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One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

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Report No. 1497
July 30, 2024

The Honorable Aviva Aron-Dine
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Marjorie A. Rollinson
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Dear Mses. Aron-Dine and Rollinson, and Mr. Werfel:

Please see attached Report No. 1497 of the Tax Section of the New York State Bar Association, which discusses Revenue Procedure 2024-24 and Notice 2024-38.

We have concerns with the new direction taken by the Treasury Department and the Internal Revenue Service in Revenue Procedure 2024-24 and Notice 2024-38, particularly as it impacts public companies. Spin-offs are critical business transactions in the life cycle of public companies and require navigating through market dynamics often over multiple years. We do not agree that the law requires a number of the positions newly advanced in Revenue Procedure 2024-24 and Notice 2024-38, and are concerned that they do not adequately take into account certain practical and commercial factors typically involved in public spin-offs. We recommend that the Treasury Department and the Internal Revenue Service expedite the issuance of a modified revenue procedure that will address the issues that have been identified.

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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

cc:

Shelley de Alth Leonard
Acting Deputy assistant Secretary
Department of the Treasury (Office of Tax Policy)

Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury

Colin Campbell, Jr.
Associate Tax Legislative Counsel
Department of the Treasury (Office of Tax Policy)

William M. Paul
Principal Deputy Chief Counsel and Deputy Chief Counsel (Technical)
Internal Revenue Service

Mark A. Schneider
Associate Chief Counsel (Corporate)
Internal Revenue Service

Lisa A. Fuller
Deputy Associate Chief Counsel (Corporate)
Internal Revenue Service

Russell G. Jones
Special Counsel to Associate Chief Counsel (Corporate)
Internal Revenue Service

Robert Liquerman,
Special Counsel, Associate Chief Counsel (Corporate)
Internal Revenue Service

Report No. 1497

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON CHANGES TO SPIN-OFF STANDARDS:

REVENUE PROCEDURE 2024-24 AND NOTICE 2024-38

July 30, 2024

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New York State Bar Association Tax Section, *Report on Procedural Guidance for Private Letter Rulings on Divisive Reorganizations: Issues Related to Section 361 Exchanges* (Report No. 1491, March 4, 2024).

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), attached as Appendix to Report No. 1491

I. INTRODUCTION

This report (the "**Report**")[1] of the New York State Bar Association Tax Section addresses certain changes made by Revenue Procedure 2024-24[2] to procedural guidance for private letter rulings ("**PLRs**") in the context of transactions intended to qualify as tax-free under section 355[3] ("**Spin-offs**"),[4] and responds to the issues raised in Notice 2024-38[5] that may be the subject of future published guidance (Revenue Procedure 2024-24 and Notice 2024-38, together, the "**Guidance**"). There are many elements of Spin-offs that are affected by the Guidance. This Report does not attempt to cover all the intricacies of the new PLR standards in Revenue Procedure 2024-24. The Report focuses primarily on the larger questions of substantive law raised by Notice 2024-38, which also have influenced certain of the guidelines in Revenue Procedure 2024-24.

We have significant concerns with the direction taken by the Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**Service**") in the Guidance, particularly as it impacts public companies. As an initial matter, many of the changes made in the Guidance have been articulated in the Guidance as necessary in light of the relevant law; however, the law in this area has not changed. As discussed in detail below, we do not agree that the law requires or supports a number of the positions newly advanced in the Guidance.

In addition, we are concerned that the Guidance does not adequately take into account certain practical and commercial factors typically involved in Spin-offs. Spin-offs are important

