the Remainder Shares and does not enter into the Debt-for-Equity Exchange with all of the Remainder Shares within a months following the Distribution Date, Distributing *may* (i) distribute such shares within a months of the Distribution Date as a pro rata dividend on the shares of Distributing common stock . . . , or pursuant to an exchange offer . . . , or (ii) sell some or all of the Remainder Shares in one or more public or private sales as soon as warranted, taking into account the business purpose for the retention, market and general economic conditions and sound business judgment, but in any event, not later than e years after the Distribution," accompanied by a ruling from the Service that "Distributing's continuing ownership of any Remainder Shares potentially until its disposal within e years after the Distribution will not adversely impact the qualification of the Proposed Transaction under sections 355, 368(a)(1)(D), and 361 and will not be in pursuance of a plan having as one of its principal purposes the avoidance of U.S. federal income tax for purposes of section 355(a)(1)(D)" (emphasis added)).

pursuant to the plan of reorganization, but that taxability is simply not addressed by Backstop Retention Rulings. The only issue that Backstop Retention Rulings explicitly address is whether the Non-Avoidance Requirement is satisfied.

Based on public statements from the Service and recent practitioner experiences in the PLR process, it appears that Treasury and the Service may be contemplating two potential shifts in its ruling policy with respect to Retention issues. First, it appears that the Service may be reconsidering its historic practice of granting Backstop Retention Rulings. As discussed further below, Backstop Retention Rulings do no violence to the relevant policies and principles animating section 355. Without the availability of Backstop Retention Rulings, unforeseen events following an Initial Distribution may imperil its section 355 qualification, and force taxpayers to incur additional costs or undertake economically detrimental transactions to preserve a separation's intended tax treatment. Furthermore, we believe any decision to cease issuing Backstop Retention Rulings would raise significant and presumably unanticipated difficulties in the Service's administration of the PLR program. As discussed below, it would also have the unintended effect of shortening the period of time taxpayers may undertake a Subsequent Section 361 Transfer, a result that would be in direct tension with the Service's own ruling guidelines. Accordingly, we urge the Service to continue granting Backstop Retention Rulings and provide explicit guidelines for such rulings in forthcoming ruling guidance under section 355.

Second, in the case of Retentions where Distributing does not intend to dispose of the Remainder Shares (or Controlled securities) in pursuance of the plan of reorganization ("**True Retentions**"), we understand that the Service may be considering requiring (or may already require) a heightened non-tax business purpose for the Retention to support a favorable Retention ruling. As will be discussed further below, the Non-Avoidance Requirement statutorily requires only a showing, to the satisfaction of the Secretary, that a Retention is not principally motivated by tax avoidance. This absence of a tax avoidance purpose can perhaps be demonstrated by other, non-tax business purposes motivating the Retention, but a heightened business purpose standard as a prerequisite for a Retention, more stringent than that traditionally applied by the Service in Retention rulings, is not warranted given the statutory language of the Non-Avoidance Requirement and relevant section 355 policies. When a taxpayer undertakes a True Retention with a view to selling the Remainder Shares (or retained Controlled securities) taxably, the potential for tax avoidance, if any, is minimal. Furthermore, the existing ruling guidelines adequately safeguard against the possibility of using a Retention to circumvent a "true separation" of Controlled and Distributing.[88] Thus, to the extent the potential absence of a "true separation" may be viewed as a proxy for an improper tax avoidance motive, this concern too is already addressed by the current standards and would not be alleviated by any elevated business purpose showing. Accordingly, a more robust showing of a specific non-tax business purpose should not be necessary to establish the absence of a tax avoidance motive that almost definitionally cannot exist or is already adequately foreclosed by existing PLR guidelines.

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[88] *See infra* Part VI.A.2, regarding the Service's current ruling standards regarding Retentions. Under the current guidelines, Distributing must vote any retained shares in Controlled in the same proportion that the non-retained shares were voted, and there may not be any director or officer overlap between Distributing and Controlled. Particularly in the context of a public company, these restrictions effectively prevent any continuing control by Distributing of the affairs of Controlled.

1. Background and History of Retentions and the Non-Avoidance Requirement

a. Legislative and Regulatory History

The Non-Avoidance Requirement first entered the Code as part of the wholesale revisions culminating in the enactment of the Internal Revenue Code of 1954 (the "**1954 Code**").[89] The legislative history discussing the Non-Avoidance Requirement is sparse, and does not identify any policy rationale for the requirement or any specific abuses it was intended to prevent.[90]

Notwithstanding the minimal legislative guidance, Treasury Regulations promulgated shortly after the enactment of the 1954 Code (the "**1955 Treasury Regulations**") provide some early insight into the original motivations for the Non-Avoidance Requirement. In discussing Retentions, generally, the 1955 Treasury Regulations noted that "[o]rdinarily, the business reasons (as distinguished from the desire to make a distribution of the earnings and profits) which support a distribution of stock and securities of a controlled corporation . . . will require the distribution of all of the stock and securities" (the "**Regulatory Retention Purpose Statement**").[91] This somewhat opaque phrase, which does not purport to establish an identifiable standard for the Non-Avoidance Requirement, was of doubtful veracity even in 1955, when closely held corporations presumably made up a larger proportion of the taxpayers undertaking section 355 transactions than they do today. Today, even more so, with the proliferation of sophisticated capital markets transactions and financing structures in public company separations, the continued accuracy of the Regulatory Retention Purpose Statement is even more in doubt. A review of the myriad business purposes that have been asserted by taxpayers in support of distributions under section 355 reveals that almost all of these business purposes would continue to be fully satisfied if Distributing were to retain a small stake in Controlled in a manner consistent with Service ruling guidelines on Retentions.[92]

Addressing potential improper motivations for a Retention, the 1955 Treasury Regulations went on to state that "[i]f the distribution of all of the stock and securities of a controlled corporation would be treated to any extent as a distribution of 'other property' under section 356,

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[89] Pub. L. No. 83-591, 68A Stat. 3.

[90] The Senate Report accompanying the 1954 Code notes only that "in order for a transaction to qualify under section 355, the distributing corporation must distribute either all of the stock and securities of the controlled corporation, or an amount of stock constituting control within the meaning of section 368(c) . . . , and the Secretary must be satisfied that no avoidance of taxes was intended[,]" and concludes that the then-proposed Non-Avoidance Requirement "is a change from present law and the House bill." *See* S. Rep. No. 83-1622, at 266 (1954).

[91] Treas. Reg. § 1.355-2(d) (flush language), T.D. 6152, 20 Fed. Reg. 8875, 8914 (Dec. 3, 1955). This language is largely maintained in current Treasury Regulations. *See* Treas. Reg. § 1.355-2(e)(2).

[92] While a comprehensive review of business purposes sufficient to support qualification under section 355 is beyond the scope of this report, a few traditional corporate business purposes expressly contemplated by Appendix A of Revenue Procedure 96-30 include: incentivizing a key employee or employee group with equity in Distributing or Controlled, *see, e.g.*, PLR 200408002 (Nov. 6, 2003); permitting or optimizing an equity raise, *see, e.g.*, Rev. Rul. 82-130, 1982 C.B. 83; facilitating borrowing by Distributing or Controlled; and cost savings. It is not apparent how a temporary Retention by Distributing of a small interest in Controlled could nullify these business purposes.

this fact does *not* tend to establish that the retention of any of such stock and securities is *not* in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."[93] Put another way, per the 1955 Treasury Regulations, the taxability, to any extent, of the distribution of all of the stock or securities of Controlled under section 356 was not a guarantee that the Non-Avoidance Requirement would be satisfied in the event of a Retention.

This somewhat awkwardly phrased provision was subsequently updated to remove the double-negative and provide, as it does today, that:

> If the distribution of all of the stock and securities of a corporation would be treated to any extent as a distribution of "other property" under section 356, *this fact tends to establish* that the retention of stock or securities is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.[94]

Thus, the Treasury Regulations clearly indicate that shareholder-level taxability under section 356 if all stock and securities were distributed provides evidence that a Retention fails the Non-Avoidance Requirement.

The express reference to the treatment of stock or securities of Controlled as "other property" under section 356 is instructive. In an otherwise qualifying section 355 distribution, section 355(a)(3) would generally (both in 1954 and, to a more limited extent, today) treat stock or securities of Controlled as "other property" in connection with a distribution in which Distributing distributes (i) Controlled securities with a principal amount in excess of the principal amount of Distributing securities surrendered in exchange therefor (or without the surrender of any Distributing securities), or (ii) Controlled stock that was acquired in a taxable transaction in the five years preceding the distribution (the so-called "hot stock" provision).[95]

In explaining the interaction of section 355(a)(3) and the Distribution Requirement, an example in the 1955 Treasury Regulations expressly contemplates a Retention of Controlled stock, and posits that such Retention need necessarily be "for proper business reasons."

> Corporation A has held 85 of the 100 outstanding shares of the stock of Corporation B for more than five years on the date of distribution. Six months before such date, it purchased 10 shares of such stock. If all of the stock of the controlled corporation owned by Corporation A is distributed, section 355 is not applicable to such distribution since the 10 shares would represent "other property." See, however, section 356. If, however, *for proper business reasons* it is decided to retain some of the stock of Corporation B, then the determination of the amount of such stock which must be distributed under section 355(a)(1)(D) in order to constitute a

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93 Treas. Reg. § 1.355-2(d) (flush language), T.D. 6152, 20 Fed. Reg. 8875, 8914 (Dec. 3, 1955) (emphasis added).

94 Treas. Reg. § 1.355-2(e)(2) (emphasis added).

95 Section 355(a)(3) (1954). Section 355(a)(3) of the 1954 Code is closely analogous to section 355(a)(3) of the current Code, *but see infra*, note 97, regarding the limited application of the "hot stock" rules under Treas. Reg. § 1.355-2(g).

distribution to which section 355 is applicable must be made by reference to all of the stock of the controlled corporation including the 10 shares acquired six months before such date and the 5 shares owned by others.[96]

As the reference to "a proper business purpose" indicates, the absence of a tax avoidance purpose may be demonstrated by the existence of non-tax business purposes for the Retention. The 1955 Regulatory Retention Example does not, however, suggest that the business reasons for a retention should face increased scrutiny. The 1955 Regulatory Retention Example, and the references in the 1955 Treasury Regulations to the treatment of stock or securities as "other property" under section 356, both also suggest that the Non-Avoidance Requirement may initially have been intended as a backstop to the rules under section 355(a)(3). A tax avoidance purpose could perhaps be discerned, for example, if Distributing distributed non-recently acquired stock, and maintained ownership of stock acquired within the past five years, the distribution of which would be taxable to the distributees as "other property" under section 356.[97] Similarly, a distributing corporation with no securities of its own outstanding may have wished to simply retain Controlled securities, rather than distribute them to shareholders taxably.

While this may have been the initial motivation, nothing in the legislative or regulatory history expressly limits the Non-Avoidance Requirement to such situations. As discussed below, the Service has addressed the Non-Avoidance Requirement in other fact patterns in subsequent guidance.

b. Revenue Rulings 75-321 and 75-469

Whatever its initial impetus, administrative and other sub-regulatory guidance has further defined (if not expanded) the contours of the Non-Avoidance Requirement since its enactment in 1954. Apart from the 1955 Treasury Regulations, two revenue rulings from 1975 represent the earliest published guidance regarding the Non-Avoidance Requirement.

In Revenue Ruling 75-321,[98] a widely held and publicly traded Distributing was required by "Federal banking laws," to either divest of all of its non-banking activities, or reduce its stock ownership in an existing bank subsidiary below a 5% threshold, to avoid a requirement to qualify as a "bank holding company." The public company proposed to distribute 95% of the banking subsidiary, which would alleviate the need to qualify as a bank holding company under applicable banking regulations. Distributing, under the facts of the ruling, retained 5% of the bank subsidiary to provide "assets of sufficient value . . . to serve as collateral so as to enable [Distributing] to

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[96] Treas. Reg. § 1.355-2(f)(2) T.D. 6152, 20 Fed. Reg. 8875, 8915 (Dec. 3, 1955) (emphasis added) (the "**1955 Regulatory Retention Example**"). The 1955 Regulatory Retention Example was subsequently modified to remove the reference to a proper business purpose for the Retention, and was ultimately removed in subsequent regulatory updates.

[97] The application of section 355(a)(3) under current law, at least as it pertains to recently acquired, so-called "Hot Stock," is significantly curtailed by the exceptions contained in Treas. Reg. § 1.355-2(g), which makes section 355(a)(3) inapplicable if, at any point prior to the distribution, Controlled is a member of Distributing's separate affiliated group (as is the case in the vast majority of section 355 transactions).

[98] 1975-2 C.B. 123.

obtain needed short-term financing for its remaining business enterprise." Interestingly, the ruling provides no time limit on Distributing's retained 5% interest in the bank subsidiary, or any requirement to dispose of such interest, indicating only that the collateral was needed for "short-term" financing. The revenue ruling also notes that Distributing had owned the bank subsidiary for more than five years, which made section 355(a)(3) inapplicable.

The Service ruled that the Retention satisfied the Non-Avoidance Requirement. In so ruling, the Service specifically noted that (i) a genuine separation of the corporate entities was effected since Distributing distributed 95% of the stock of Controlled; (ii) retention of a 5% stock interest would not enable Distributing to maintain practical control since several other shareholders of Controlled, following the distribution, would each individually own nearly as much stock of Controlled as Distributing would own; and (iii) a sufficient business purpose (i.e., the need to obtain short-term financing) for the retention was shown to exist. The final requirement described by the Service appears wholly consistent with the reference, in the 1955 Regulatory Retention Example, to a proper business purpose for a Retention. However, the first two requirements appear to reflect the concern that any Retention should not interfere with a spin-off effecting a "true separation" of Distributing and Controlled.[99]

In Revenue Ruling 75-469 (together with Revenue Ruling 75-321, the "**1975 Revenue Rulings**"),[100] the Service addressed the Retention of Controlled securities by a widely held and publicly traded Distributing. To resolve a dispute with dissident shareholders, Distributing proposed to distribute all of the stock of an existing controlled subsidiary to these shareholders in redemption of their interests in Distributing. The revenue ruling indicates that the controlled subsidiary had previously been acquired from these now-dissatisfied shareholders in a purely tax-free transaction within five years. Given the tax-free nature of the acquisition, however, section 355(a)(3) would have been inapplicable to any Controlled stock distributed. Prior to the proposed Spin-off, the stock of the controlled subsidiary served as collateral for bank debt of Distributing due in 15 years. Distributing had entered into this borrowing to finance the operations of Controlled, and on-lent the funds to Controlled. To satisfy the continuing collateral obligations under the loan, Controlled issued a new interest-bearing debenture to Distributing (representing money on-lent to Controlled from Distributing).

The maturity and principal amount of Controlled's debenture matched the term and principal amount of the outstanding bank debt of Distributing. The new Controlled debenture was substituted as collateral on Distributing's bank debt and all of the stock of Controlled was distributed. As in Revenue Ruling 75-321, no time period for Distributing's disposal of the retained securities of Controlled was provided. Although not explicitly stated, the facts of the ruling,

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99 The requirement that a distribution under section 355 effect a "true separation" is not explicitly stated in section 355 or the Treasury Regulations thereunder as a requirement separate and apart from the technical requirements to distribute an amount of stock representing either all of Distributing's interest or "control" within the meaning of section 368(c). Nevertheless, the concept of a complete separation appears to animate Service pronouncements outside of the context of Retention as well. For example, in Revenue Ruling 2003-75, 2003-2 C.B. 79, in examining post-spin-off agreements between a controlled and distributing corporation, the Service stated that "[t]he limited continuing relationship between Distributing and Controlled evidenced by the various administrative agreements and the loan for working capital is not incompatible with the extent of separation contemplated by § 355."

100 1975-2 C.B. 126.

particularly the matching maturities and amounts of the retained Controlled security and Distributing's bank debt, seem to suggest that Distributing would retain the Controlled security until maturity (in 15 years) of its bank debt, and use the proceeds and interest therefrom to satisfy the bank debt.

The Service ruled that the Retention satisfied the Non-Avoidance Requirement, citing the same three factors referenced in Revenue Ruling 75-321, but without any explicit discussion or analysis of the potential applicability of section 356 to a distribution of the Controlled securities.[101]

Given the unique and fact-intensive nature of the 1975 Revenue Rulings, they provide limited guidance to taxpayers and their advisors confronting more typical potential Retentions. For this reason, the administrative ruling practices of the Service and the availability of Retention rulings (including Backstop Retention Rulings) have taken on critical importance in this area.

c. Relation of Retention Rules to Subsequent Section 361 Transfers

Prior to discussing the current Service ruling standards on Retentions and related points, a word is in order regarding the relationship between the Retention rules and transfers of Remainder Shares or Controlled securities undertaken "in pursuance of the plan of reorganization" within the meaning of section 361. Although not entirely clear, it does not appear that the continued ownership (we deliberately avoid the use of the term "retention" here) of Controlled stock or securities by Distributing following the Initial Distribution constitutes a Retention for purposes of the Non-Avoidance Requirement if such stock or securities are ultimately disposed of in one or more transfers described in section 361(c) and properly considered "in pursuance of the plan of reorganization." The plain language of section 361(c)(3), for example, provides that any transfer of Controlled stock or securities to Distributing's creditors in connection with a Divisive Reorganization shall be treated as "a distribution to [Distributing's] shareholders pursuant to the plan of reorganization," a treatment entirely consistent with the satisfaction of the Distribution Requirement (without any need to analyze the Non-Avoidance Requirement). In other words, any disposition of Controlled stock or securities that qualifies as a Subsequent Section 361 Transfer is properly viewed, almost by definition, as part of a single, integrated reorganization transaction that includes the Initial Distribution. This view may be illustrated most directly by the absence, in Revenue Procedure 2018-53, of any required representations relating to Retentions in the guidelines for Subsequent Section 361 Transfers.