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[1] The authors of this Report were William D. Alexander, Michael J. Cardella, Lulu Ma, Joshua Micelotta, Andrew S. Park, Rachel B. Reisberg, David M. Rievman, Jodi J. Schwartz, Karen Gilbreath Sowell, Thomas F. Wessel, Thomas F. Wood, and Tatsuro T. Yamamura. Helpful contributions were made by Marharyta Bahno, John Barrie, Andrew Carlon, Robert Cassanos, Peter Connors, Matt Donnely, Tijana J. Dvornic, Swift Edgar, Jason R. Factor, Lucy W. Farr, Lawrence M. Garrett, Edward E. Gonzalez, Ethan D. Harris, Josh M. Holmes, Dina Kali, Michael Kliegman, Brian P. Krause, Jiyeon Lee-Lim, Thomas May, Michael T. Mollerus, Richard M. Nugent, Vadim Mahmoudov, Stephen M. Massed, Deborah L. Paul, Arvind Ravichandran, Jason Sacks, Alexander Saffi, Peter F. G. Schuur, Michael L. Schler, Patrick E. Sigmon, Linda Z. Swartz, Joseph Toce, Shun Tosaka, Andrew R. Walker, Davis J. Wang, Gordon E. Warnke, and Ruoxi Zhang.

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] 2024-21 I.R.B. 1214.

[3] 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**").

[4] In a typical Spin-off, a corporation ("**Distributing**") distributes to its shareholders and/or security holders the stock and securities of a controlled corporation ("**Controlled**"). Controlled may be a preexisting corporation, holding all relevant Controlled business assets, or Distributing may transfer property to a 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.

[5] 2024-21 I.R.B. 1211.

business-motivated transactions in the life cycle of public corporations. To achieve the business objectives of the Spin-off, extensive financial analysis often is required and debt previously incurred by the distributing corporation typically needs to be allocated between the distributing and controlled corporations (or, in certain circumstances, the total amount of such debt needs to be reduced). In addition, Spin-offs often involve standing up the controlled corporation as a separate public corporation capable of being independent of the distributing corporation, as well as extensive internal, global separations. Accordingly, there typically is a long period of time between the initiation of the planning and the completion of a Spin-off. We believe that the Guidance does not adequately address these critical dynamics and, to the extent that it does not do so, it creates significant impediments to transactions that should qualify for tax-free treatment. For example, it does not provide sufficient flexibility (*e.g.*, the so-called "Pick-a-Lane" rule) to allow taxpayers to revise their transaction structure as necessary or appropriate to respond to changing circumstances (*e.g.*, market dynamics that make implementation of a debt-for-equity exchange inefficient within a prescribed timeframe). As another example, the Guidance includes certain rigid rules (*e.g.*, the absolute prohibition on using Section 361 consideration, including cash boot, to satisfy refinancing debt issued after the "Earliest Applicable Date") that effectively preclude economically efficient debt allocations, thereby potentially forcing companies to structure the economics of a Spin-off in an economically inefficient manner or to abandon a Spin-off altogether.

The net effect of the deficiencies in the Guidance, in our view, is to create distinctions between economically similar transaction formats not compelled by law, which distinctions distort, and increase the costs of implementing, bona fide business transactions without significant policy upside. Accordingly, we believe that the Guidance should be modified on an expedited basis, so as not to unintentionally and unnecessarily deter or impede good business transactions.[6]

We have written two prior reports in this area that discuss the administrative standards for seeking PLRs on, and the practical realities of planning and executing, Spin-offs; our prior commentary and recommendations generally have not been reflected in the Guidance.[7] We continue to believe strongly that the recommendations in the 2020 Report and the Prior 2024 Report are appropriate and correct. While we do not repeat the discussion, we attach the prior reports hereto for submission into the formal public record for this Guidance and, in this Report, attempt to provide the input requested by Treasury and the Service taking into account the law and the practical limitations created by dynamic markets. We would welcome any available opportunity to meet with Treasury and the Service to advance the discussion of these issues.

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[6] As noted in the Report's first recommendation on page 7, consideration could be given to reserving certain issues for study under a "no-rule" policy.

[7] The first report addressed 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 "**2020 Report**"). 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). The second report addressed issues we had learned were under consideration by Treasury and the Service, including creditor transactions and retained equity ("**Prior 2024 Report**"). New York State Bar Ass'n Tax Section, Report No. 1491, *Report on Procedural Guidance for Private Letter Rulings on Divisive Reorganizations: Issues Related to Section 361 Exchanges* (March 4, 2024).