In different ways, both Extended Timing Protection and Alternative Transaction Protection address transactions that fall outside the patterns permitted by section 361 (e.g., taxable sales of Controlled stock) or that otherwise are not (or may not be) part of the plan of reorganization. Alternative Transaction Protection inoculates a taxable sale that definitionally does not fall under section 361. Less obviously, Extended Timing Protection, though relating to exchanges that fall within the statutory framework of section 361, provides incremental protection to a taxpayer when

[101] The facts of Revenue Ruling 75-469 may have permitted a transfer of the debentures of Controlled to the third-party lender in exchange for the loan without application of section 356, if the loan from the third-party qualified as a "security." *See* section 355(a)(1)(A)(ii). It is unclear if the Distributing debt, which was characterized as a loan from a bank, would qualify as a "security."

such an exchange occurs beyond whatever period is permitted for such transaction to be considered part of the "plan of reorganization" under the applicable PLR.

2. Current Service Retention Ruling Standards and Practice

Under Appendix B of Revenue Procedure 96-30, the Service historically has issued favorable rulings under section 355(a)(1)(D)(ii) if (i) there is a sufficient business purpose for the Retention; (ii) there will be no overlapping directors or officers between Distributing and Controlled for the period of the Retention, or sufficient business reasons exist for such overlap; (iii) the retained stock or securities will be disposed of as soon as a disposition is warranted consistent with the business purpose for the Retention, but in all events not later than five years after the distribution; and (iv) Distributing will vote the retained stock in proportion to the votes cast by Controlled's other shareholders.[102] Revenue Procedure 96-30 also indicates that, even if Distributing and Controlled share overlapping officers or directors, the Service may issue a favorable ruling depending on "the extent and nature of the [overlapping officers and directors] in each corporation,"[103] including if there are overlapping officers or directors "solely to accommodate [Controlled]'s business needs."[104] Even after Revenue Procedure 96-30 was superseded, the Service has continued to look to Appendix B for ruling guidelines on Retentions.[105]

The requirement of a non-tax business purpose for the Retention fits within the earliest interpretations of the Non-Avoidance Requirement, as reflected in the 1955 Regulatory Retention Example. While the provenance of the other three requirements, and the "true separation" concern generally, is less clear, this concern has been consistently associated with Retentions since the 1975 Revenue Rulings.

Historically, the Service has not limited its rulings on Retentions to situations where a taxpayer indicates its fixed intention to retain shares and sell them taxably. Much more commonly, Retention rulings are directed to taxpayers who have affirmatively indicated, at the time of their request for a PLR, that they intend to dispose of all Remainder Shares owned after the Initial Distribution in one or more Subsequent Section 361 Transfers (i.e., Backstop Retention

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[102] *See* Rev. Proc. 96-30, Appendix B, section 1.01.

[103] *Id.*at Appendix A, section 2.05.

[104] *Id.* at Appendix B, section 1.01. Prior to Revenue Procedure 96-30, the Service had set forth substantively identical ruling guidelines on the Non-Avoidance Requirement. *See* Rev. Proc. 89-28, 1989-1 C.B. 893, *amplifying* Rev. Proc. 86-41, 1986-2 C.B. 716, *and superseded by* Rev. Proc. 91-62, 1991-2 C.B. 864.

[105] The Service has indicated, following the issuance of Revenue Procedure 2017-52, that "in determining whether a retention of stock or securities is in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax, within the meaning of section 355(a)(1)(D)(ii), [the Service] will continue to follow the guidelines in Appendix B of [Revenue Procedure] 96-30 . . . . Thus, [the Service] will continue to rule in accordance with prior practice as to the application of section 355 to the distribution of the stock, or stock and securities, that are not retained." *See IRS statement regarding private letter rulings on certain corporate transactions* (Oct. 13, 2017), https://www.irs.gov/newsroom/irs-statement-regarding-private-letter-rulings-on-certain-corporate-transactions.

Rulings).[106] As discussed above, although there is little formal guidance on point, Distributing's continued ownership of stock or securities of Controlled following the Initial Distribution does not appear to implicate the Non-Avoidance Requirement if such stock or securities are transferred in one or more Subsequent Section 361 Transfers. Nevertheless, taxpayers in that posture typically request Backstop Retention Rulings because, at the time of the Initial Distribution (or, more accurately, at the time a taxpayer submits its request for a PLR), it is not possible to predict with certainty that economic and regulatory conditions will permit the Subsequent Section 361 Transfer to occur on time and as intended following the Initial Distribution.

When the Service issues a favorable Retention ruling, the underlying non-tax business purpose is not always apparent on the face of the publicly disclosed ruling.[107] However, several rulings do provide a high-level view of the types of business reasons the Service has traditionally accepted. Consistent with the 1975 Revenue Rulings, the Service has permitted True Retentions of Controlled stock and securities to provide necessary collateral for Distributing's existing financing.[108] In the context of what appear to be Backstop Retention Rulings, numerous permissible business purposes have been noted. Stock retained to provide Distributing with a pool of equity necessary to satisfy compensatory employee equity awards as they vested was also found to satisfy the Non-Avoidance Requirement.[109] Achieving capital markets efficiencies and addressing diffuse liquidity concerns have also been deemed acceptable purposes.[110] Notably, the Service has frequently blessed Retentions for the purpose of providing funds for bona fide

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[106] *See*, *e.g.*, PLR 202345008 (Nov. 21, 2022); PLR 202344013 (Aug. 3, 2023); PLR 202343025 (Aug. 2, 2023); PLR 202330002 (May 1, 2023); PLR 202304005 (Nov. 1, 2022); PLR 202218002 (Nov. 19, 2021); PLR 202152010 (Oct. 4, 2021); PLR 202151001 (Sept. 24, 2021); PLR 202139006 (July 6, 2021); PLR 202047007 (Aug. 24, 2020); PLR 201818010 (May 22, 2017); PLR 201731004 (Feb 16, 2017); PLR 201703012 (Sept. 20, 2016); PLR 201651010 (Sept. 13, 2016); PLR 201634010 (Mar. 1, 2016); PLR 201612012 (Apr. 1, 2015).

[107] *See*, *e.g.*, PLR 202149006 (Sept. 9, 2021) (in a transaction where Distributing intended to "retain up to b shares of Controlled stock ('Retained Shares') and sell the Retained Shares into the public market or through privately negotiated transactions with third parties in exchange for cash as soon as reasonably practical after the Distribution" the publicly available PLR provides only a representation that "[a] sufficient business purpose exists for the retention of the Retained Shares").

[108] PLR 8908075 (Dec. 2, 1988) (retention of Controlled common stock to satisfy terms of indenture of Distributing debentures satisfied Non-Avoidance Requirement), PLR 8927020 (April 4, 1989), *supplementing* PLR 8913050 (Jan. 4, 1989) (Distributing's retention of indebtedness of a spun-off subsidiary, which indebtedness was pledged as collateral for Distributing debt, satisfied the Non-Avoidance Requirement), PLR 200712026 (Dec. 20, 2006) (Controlled voting preferred stock, which represented less than 1% of the voting power of Controlled, was retained and pledged as collateral of Distributing's senior indebtedness).

[109] PLR 200239005 (Sept. 27, 2002).

[110] PLR 200841021 (Oct. 10, 2008) (finding the Non-Avoidance Requirement was satisfied by a business purpose of the Retention "(i) to avoid adding confusion and complexity to the Distributing shareholders' decision making process concerning the Split-Off and to the transaction more generally, which could in turn result in the Exchange Offer being undersubscribed and the transactions generally being financially less efficient, (ii) to avoid, given the relatively small number of shares of [a certain class of Controlled stock], having a large number of Controlled shareholders after the Distributions (each holding a small number of [that class of Controlled stock]), which could adversely impact orderly and efficient public trading in the Controlled stock and (iii) to avoid execution risk and pricing inefficiencies in the [debt-for-debt exchange].").

corporate purposes, including debt repayment, working capital needs, and acquisitions and organic business expansion.[111]

3. Continued Importance of Backstop Retention Rulings

As noted above, it appears that the Service may have concerns with continuing to issue Backstop Retention Rulings. There appear to be at least two interrelated concerns.

First, there appears to be a concern that a potential future contingency preventing or delaying the completion of a Subsequent Section 361 Transfer is simply too hypothetical to permit granting a PLR divorced from an actual expected Retention. At the time a PLR is issued, almost all taxpayers seeking Backstop Retention Rulings fully intend and expect to undertake Subsequent Section 361 Transfers in the manner and within the time limits set forth in the ruling. The contingency or business exigency that could delay or inhibit the Subsequent Section 361 Transfer from occurring on time is always unknown at the time the PLR is issued. For this reason, it might be argued that it is inappropriate to validate the non-tax business reasons for any theoretical Retention *ex ante*, and that the taxpayer instead should be required to submit a separate supplemental ruling request when and if a contingency arises that makes Retention ruling necessary.

Second, with respect to Alternative Transaction Protection, the Service may be concerned that a Backstop Retention Ruling undermines the conclusion that a Subsequent Section 361 Transfer is in fact "in pursuance of the plan of reorganization" as required by statute. If a taxpayer indicates that it either *may* undertake a Debt-for-Equity Exchange, *or may* dispose of shares of Controlled taxably, the concern appears to be that taxpayer does not truly have a fixed intention to undertake a disposition that is "in pursuance of the plan of reorganization" as required by section 361. This concern is presented most directly where a PLR indicates that a taxpayer *may* undertake one or more Subsequent Section 361 Transfers or Retentions. However, we do not believe this concern justifies ceasing to grant Backstop Retention Rulings, as will be discussed below.

a. No Tax Avoidance Incentive

Because of the limited potential for tax avoidance raised by post-distribution taxable sales (or Delayed Exchange), we believe the Service should continue to issue Backstop Retention Rulings. Almost by definition, a taxable sale of appreciated Remainder Shares (or retained Controlled securities), or a Delayed Exchange involving such stock or securities, will never have a tax avoidance motive. A taxable sale of Controlled stock or securities with a built-in gain is the worst possible outcome for a taxpayer from a purely tax perspective. If a taxpayer actually chooses

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[111] *See*, *e.g.*, PLR 201034005 (August 27, 2010) (retention of Controlled equity would permit the Distributing business to "fund various corporate purposes and improve [its] credit rating"). *See also* PLR 201123030 ("The business purpose for Distributing's retention of the Retained Shares is to improve Distributing's debt-equity ratio, to solidify its credit rating, and to provide Distributing with a source of cash for working capital needs, expansion and acquisitions.").

to undertake a taxable sale of Controlled stock or securities, the economic or legal motivations for the sale would presumably predominate in order to justify a 21% tax on the built-in gain.[112]

The considerations are largely identical for Delayed Subsequent Section 361 Transfers. A taxpayer has no apparent tax-motivated reason for disposing of Controlled shares or securities that could otherwise be disposed of tax-free outside of the protection afforded by a PLR's timing guidance.

Additionally, particularly in the public company context, an unanticipated Retention does not undermine the business purposes for a distribution, as a general matter, or provide a potential for tax avoidance with respect to the distribution writ large. As an initial matter, a truly unexpected Retention should have little impact on the meaningful, *expected,* business motivations for a distribution, at the time of the distribution. The motives for a Retention (e.g., Distributing's need to raise funds for general corporate purposes) are simply separate from and unrelated to the business purposes underpinning a distribution (e.g., to permit tailored equity compensation and separate management teams that focus on each respective business). The continued ownership of a small stake in Controlled, with no overlapping directors or officers (except as justified by a business purpose), and no voting power in the retained shares held by Distributing (i.e., the requirements set out in Appendix B of Revenue Procedure 96-30), does not undermine this. Nor is any violence done to a Spin-off's qualification under section 355 by virtue of Distributing's ability to benefit from appreciation (or, for that matter, its downside exposure) in the retained stock or securities following the Initial Distribution. This is simply part and parcel of Distributing's temporary continued ownership and in no way impugns non-the tax motives for the Spin-off.

Given the above, in the context of Backstop Retention Rulings, concerns regarding issuing a PLR when the facts giving rise to a Retention are unknown or uncertain should not prevent the continued issuance of Backstop Retention Rulings. Put succinctly, it should be self-evident that both taxable stock sales and Delayed Exchanges will only actually occur as a result of factual developments that are unexpected at the time of a PLR request and have nothing to do with tax avoidance. Furthermore, the potential for a Retention in no way undermines or runs contrary to the business purposes motivating public company separations. Viewed through this lens, Backstop Retention Rulings are not ruling on a theoretical and as of yet unanalyzed contingency. In seeking Backstop Retention Rulings, taxpayers are doing nothing more than requesting confirmation of the commonsense conclusion that a taxpayer who disposes of shares taxably, or in Delayed Exchanges occurring beyond the timing deadline set forth in a PLR, can be presumed to have done so for

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[112] In the relatively rare circumstance where Distributing has or comes to have a built-in loss in retained Controlled stock or securities, this too cannot be seen as an indication of a tax avoidance motive. If Distributing has a built-in loss in Controlled stock or securities at the time of the Initial Distribution, the Retention itself does not provide any increased ability of Distributing to utilize such loss. Distributing could simply sell the Controlled stock, for cash, on the date of the Initial Distribution, instead of deferring such loss. If Distributing holds stock or securities of Controlled that do not have a built-in loss on the date of the Initial Distribution, it would be counter to Distributing's interest to set out to hold such stock or securities, with the expectation to suffer a decrease in value for the purpose of, at some later period, recognizing a stock loss. Accordingly, Retention of stock beyond the Initial Distribution date is not tax planning or tax avoidance.

valid, non-tax business reasons that should not endanger the tax-free nature of an entire distribution.[113]

b. "Speculation" On Controlled Stock or Securities

Some public statements from Treasury and Service officials have expressed concern that Retentions may permit Distributing to unduly or inappropriately speculate on the value of its retained stake in Controlled. However, for much the same reason that taxable sales at a gain in general do not present tax avoidance, the potential for Distributing to benefit from appreciation in the Remainder Shares (or retained Controlled securities) following an Initial Distribution poses no potential for tax avoidance. As discussed above in Part III.F.1, Distributing will have significant financial accounting reasons to dispose of any Remainder Shares as soon as practical after an Initial Distribution. Furthermore, the Service's ruling guidelines for Retentions require that the Remainder Shares be disposed of "as soon as warranted consistent with the business purpose" for the Retention,[114] a standard that does not permit unchecked speculation.

Moreover, a Retention followed by a taxable cash sale of Controlled stock or securities that have appreciated since the Initial Distribution simply reflects increased proceeds *and* taxable income for Distributing. The potential for Distributing to strategically dispose of its stake in Controlled within the limits of the existing Retention guidelines should not, in and of itself, raise any inference that a Retention is undertaken for a tax avoidance motive. To the contrary, Distributing's decision to maintain or dispose of its ownership in Controlled stock or securities at any given time reflects Distributing's best judgment on future pricing movements and a prudent objective to avoid market distortions.

The Non-Avoidance Requirement explicitly contemplates Distributing's continued ownership of the Remainder Shares (or Controlled securities) in the absence of a tax avoidance motive. The value of this continued ownership stake may increase, decrease, or stay the same following the Initial Distribution. But nothing in the Non-Avoidance Requirement, the Treasury Regulations interpreting it, or the nearly seventy years of accompanying administrative practice indicates that rational value optimization of a temporarily retained stake is indicative of tax avoidance. The potential for value fluctuations is simply irrelevant to the Retention inquiry. If, for example, Distributing were to covenant that it would not sell the Remainder Shares (or Controlled securities) for a price above their fair market value on the date of the Initial Distribution, the Non-Avoidance Requirement would not be any more or less likely to be satisfied. Accordingly, the fact that Distributing may speculate or benefit from potential market fluctuations in the value of Controlled following the Initial Distribution does not justify an end or curtailment to Backstop Retention Rulings.

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[113] As discussed above, this is not to say that a Backstop Retention Ruling is in any way giving comfort that a Delayed Exchange is tax-free. It only provides comfort that the Delayed Exchange does not cause all other, otherwise qualifying tax-free distributions, to run afoul of the Non-Avoidance Requirement.

[114] *See* Rev. Proc. 96-30, Appendix B, section 1.01(3).

c. Taxpayer Timing Dynamics for Supplemental Retention Ruling

In lieu of Backstop Retention Rulings, we understand that the Service may believe that supplemental rulings would adequately address any Retention issues as they arise ("**Supplemental Retention Rulings**"). However, Supplemental Retention Rulings would pose several additional timing constraints on transactions and would be a poor substitute for the existing Backstop Retention Ruling procedure. As discussed in Part III.F, there are numerous legal and economic reasons that taxpayers seeking to undertake dispositions of Remainder Shares (or Controlled securities) in exchange for debt or equity of Distributing (i.e., Subsequent Section 361 Transfers) may be unable to accomplish such dispositions promptly after with an Initial Distribution. In recognition of the practical realities of today's capital markets, the Service has long permitted Subsequent Section 361 Transfer to qualify for tax-free status. Under Revenue Procedure 2018-53, the Service expressly permits, for ruling purposes, a Subsequent Section 361 Transfer to be considered "in pursuance of the plan of reorganization" if it occurs within 30 days following an Initial Distribution without further explanation. A substantially longer period of continuing ownership prior to a Subsequent Section 361 Transfer is permissible if the taxpayer provides an explanation of the business reasons requiring the delay.[115]

With this background, an example may be useful to demonstrate the inadequacy of an approach requiring Supplemental Retention Rulings. If the Service were to cease issuing Backstop Retention Rulings, taxpayers would likely continue to seek rulings to the effect that Distributing would recognize no gain or loss on, for example, Debt-for-Equity Exchanges. These exchanges would be defined to include, among other things, exchanges of Remainder Shares for Distributing debt within a certain timeframe (e.g., 12 months) of an Initial Distribution.[116]

While on its face, such a PLR appears to give a taxpayer 12 months to complete the Debt-for-Equity Exchanges, the absence of a Backstop Retention Ruling would in fact drastically shorten the available time period as a practical matter. Consider the dilemma faced by Distributing if, nine months following the Initial Distribution, it has been unable to complete a Subsequent Section 361 Transfer and still held stock of Controlled. At that point, Distributing would face a difficult decision. A Supplemental Retention Ruling, even if eligible for the "fast-track" ruling procedure,[117] would likely not be issued in less than three months, and even in that case would then be issued only at or after the expiration of the 12-month period from the Initial Distribution.