Part II of this Report contains a more expansive articulation of the concerns outlined above and a summary of our principal recommendations. Part III provides a summary of the relevant recommendations from the 2020 Report and the Prior 2024 Report. Part IV discusses our general recommendation to issue modified guidance on an expedited basis. Part V addresses issues relating to the "plan of reorganization" and retention of Controlled stock. Part VI comments on issues relating to debt allocation limitations in creditor transactions. Finally, Part VII provides observations on the amount and timing of the information required to be submitted to obtain a PLR under Revenue Procedure 2024-24.

II. SUMMARY OF RECOMMENDATIONS

Our recommendations are rooted in our strong belief that Spin-offs are critical business transactions in the life cycle of public corporations. The Code provides a number of pathways for corporations to combine tax-free, but it also provides a pathway for corporations to separate on a tax-free basis. In a sense, the Code facilitates efficient economic behavior through corporate combinations and separations that permit corporations to determine and implement their optimal business portfolios without undue tax obstacles.

Fundamentally, a Spin-off requires a separation of a distributing corporation's valuable assets and, typically, an allocation of its liabilities. To achieve the Code's objective of providing a viable pathway to de-conglomeration, it is critical that tax rules not unnecessarily impede the ability to structure a corporate separation in a manner that sets up each of Distributing and Controlled for success with its own optimal capital structure. The optimal capital structure commonly requires that Distributing reduce its outstanding debt in light of the separation of value and earnings in the Spin-off. This reduction of debt rarely can be achieved as a legal or practical matter by simply causing Controlled to assume Distributing debt. Instead, as has been sanctioned by the Code for decades, Controlled typically must undertake its own borrowing and return the proceeds to Distributing in the asset separation or Distributing may use retained Controlled stock or securities to reduce its leverage. At the same time, it is clear that the Code does not permit the distributing corporation to sell Controlled stock or securities tax-free, even if the distributing corporation uses the proceeds to reduce its debt.

We believe that the Service's ruling policies and practices under Revenue Procedure 2018-53 struck a sensible balance between what is permissible and what is not. Much of the Guidance is focused on the intricacies of debt allocation – what are appropriate uses of cash proceeds from Controlled and the mechanics for using Controlled stock and securities to repay Distributing debt. There may be room for debate on certain of these topics. However, in our view, the Guidance does more than just re-adjust the lines within an acceptable range. A number of Revenue Procedure 2024-24 guidelines are unworkable as a practical matter. Moreover, we do not believe that it is sufficient to view these changes only as ruling guidelines with the potential for more definitive guidance that is more flexible. Due to the complexity involved with planning and executing a Spin-off and the potential for material tax to Distributing and its shareholders, Spin-offs are essentially unique among large corporate transactions in that they often are executed only after the 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. We are concerned that changes made in Revenue Procedure 2024-24 can disrupt the successful implementation of Spin-

offs. The confusion and uncertainty created by the Guidance is most certainly impacting legitimate business transactions, both those that are in the process of being implemented and others that are only in the planning stages.

The Report makes the following recommendations:[8]

A. General Recommendation

1. In light of the confusion and complexity created by the new PLR standards included in Revenue Procedure 2024-24, we recommend that Treasury and the Service expedite the issuance of a modified revenue procedure that will address the issues that have been identified. One alternative approach may be to create a no-rule policy around the issues of concern for Treasury and the Service, as has been done in the past where there are elements of Spin-offs that are under study.

B. Plan of Reorganization and Retention of Controlled Stock

2. To preserve the intended "elasticity" of a plan of reorganization in affording nonrecognition treatment, we recommend clarifying that all Delayed Distributions, whether before or after the Control Distribution Date, to the extent effected in pursuance of the plan of reorganization and thus subject to section 361, are also treated as part of the distribution (within the meaning of section 355(a)(1)(D)).

3. In the case of a transaction otherwise satisfying the requirements under section 355 but which involves Delayed Distributions and does not otherwise contemplate a Retention, we recommend clarification that the Non-Avoidance Requirement applies only to the extent a Delayed Distribution fails to qualify under the Operative Provisions.

4. We continue to recommend that the Service make available Backstop Retention Rulings to taxpayers, affording both Extended Timing Protection and Alternative Transaction Protection.