It may be tempting to dismiss this concern as one that could be easily addressed by the receipt of a Supplemental Retention Ruling, in due course, even if past the 12-month time period initially provided. However, that reasoning is unrealistic, especially for public reporting

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[115] The Service has issued multiple PLRs permitting delays beyond 30 days, but the business reasons for such delay are not always explained in detail in publicly available versions of the PLR. *See, e.g.*, PLR 202218002 (Nov. 19, 2021) (permitting satisfaction of two identified tranches of debt 180 and 365 days after the relevant distribution), *supplemented by* PLR 202244009 (Aug. 11, 2022); PLR 202151001 (Sept. 24, 2021) (amount of time, longer than 30 days, redacted).

[116] For ease of illustration, we have not incorporated into this example typical language from PLRs regarding intermediation of distributing debt through a financial intermediary.

[117] *See* Rev. Proc. 2023-26, 2023-33 I.R.B. 486.

companies. A public company must satisfy not only the Service, but also its independent financial auditors more or less in real time, that the material tax positions it has asserted are correct. While the U.S. federal income tax audit cycle of a large public company likely provides a significant amount of timing cushion beyond the 12-month window of a PLR, financial statements prepared in accordance with U.S. generally accepted accounting principles ("**GAAP**") generally do not. A taxpayer faced with an unplanned Retention, and no Backstop Retention Ruling, faces the very real prospect of being required by its auditors to book a reserve for taxable gain on a prior spin-off.[118] This is particularly the case with the Non-Avoidance Requirement because the operative legal rule references a determination of a proper motive "to the satisfaction of" the Secretary.

If Backstop Retention Rulings are disfavored because they are viewed as providing an inappropriate degree of optionality to a taxpayer, the same logic could seem to prevent a Supplemental Retention Ruling. Would the Service require a taxpayer to expressly abandon its intention to dispose of its continued stake in Controlled in otherwise tax-free Subsequent Section 361 Transfer in order to obtain the Supplemental Retention Ruling? Such a ruling position would again present an unsolvable dilemma to taxpayers. If economic conditions improve during the pendency of Supplemental Retention Ruling request, a taxpayer may be foreclosed from undertaking a qualifying Subsequent Section 361 Transfer because of statements made in the request for the Supplemental Retention Ruling. Even if not foreclosed, the taxpayer's continued reliance on its original PLR may be in doubt if the taxpayer is required to abandon its plan of reorganization with respect to the shares it continues to own. Additionally, if a *request* for a Supplemental Retention Ruling prevents a taxpayer from undertaking Subsequent Section 361 Transfers tax-free, the taxpayer is reliant on the receipt of that Supplemental Retention Ruling to preserve the spin-off tax treatment. In the absence of a requested Supplemental Retention Ruling, the taxpayer will have conceded to the Service that it retained the Remainder Shares (or Controlled securities) and will then be in the unenviable position of needing to satisfy the Non-Avoidance Requirement "to the satisfaction of the Secretary" other than with a PLR. For all of these reasons, for all intents and purposes, the failure to give Backstop Retention Rulings would effectively shorten the time period for dispositions considered part of a "plan of reorganization" by at least as much time as is required to receive a favorable supplemental ruling from the Service, if not more. It would be a very odd administrative result if a ruling standard permitting a specified period of time over which Subsequent Section 361 Transfers may occur tax-free was effectively undercut by a contrary ruling standard declining to provide confirmatory, protective rulings on Retentions.

d. Backstop Retention Rulings Need Not Undermine Plan or Reorganization Conclusions

As discussed above, one potential concern the Service may have with Backstop Retention Rulings is that the enumeration of multiple possible disposition scenarios undermines the conclusion that any one of those is truly undertaken "in pursuance of the plan of reorganization." This concern has some validity, particularly with respect to PLRs that describe Subsequent Section 361 Transfers permissively (i.e., which indicate that a taxpayer *may* undertake one or more Subsequent Section 361 Transfers or taxable sales). However, in the vast majority of cases,

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[118] Presumably, if and when a Retention ruling was obtained, the taxpayer could, at that time, release the reserve. But the damage will have been done by that point.

taxpayers seeking rulings do firmly intend to undertake Subsequent Section 361 Transfers that are timely and in accordance with the tax-free transactions described in their PLR. This is so for the same reason that a taxpayer is unlikely to have a tax avoidance motive for undertaking a taxable sale or a Delayed Exchange: a Subsequent Section 361 Transfer within the parameters of a PLR is tax-free, while other taxable alternatives are not. In these circumstances, the mere possibility of alternative, non-qualifying dispositions is consistent with the view that the intended and actually executed transaction—the Subsequent Section 361 Transfer—is in pursuance of a plan of reorganization.[119]

Accordingly, we believe this concern can best be addressed through more robust representations regarding a taxpayer's fixed intention to undertake a Subsequent Section 361 Transfer in pursuance of the plan of reorganization. If a taxpayer represents, for example, that it will use all commercially reasonable efforts to complete Subsequent Section 361 Transfers of all stock and securities of Controlled that it continues to own after the Initial Distribution, in Debt-for-Equity or equity-for-equity exchanges (or distributions) within the time limits specified in the ruling, we see no reason why the taxpayer has not chosen a fixed course of action, wholly consistent with acting pursuant to a plan of reorganization. With a more robust representation regarding the taxpayer's intentions, we believe Backstop Retention Rulings could be maintained without undercutting or undermining an intention to act in pursuance of a plan of reorganization.

e. Supplemental Retention Rulings and Service Resources

Furthermore, beyond the challenges posed by financial reporting, refusing to issue Backstop Retention Rulings, and instead offering Supplemental Retention Rulings, would impose a meaningful additional workload on the Service, with little or no discernable administrative benefit. Given the dire consequences to taxpayers, we believe that few distributing corporations would be willing to hold Controlled stock or securities beyond the time period specified in their initial PLR with no Backup Retention Ruling and without the benefit of a Supplemental Retention Ruling. The downside of the Service ultimately being unwilling to issue a Supplemental Retention Ruling is simply too great. Given the inherent uncertainty in the application and availability of fast-track processing, in the absence of Backstop Retention Rulings, we anticipate that taxpayers would seek Supplemental Retention Rulings well in advance even of the nine-month mark (assuming such supplemental rulings do not require abandoning an intention to complete Delayed Exchanges).

In our view, analyzing requests for Supplemental Retention Rulings would not further the interests of sound tax administration. Supplemental Retention Rulings, by definition, will not bring new transactional forms to the attention of the Service, or allow the Service to play any greater or more useful role in ongoing market transactions. The Service will already have seen and understood the transaction at issue in a Supplemental Retention Ruling when it issued the original PLR. Additionally, personnel at the Service would need to commit time and resources to re-familiarizing themselves with the facts and analysis of the original ruling (or learning the facts and

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[119] *See generally* Sara B. Zablotney, "Sticking to your Resolutions: Acting under a Plan of Reorganization," 163 TAX NOTES FED. (TA) 29 (Apr. 1, 2019).

analysis afresh, if new personnel are involved) after what is presumably a period of at least several months from the issuance of the original ruling.

The only benefit provided by this diversion of administrative resources and time would be a more robust confirmation of the seemingly incontrovertible conclusion that a taxable sale of Controlled stock or securities is not undertaken with a principal purpose of tax avoidance.

f. The Discretionary Standard of the Non-Avoidance Requirement

Finally, any decision to cease providing Backstop Retention Rulings would impose a particularly onerous burden on taxpayers, given the significant authority granted to the Treasury Secretary (and the Service) under the Non-Avoidance Requirement. While the Non-Avoidance Requirement should not be read as reserving sole and unfettered discretion to the government,[120] taxpayers unexpectedly encountering the need to retain stock or securities of Controlled may struggle to definitively conclude that their Retention would be "to the satisfaction of the Secretary" in the absence of a PLR. Furthermore, while the Service's conclusions regarding the Non-Avoidance Requirement are likely subject to judicial review, those decisions likely receive some degree, and perhaps a significant degree, of deference.[121] A taxpayer wishing to establish the Secretary's satisfaction under the Non-Avoidance Requirement is thus well-advised to seek that confirmation through the PLR process. The extent of this discretion is, itself, a further reason to continue to provide Backstop Retention Rulings. To the extent the Service's views of the Non-Avoidance Requirement are subject to meaningful deference from judicial review, the Service should be willing to, at the earliest opportunity (i.e., in a taxpayer's initial request for a ruling), provide those views.

g. Recommendations

For the reasons discussed above, we urge the Service to continue its prior practice of granting Backstop Retention Rulings. Such rulings will not only bring needed certainty to taxpayers, but also will avoid meaningful risk to taxpayers and significant administrative inconsistency and burdens on the Service.

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[120] *See*, *e.g.*, *Mailman v. Commissioner*, 91 T.C. 1079, 1081 n.2, 1082-83 (1988) (in interpreting section 6661(c) of the Code, which provided that "[t]he Secretary *may* waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement . . . and that the taxpayer acted in good faith," the Tax Court concluded that the discretionary wording in the Code was nonetheless subject to judicial review because, *inter alia*, "[o]nly in cases in which it can be found that the existence of broad discretionary power is not appropriate for judicial review, or that the agency determination involves political, economic, military, or other managerial choices not susceptible to judicial review, or that the agency determination requires experience or expertise for which legal education or the lawyer's skills provide no particular competence for resolution and for which there are no ascertainable standards against which the expertise can be measured, have the courts refrained from reviewing administrative discretion").

[121] *See id.*at 1084 ("The administrator's judgment and ability to provide uniform treatment to similarly situated taxpayers deserves our deference. We should not substitute our judgment for [the Commissioner's]. Nevertheless, we should not refrain from judging whether [the Commissioner's] discretion has been exercised arbitrarily, capriciously, or without sound basis in fact.").

The absence of a tax avoidance motive should be apparent at the time of an initial request for a ruling, so concerns about ruling on non-specific contingencies seem misplaced. On the other hand, we appreciate and understand concerns that an overly permissive Backstop Retention Ruling may undermine an intention to act pursuant to a "plan of reorganization." However, we believe these concerns can best be addressed through properly tailored factual representations while also retaining Backstop Retention Rulings. Accordingly, if changes are desired to the Backstop Retention Ruling practice, we recommend the following changes in lieu of a wholesale discontinuation of the practice.

First, a taxpayer requesting a Backstop Retention Ruling should be required to provide a representation as to its firm intention to use commercially reasonable efforts to complete any planned Subsequent Section 361 Transfers in the time frame indicated in the PLR and a representation regarding the taxpayer's expectation of completing the planned Subsequent Section 361 Transfers in that time frame.[122] These representations would be in addition to the standard Retention representations from Appendix B of Revenue Procedure 96-30 historically provided by taxpayers. Second, given the timing difficulties inherent in a Supplemental Retention Ruling and the timing difficulties that arise in executing a Debt-for-Equity Exchange,[123] if the taxpayer is unable to complete the Subsequent Section 361 Transfers on time, or if doing so becomes economically impractical or detrimental notwithstanding the taxpayer's commercially reasonable efforts, the taxpayer should have an additional 12 months (i.e., one extra year from the end of the time for completing the Subsequent Section 361 Transfers in the PLR) to dispose of any Remainder Shares (or retained Controlled securities) without violating the Non-Avoidance Requirement. No further submission to the Service should be required for this one-year extension to comply with the Non-Avoidance Requirement.

We believe these two recommendations should adequately address any concerns with Backstop Retention Rulings, while preserving the valuable administrative tool bringing needed certainty to taxpayers.

4. Required Showing for a True Retention Ruling

As noted above, it appears that the Service may be considering applying a more rigorous business purpose standard to PLR requests involving True Retentions. We understand this more rigorous standard may require the showing of a predominant business purpose effectively compelling the Retention in order to receive a ruling on the Non-Avoidance Requirement. In what appears to be a noted departure from prior PLRs, any such heightened business purpose requirement may require a showing that the reasons for the Retention are wholly outside of the control of Distributing or Controlled. The origins and motivations for this potential new practice are unclear, but we do not believe it is justified by the statutory text of section 355(a)(1)(D)(ii), relevant policy considerations, or the published authorities in this area, including the 1975 Revenue

[122] We note, for completeness, that the feasibility of timely completing a Subsequent Section 361 Transfer depends to a significant extent on what mechanical requirements may be imposed on such transfers. For example, if the Service no longer permits Direct Issuances, it may often take Distributing longer to complete a Subsequent Section 361 Transfer.

[123] *See supra* Part III.F.

Rulings. While the business purposes motivating the Retentions in the 1975 Revenue Rulings are certainly robust (so much so as to limit the interpretive aid of those rulings), they are and should be viewed as illustrative, not definitional. Put another way, the 1975 Revenue Rulings do not purport to establish a minimum showing necessary to satisfy the Non-Avoidance Requirement; they only describe circumstances that are clearly sufficient to overcome any inference of a tax avoidance motive.

To the extent the Regulatory Retention Purpose Statement is the source of any heightened business purpose standard for Retentions, reliance on that historic Treasury Regulation is likewise misplaced. As a threshold matter, we believe the Regulatory Retention Purpose Statement was incorrect, from a business perspective, when initially made. In only rare circumstances, we believe, will a business purpose be undercut by the True Retention of a small stake in Controlled otherwise in compliance with the guidelines set forth in Revenue Procedure 96-30. Furthermore, whatever its original intention, the modernization of capital markets in the almost 70 years since the Regulatory Retention Purpose Statement was first promulgated significantly diminishes any interpretive value of that statement today, particularly with regards to public company Spin-offs and Retentions, where valid business purposes necessarily predominate.[124]

The inappropriateness of a more stringent business purpose standard is further reinforced by the fact that, as discussed above, Retentions provide minimal occasion for tax avoidance. This is the case even though Distributing may benefit from appreciation in the value of the Remainder Shares (or Controlled securities) following the Initial Distribution. The Non-Avoidance Requirement, by its terms, only requires the *absence* of a tax avoidance motive. To the extent there are specific concerns regarding certain types of transactions, we see no reason why an elevated business purpose standard is an optimal or even proper avenue to address these concerns. For example, if the Service is concerned about Retentions of high-basis stock or securities of Controlled or triggering losses in taxable sales, or about Retentions of Controlled stock or securities the distribution of which would be taxable under section 356, representations could be developed specifically limiting those transactions. A heightened business purpose requirement is, in many ways, a poor proxy for these tax avoidance scenarios, and is likely to be both over- and under-inclusive.

a. Recommendations

For all the reasons outlined above, we recommend that the Service continue to evaluate True Retentions under the standards it has applied for many years. The Service has identified numerous appropriate business purposes for a Retention, including, most notably, a desire to raise funds that Distributing would deploy for various bona fide corporate uses. Put simply, an appropriate business purpose for a Retention was found in Distributing's business need to raise cash for general or specific corporate purposes. The Service's historic willingness to bless a business purpose that is almost definitionally present in any Retention (at least in normal public company transactions) demonstrates the appropriate, narrow scope of a business purpose sufficient to rebut an inference of a tax avoidance plan under the Non-Avoidance Requirement. Given both

[124] It is possible that a heightened business purpose showing for a Retention may be somewhat more appropriate in the context of a private, closely-held corporation, where the retention of a stake in Controlled by Distributing could more easily be seen as preventing a true separation.

the plain language of the Non-Avoidance Requirement, which requires only the absence of a tax avoidance motive, and the long-standing administrative practice in this area, it would be unhelpful and unsound administratively to introduce a heightened business purpose requirement for Retention rulings.

To the extent the Service is concerned about various potential transactions that could indicate a Retention has an improper tax avoidance motive, objective representations could be required foreclosing those scenarios. For example, taxpayers could be required to represent that (i) Distributing's basis in any Remainder Shares and retained Controlled securities is expected to be no less than their fair market value on the date of the Initial Distribution, and/or (ii) none of the Remainder Shares and retained Controlled securities would be taxable under section 356 if they were distributed to shareholders or security holders of Distributing. If necessary, taxpayers could even provide information establishing that the sale for cash of retained stock or securities following the Initial Distribution is, under the law on the date of the Initial Distribution, unlikely to decrease Distributing's aggregate tax liability as compared to Distributing's tax liability if it disposed of the stock or securities tax-free or taxably on the date of the Initial Distribution.[125]

If, contrary to our recommendations, the showing of some heighted business purpose becomes a prerequisite for rulings involving a True Retention, we believe the scope of this heightened business purpose should be clarified in published guidance, and would suggest its applicability be limited to Spin-offs involving closely-held corporations. While we believe requiring a heightened business purpose for a ruling involving a True Retention is misguided, if that ultimately is or becomes the policy of the Service, taxpayers and the sound administration of the PLR program will both be well served by concrete, publicly available guidance in this area.