5. If Treasury and the Service are unwilling to resume the prior practice of granting Backstop Retention Rulings, we recommend that the Service issue Backstop Retention Rulings to accommodate the potential for taxable dispositions of Controlled stock within the 12-Month Period pursuant to the plan of reorganization (*i.e.*, Alternative Transaction Protection), with the same set of representations typically accompanying Backstop Retention Rulings prior to Revenue Procedure 2024-24.

6. To the extent a taxpayer is uncertain as to whether all of the intended Delayed Distributions following the Control Distribution Date will be accomplished within the 12-Month Period, we recommend that the Service consider issuing favorable rulings providing

[8] Defined terms used but not defined in this summary of recommendations are defined further below in this Report.

qualification under section 361 for Delayed Distributions to the extent completed within the 12-Month Period.

C. Continuing Arrangements

7. We believe that current law (including the existing requirements under section 355 and the companion revenue rulings on continuing arrangements discussed below) adequately addresses the notion of genuine separation in Spin-offs. Accordingly, we recommend that the government leave unchanged the existing standards for continuing arrangements, including Revenue Ruling 2003-74 and Revenue Ruling 2003-75.

8. We believe that the Retention Factor Test is not needed. If the government decides to retain the Retention Factor Test, we recommend that (i) the Contractual Agreements Factor be revised to except short-term transitional services agreements, such as the ones described in Revenue Ruling 2003-75; (ii) the Retention Factor Test be revised to except overlap of outside directors whose positions will be subject to normal-course elections after an initial term; and (ii) the government clarify the factual showing required to demonstrate the presence of a business exigency.

D. Sections 357 and 361

9. We recommend that the Service revise the PLR guidelines to set forth a single definition of "Liability" that would apply to define the scope of obligations eligible to be assumed under section 357 and satisfied in an exchange described in section 361(b)(3) or (c)(3).

10. Consistent with Revenue Procedure 2024-24's current definition of "Liability," we recommend that the "Liability" definition expressly include indebtedness and other liabilities that, in each case, are economically attributable to periods preceding the Divisive Reorganization (including indebtedness the proceeds of which are used to refinance any such indebtedness). In addition to indebtedness, Liabilities should include (i) other liabilities that are economically attributable to periods preceding the Divisive Reorganization and include one or more contingent payments (i.e., "Contingent Liabilities" under Revenue Procedure 2024-24), and (ii) short-term and non-financial liabilities (such as trade debt) that are similarly economically attributable to periods preceding the Divisive Reorganization and are therefore assumable under section 357.

11. To the extent this topic is addressed in Treasury Regulations or other substantive guidance, we likewise recommend that such guidance affirm the parity between section 357, on the one hand, and section 361(b)(3) and (c)(3), on the other hand.

E. Post-Distribution Payments

12. With the possible exception of Indemnity Purges, we do not believe that published guidance is (i) appropriate for non-indemnity Post-Distribution Payments in light of the variable fact patterns, non-recurring nature, and complex intersection of the relevant legal provisions or (ii) needed to address the more pedestrian issues raised by indemnity payments and the application of the *Arrowsmith* and open transaction doctrines.

13. In the context of an Indemnity Purge, we believe that the timely repayment of liabilities arising under indemnification provisions of the transaction documents should fall within the ambit of permissible purges of Post-Distribution Payments, even though such liabilities only materialize post-Spin-off.

14. We recommend revising Representation 28 of Revenue Procedure 2024-24 to address solely Post-Distribution Payments that are indemnification payments, to require an accounting or other documentation describing categories of intended uses of Post-Distribution Payments (in effect, matching the payment with the liability), and, in the case where Distributing liabilities may be repaid prior to the receipt of a Post-Distribution Payment, noting such potentiality and the need for the particular sequencing.

15. We believe that indemnity payments from Controlled to Distributing that constitute Section 361 Consideration but which are received after the contribution of assets to Controlled and prior to any Distribution should likewise be permitted.

16. We recommend that the Service and Treasury relax the requirement to provide the information and analysis with respect to Post-Distribution Payments required by Section 3.05(1)(c)(ii) of Revenue Procedure 2024-24 and instead accept a broad description of categories of potential Post-Distribution Payments.