VII. PENSION AS A CREDITOR FOR PURPOSES OF SECTION 361

A. Background

As discussed above,[126] with respect to a Creditor Transaction, section 361 is intended to facilitate the allocation of historic Distributing liabilities between Distributing and Controlled (i.e., the Debt Allocation Principle).[127] Stated differently, with respect to a Creditor Transaction, sections 361(b)(3) and (c)(3) require that boot and Controlled stock or securities received in the section 361 exchange actually be used to retire Distributing debt or other liabilities. This has the effect of moving to Controlled liabilities that would not otherwise be assumable as a matter of their terms.

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[125] As noted above, Appendix B of Rev. Proc. 96-30 requires that Retained Stock be disposed of as soon as a disposition is warranted consistent with the business purpose for a Retention, but in no event later than five years after the distribution. If the Service were concerned that a True Retention ruling (as opposed to a Backstop Retention Ruling) not permit Distributing to speculate on an increase in the value of the Retained Stock over a relatively long period of time, it could require the submission of additional detail about the projected timing of Distributing's cash needs over time (or the timing of other factors underlying the True Retention).

[126] *See supra* Part III.E.

[127] Rev. Proc. 2018-53, section 3.04(4); *see also* Prior Report (discussing the Debt Allocation Principle).

Historically, the Service has defined "liability" broadly,[128] reflecting a policy of affording companies flexibility within the limits of section 361.[129] The Service has also respected Distributing's transfer to a pension plan as a tax-free Subsequent Section 361 Transfer (such transfer to a pension plan, a "**Pension Plan Transfer**").[130] We understand that the Service is revisiting this guidance. For the reasons outlined below, we recommend that the Service continue to rule favorably with respect to such Pension Plan Transfers under the standards it has historically applied to other Creditor Transactions.

B. Measuring Pension Plan Liability

A distributing corporation may sponsor and maintain a tax-qualified defined benefit pension plan for its eligible employees. Pension plan benefits generally are based on each participant's years of service, compensation, and age at retirement or termination.

Under GAAP, there are three ways to measure the benefit obligations of the pension plan.[131] The first (and most commonly reported on GAAP-based financial statements) is the "projected benefit obligation method," which measures the funds that Distributing presently needs in order to meet future pension plan liabilities by reflecting the present value of vested and non-vested benefits earned by employees taking into account projected future increases in employee

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[128] *See, e.g.*, Treas. Reg. § 1.446-1(c)(1)(ii)(B) (defining a "liability" for purposes of determining when expenses are deductible by accrual basis taxpayers as "any item allowable as a deduction, cost, or expense for Federal income tax purposes. . . . The term 'liability' is not limited to items for which a legal obligation to pay exists at the time of payment."); Treas. Reg. § 1.752-1(a)(4) (defining a "liability" for purposes of section 752 as an "obligation" "only if, when, and to the extent that incurring the obligation — (A) Creates or increases the basis of any of the obligor's assets (including cash); (B) Gives rise to an immediate deduction to the obligor; or (C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital"; and an "obligation" as "any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, ***pension obligations***, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps" (emphasis added)).

[129] Such flexibility is also illustrated by 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). More broadly, the Service has ruled that a wide range of liability categories may qualify as Distributing debt that can be repaid, including ordinary course and short-term liabilities, commercial paper, revolver debt and refinanced debt. *See, e.g.*, PLR 202345008 (Nov. 21, 2022); PLR 202145027 (Aug. 20, 2021); PLR 201827006 (Apr. 9, 2018); PLR 202114017 (Jan. 12, 2021); PLR 202047007 (Aug. 24, 2020); PLR 202019016 (Feb. 3, 2020); PLR 202344013 (Aug. 3, 2023).

[130] *See, e.g.*, PLR 202145027 (Aug. 20, 2021) (Ruling (39)); PLR 202051009 (Mar. 17, 2020) (Ruling (ii)); PLR 201818010 (May 22, 2017) (Ruling (3)(ii)); PLR 201703012 (Sept. 20, 2016) (Ruling (2)); PLR 201612012 (Apr. 1, 2015) (Ruling (4)).

[131] *See* AM. BAR ASS'N, TAX SEC., *Comments on Proposed Regulations Under Section 382(h)*, at 33 (Nov. 12, 2019), https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/2019/111219comments.pdf (discussing the three methods).

pay (the "**PBO Method**"). The second is the "accumulated benefit obligation method," which is essentially a subset of the PBO Method that assumes the pension plan terminates immediately after measurement by calculating benefits without regard to future increases in employee pay (the "**ABO Method**"). The third is the "vested benefit obligation method," which is a subset of the ABO Method that assumes a pension plan terminates immediately after measurement and that employees will only be entitled to benefits that have been earned as of the date of measurement by reflecting only the present value of vested benefits (the "**VBO Method**").[132]

If the benefit obligations of the pension plan exceed the plan's assets, the pension plan is underfunded. If the plan is underfunded, then the difference is recorded in the liability section of the financial statements (using the PBO Method and classified between current and non-current liabilities based on what amount of the pension is expected to be due in the next 12 months). In addition, pursuant to the amendments in Accounting Standards Update 2018-14,[133] companies must disclose both (i) the PBO and fair value of plan assets for plans with PBOs in excess of plan assets, and (ii) the ABO and fair value of plan assets for plans with ABOs in excess of plan assets. Thus, a Pension Plan Transfer will reduce Distributing's overall liabilities under GAAP because GAAP generally treats the underfunded status of a company's pension plan as a liability.[134]

Another way to measure the liability of a pension plan is based on PBGC methodology. PBGC is a federal agency created by ERISA to protect the benefits associated with private sector pension plans. PBGC measures underfunding assuming the plan is immediately terminated. PBGC measures the benefit obligation with reference to the cost of annuitizing the benefit, giving an arguably market-based objective picture of a plan's funded status at a particular point in time.[135] PBGC tends to use more conservative assumptions for the discount rate used to calculate the present value of benefits, the expected retirement age used to estimate when benefits will commence and the amount of early retirement benefits that will become payable.

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[132] Since minimum vesting requirements are generally five years under the Employee Retirement Income Security Act of 1974 ("**ERISA**"), the ABO Method and VBO Method values are very close in most pension plans.

[133] FIN. ACCT. STANDARDS BD., *Accounting Standards Update: Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans*, No. 2018-14 (Aug. 2018), https://fasb.org/page/ShowPdf?path=ASU+2018-14.pdf&title=ASU%202018-14.pdf.

[134] A question was raised as to whether allowing a Pension Plan Transfer when the underfunded plan is divided between Distributing and Controlled (and therefore Controlled inherits some of the underfunding) effectively "double counts" the historic liability; however, it seems that the liability paid is merely a mechanism to get the appropriate capital structure (but note this could result in Controlled bearing the pension deficit for not only its own employees but also for Distributing's). Note also that such a transaction would be required to be noticed to the Pension Benefit Guarantee Corporation ("**PBGC**") and might impede or delay significantly the spin off. *See* 29 C.F.R. § 4043 (describing the requirement that plan administrators and sponsors notify PBGC of the occurrence of certain events, including a change in the controlled group).

[135] *See* PENSION BENEFIT GUAR. CORP., *2022 Annual Report* 39 (2022), https://www.pbgc.gov/sites/default/files/documents/pbgc-annual-report-2022.pdf ("PBGC discounts its liabilities for future benefits with interest factors that, together with the mortality table used by PBGC, approximate the price in the private-sector annuity market at which a plan sponsor or PBGC could settle its obligations." (footnote omitted).

The Service should rule that Distributing may, in order to reduce the amount of funding shortfall and in pursuance of a plan of reorganization, contribute to the pension plan an amount that will not exceed the underfunded amount (the "**Underfunded Amount**"). The Service may choose to define the Underfunded Amount by reference to the particular method described above which the Service determines is appropriate, but we think that the ABO Method best serves the underlying purpose of section 361. While the PBO Method is the most common measurement used on financial statements, it may overstate the amount of actual economic liability because it takes into account future salary raises. However, because Distributing could freeze or terminate the plan, the amount of the liability associated with the pension plan may be more accurately captured by the ABO Method. The ABO Method also most closely reflects the termination liability under PBGC methodology.[136]

Thus, we would suggest that the Service calculate the Underfunded Amount utilizing the ABO Method because it approximates more closely the termination liability.

C. Pension Plan as a Creditor under Section 361

The pension plan should be treated as a "creditor" of Distributing to the extent of the Underfunded Amount for purposes of section 361(b)(3) because, as set forth more fully below, (i) the obligation to make sufficient contributions to the pension plan is enforceable against Distributing; (ii) the amount of such obligation is reasonably determinable; (iii) the contribution of Section 361 Consideration to the pension plan will not create a discretionary fund for Distributing's use over time because of the significant restrictions on any refund or reversion from the pension plan; and (iv) treating the pension plan as a "creditor" of Distributing is consistent with a bona fide allocation of Distributing's historic liabilities between Distributing and Controlled.