F. Refinancings

17. We recommend that the Service continue to issue, or resume issuing, favorable PLRs in circumstances where Refinancing Debt incurred after the Earliest Applicable Date is satisfied with Section 361 Consideration.

18. Alternatively, if potential recast or principal-agent concerns in the context of direct issuance transactions continue to trouble Treasury and the Service, we recommend at a minimum that the Service continue to issue (or resume issuing) favorable PLRs with respect to (i) Regular Refinancing Debt and other Refinancing Debt that is not issued as part of a Covered Direct Issuance Transaction (whether the debt is satisfied with boot pursuant to section 361(b)(3) or with Controlled stock or securities pursuant to section 361(c)(3)), and (ii) all Refinancing Debt (whether or not issued as part of a Covered Direct Issuance Transaction) that is satisfied with cash.

G. Debt-for-Equity Exchange/Recast Issues

19. Generally, we recommend that the Service continue to provide PLRs where taxpayers are, by reference to the TAM Factors, able to establish the intermediary's status as a creditor acting for its own account and that the form of an intermediated exchange is respected under substance over form principles.

20. Save for the one exception outlined below, we believe that qualification under the Intermediated Exchange Model should continue to be determined on a case-by-case basis in the Service's administration of the PLR program.

21. We recommend formal PLR guidelines confirming what, if any, designated Minimum Ownership Period is required to establish an intermediary's status as a creditor of Distributing for purposes of section 361(c)(3).[9]

22. We recommend that the Service permit intermediated exchanges involving Regular Refinancing Debt where the taxpayer establishes the intermediary's creditor status under the generally applicable standard described below.

23. If Treasury and the Service decline to adopt our general recommendation of sanctioning direct issuance transactions, we recommend that the Service continue to issue (or resume issuing) favorable PLRs with respect to Regular Refinancing Debt that is not issued as part of a direct issuance transaction, including Regular Refinancing Debt that is satisfied with Controlled stock or securities in a Debt-for-Debt Exchange or Debt-for-Equity Exchange.

24. While we understand Treasury's and the Service's heightened vigilance with regard to direct issuance transactions, we believe the appropriate response is not to rule out an entire category of statutorily appropriate and commercially efficient transactions; rather, additional consideration should be given to formulating concrete and clear guidance as to the circumstances in which such direct issuance transactions should be permitted for PLR purposes, including adherence to the TAM Factors and any designated Minimum Ownership Period.

25. Additionally, we recommend that the Service narrowly define prohibited direct issuance transactions, and provide specific, commercially-grounded carve-outs from their scope. For example, a prohibited direct issuance transaction could be defined as a Debt-for-Debt Exchange or Debt-for-Equity Exchange with respect to Distributing debt issued to the participating Intermediary within a specified number of days of the subsequent exchange of the debt for Section 361 Consideration (in effect, requiring a Minimum Ownership Period in the direct issuance context), and consistent with the limitations in Revenue Procedure 2024-24, could be explicitly limited to those transactions in which the Intermediary participating in the Debt-for-Debt Exchange or Debt-For-Equity Exchange is the same party (or an affiliate of the party) that is the initial lender on the Distributing debt ultimately satisfied in the subsequent exchange.

H. Representation 37

26. We recommend that the Service provide further guidance on the scope of Representation 37 of Revenue Procedure 2024-24 and make clearer the types of actions that would be viewed as having a principal purpose of inappropriately avoiding the requirements or limitations in sections 357 or 361. Additionally, any such guidance should explicitly provide that merely structuring a transaction to fall within a particular provision of section 357 or 361 will not be considered as having a principal purpose to avoid another provision of those sections.

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[9] If Treasury and the Service decline to prescribe a Minimum Ownership Period, we recommend guidance confirming that satisfaction of all of the TAM Factors is sufficient to establish an intermediary's creditor status.

I. Replacement of Distributing Debt

27. We do not believe that substantive guidance is necessary (or well-suited) to identify the artificial transactions that implicate the Debt Replacement Concern, and we recommend that no such substantive guidance be issued.