First, where a sponsor has an obligation relating to the underfunding of a defined benefit pension plan, such plan is properly viewed as a creditor of the sponsor in the ordinary, common, and commercial sense.[137] A pension plan sponsor has significant financial obligations to its pension plan. The sponsor is generally liable for making minimum contributions required by ERISA and the Code, and otherwise complying with the minimum funding requirements of ERISA and the

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[136] Another potential alternative is to define the Underfunded Amount by reference to the amount the PBGC would require to fully fund the plan on termination. Since this requires market analysis of the cost of annuities (which is likely to exceed ABO), which is not a process that most companies perform annually and entails several technical actuarial assumptions, we have not proposed this as a principal recommendation. *See, e.g.*, Valuation Assumptions and Methods, 88 Fed. Reg. 56,563, 56,564 & n.1 (proposed Aug. 18, 2023) (explaining that "PBGC's long-standing policy is to set assumptions that produce valuations similar to the premium that a private-sector insurance company would charge for a group annuity contract covering the same plan benefits" and describing how "[b]ecause plan terms, plan demographics, and annuity providers' methods vary, no single set of assumptions could exactly match the value private-sector annuity providers would assign to benefits for all terminating plans").

[137] *See supra* note 128 and accompanying text.

Code.[138] Section 412 provides general funding rules for defined benefit plans, and generally requires a minimum contribution for employers of underfunded pension plans. Section 303(k) of ERISA imposes an automatic lien if an employer fails to make required contributions to a single-employer plan covered under section 4021 of ERISA, such as the pension plan, for a year in which the plan's funding target attainment percentage (as defined in section 303(d)(2) of ERISA and section 430(d)(2)) is less than 100% and the unpaid balance owing to the plan exceeds $1 million. The Service can also use section 4971 to collect an excise tax from the employer if an employer fails to meet the minimum funding contributions under section 412. The obligation to make sufficient contributions to the pension plan is enforceable against Distributing. Distributing has an annual recurring obligation to contribute assets to the pension plan, a lien and federal excise tax would be imposed on Distributing if it were to fail to make the required contributions, and Distributing and its controlled group would be jointly and severally liable for the pension plan's unfunded benefit were Distributing to terminate the pension plan.[139] Thus, the pension plan is properly considered a "creditor" of Distributing in the ordinary, common, and commercial sense with respect to the pension plan's Underfunded Amount.

Second, while the amount by which a pension plan is underfunded is contingent upon the life of the plan, the performance of plan assets and the facts with respect to the participants (and, therefore, the amount and timing of the sponsor's ultimate liability pursuant to the pension plan is contingent), the sponsor has a bona fide economic obligation to fund the pension plan, which obligation is susceptible to a present valuation. Under GAAP, the overfunded or underfunded status of a company's pension plan is required to be recognized on its balance sheet.[140] Indeed, Distributing's financial statement disclosures reflect its obligation to the pension plan as a net liability. Further, under an accrual method of accounting, a liability is incurred, and generally is taken into account for U.S. federal income tax purposes, in the taxable year in which all the events have occurred that establish (i) the fact of the liability, (ii) the amount of the liability can be determined with reasonable accuracy, and (ii) economic performance has occurred with respect to the liability.[141] However, the fact that the exact amount of the liability cannot be determined does not prevent a taxpayer from taking into account that portion of the amount of the liability which

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[138] *See* 29 U.S.C. § 1082(a), (b); *see also, e.g.*, *PBGC v. J.D. Indus., Inc.*, 887 F. Supp. 151 (W.D. Mich. 1994) (holding that the parent company and the grandparent company of a plan sponsor were members of the plan sponsor's controlled group and therefore jointly and severally liable for the plan's unfunded benefits, notwithstanding defendants' argument that they did not have "actual" control of the plan sponsor; bright-line stock ownership test applied). For purposes of joint and several liability under ERISA, a "controlled group of corporations" is defined by reference to section 1563 with certain modifications. *See* 29 U.S.C. § 1301(a)(14)(A), (B); sections 414(b), 1563.

[139] 29 U.S.C. § 1362(a). Under certain circumstances, the PBGC has the ability to bring a legal or equitable action under ERISA or the Code in federal district court to enforce liens against Distributing in favor of the pension plan and compel Distributing to make minimum required contributions (or, ultimately, in a liquidation or bankruptcy scenario, to compel Distributing to make sufficient contributions so that the pension plan is fully funded).

[140] *See* Financial Accounting Standards Board Statement No. 158 "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" FAS158-2 (as amended) (issued Sept. 2006) (requiring an employer "to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur").

[141] Treas. Reg. § 1.461-1(a)(2)(i).

can be computed with reasonable accuracy within the taxable year.[142] In general, economic performance is satisfied to the extent that any amount is otherwise deductible under section 404.[143] Distributing's payment of the pension plan amount to the pension plan may also be intended to be treated as tax deductible under section 404(a). Thus, treating the pension plan as a creditor of Distributing (to the extent of the funding shortfall) for purposes of section 361(b)(3) is consistent with the treatment of payments by a plan sponsor under section 404. Moreover, the Service has reached similar conclusions in analogous situations involving contingent liabilities that are not immediately due and payable and not certain to arise in any amount.[144]

Third, there are significant restrictions on any refund or reversion to a sponsor once contributions are made to a pension plan, further supporting treatment of a pension plan as a creditor of the sponsor (to the extent of the funding shortfall). As a general rule, a sponsor is not entitled to a return of its contributions; rather, such contributions must be only for the benefit of employees and their beneficiaries.[145] Under applicable Treasury Regulations, it must be impossible under the trust instrument for any part of the corpus or income of a qualified benefit plan to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust.[146] Any refund or reversion of funds contributed to a qualified plan are subject to stringent restrictions and are only permitted under certain limited circumstances. For example, the plan document may permit the sponsor to recover any excess assets remaining after all plan obligations are satisfied (i.e., upon plan termination), but only to the extent any remaining balance is due to erroneous actuarial computations during the previous life of the qualified plan.[147] Moreover, section 4980 imposes an excise tax of up to 50% on reversions of excess plan assets to sponsors after satisfying all of the plan liabilities.[148] Accordingly, the possibility of any such refund or reversion with respect to payments made by Distributing to a pension plan would be remote and, therefore, the contribution to the pension plan will not create a discretionary fund for Distributing's use over time.

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[142] Treas. Reg. § 1.461-1(a)(2)(ii).

[143] Treas. Reg. §§ 1.461-1(a)(2)(iii)(D), 1.461-4(d)(2)(iii).

[144] *See* Rev. Rul. 94-45, 1994-2 C.B. 39 (characterizing life insurance reserves as liabilities for purposes of section 357); Rev. Rul. 95-74, 1995-2 C.B. 36 (in a section 351 exchange, assumed contingent environmental obligations constitute liabilities for purposes of sections 357(a), but are not taken into account for purposes of sections 357(c)(1) and 358).

[145] Section 401(a)(2).

[146] Treas. Reg. §§ 1.401-1(a)(3)(iv), 1.401-2(a)(1).

[147] Treas. Reg. § 1.401-2(b)(1).

[148] Section 4980(a), (d). It may be technically possible to isolate the surplus in a plan for the benefit of a small division and sell that division (and overfunded plan) to a buyer with an underfunded plan. Given the "exclusive benefit" rule of ERISA, *see* Section 404(a)(1)(A), receiving a purchase price adjustment in reflect of this surplus would be somewhat challenging.

Fourth, treating a pension plan as a creditor of the sponsor (to the extent of the funding shortfall) for purposes of section 361(b)(3), is consistent with the policies relating to Divisive Reorganizations that allow a bona fide allocation of the distributing corporation's historic debt between the distributing corporation and the controlled corporation. Liabilities to pension funds are incurred for reasons unrelated to the Spin-off and generally reflect obligations to employees and retirees of both Distributing's and Controlled's respective businesses. Treating the pension plan as a creditor of Distributing to the extent of the Underfunded Amount and permitting the allocation of pension liability between Distributing and Controlled is consistent with a bona fide allocation of Distributing's historic liabilities between Distributing and Controlled. This position is consistent with rulings granted by the Service, including recently issued PLRs under sections 355 and 368(a)(1)(D) with respect to the transfer to a pension plan by Distributing.[149]

Accordingly, we believe that the Service's ruling practice should continue to respect the pension plan as a "creditor" of Distributing to the extent of the Underfunded Amount for purposes of section 361(b)(3), and that payments in satisfaction of the Underfunded Amount to the pension plan should be treated as distributions in pursuance of the plan of reorganization under section 361(b)(3).

[149] *See supra* note 130 and accompanying text.

Appendix:

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* (Report No. 1436, Mar. 13, 2020)

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

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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

[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

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[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

[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.
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> 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.
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> 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

[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.
>
> 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

[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)).