28. We recommend that any substantive guidance regarding the Debt Replacement Concern confirm when a borrowing transaction will *not* be recast in a manner that disturbs the section 361 qualification of the de-leveraging transaction undertaken pursuant to a Divisive Reorganization by:

    a. Establishing a safe harbor (*i.e.*, the New Borrowing Safe Harbor) for any borrowing motivated by a Borrowing Business Purpose, where the proceeds of the borrowing are utilized in a manner consistent with the Borrowing Business Purpose, and the de-leveraging transaction has Economic Effect; and

    b. Providing that the determination of whether a borrowing (other than a borrowing that qualifies for the New Borrowing Safe Harbor) will be subject to recast will be made from all of the facts and circumstances, including the New Borrowing Factors and the Unwind Factors.

29. We recommend that Representation 30 be replaced by a representation that any planned or anticipated re-leveraging transaction (whether committed or not and whether occurring in the ordinary course or otherwise) is expected to qualify for the New Borrowing Safe Harbor (*i.e.*, the New Borrowing Representation).

30. To the extent the Service prefers to maintain a more nuanced approach in Revenue Procedure 2024-24, in particular with respect to Committed Borrowings, we recommend:

    a. Representation 30 should be limited to Committed Borrowings;

    b. With respect to non-Committed Borrowings (including Anticipated Borrowings), Representation 30 should be replaced with the New Borrowing Representation.

31. If the Service does not adopt our recommendation with respect to the New Borrowing Representation, then we recommend that, with respect to non-Committed Borrowings, Revenue Procedure 2024-24 (i) require taxpayers to submit analysis to establish that, based on the New Borrowing Factors and the Unwind Factors, any planned or anticipated non-Committed Borrowing would not be expected to be subject to recast (*i.e.*, the New Borrowing Factor Analysis) and (ii) retain the Changed Circumstances Exception in the form of a safe harbor to establish that a non-Committed Borrowing satisfies the New Borrowing Factor Analysis with the following modifications:

    a. Any requirement that the changed circumstances were not anticipated should be eliminated,

    b. Changed circumstances arising from ordinary course events should be included, and

c. There should not be a requirement to establish that, in a counterfactual world in which the business separation transaction did not occur, the borrowing would have occurred.

32. In the event the Service retains Representation 30 with respect to Committed Borrowings:

    a. We agree with the maintenance of an exception for borrowings pursuant to previously committed revolving credit agreements in place as of the Earliest Applicable Date, consistent with the Service's historic ruling approach and our comments in the 2020 Report; and

    b. We recommend that Revenue Procedure 2024-24 should (i) include an exception applicable to Non-Ordinary Course Borrowings and (ii) not require a showing that a post-Spin-off Committed Borrowing would have occurred without regard to the Spin-off.

J. Solvency and Continued Viability of Distributing and Controlled

33. We believe that existing tax and non-tax (both legal and economic) guardrails adequately police the Solvency Concern, and there is no basis to import a standalone solvency inquiry into the rules governing Divisive Reorganizations.

34. We do not believe that substantive guidance should address the Solvency Concern, and it would be inappropriate to import a solvency element to a statutory framework that does not purport to assess solvency.

35. Revenue Procedure 2024-24 should eliminate Representation 8 and any other requirement to make a flat solvency representation or factual showing related thereto, because the Solvency Concern is not about objective insolvency, rather *intent*.

36. If our recommendations with respect to Representation 8 are adopted, we do not believe there is a separate and distinct need for Representation 9.

37. If our recommendations with respect to Representation 8 are not adopted, we would equally recommend that a commitment to obtain a solvency opinion of an independent valuation expert be sufficient to establish future economic viability in lieu of making any specific representation or factual showing. However, for taxpayers who cannot so commit, we recommend that Representation 9 be limited to the subjective inquiry as to expected solvency (*i.e.*, future economic viability) that is not addressed by Representation 8.

38. We recommend that guidance clarify how "economic viability" is measured, as there is no clear calculation required by Representation 9 and it is unclear what showing is required, other than an expectation of having the means to satisfy all relevant liabilities, which is a separate concept required by the representation.

39. The Service should eliminate any requirement to provide detailed financial analysis and projections to support Representations 8 and 9, beyond, perhaps, financial statements and projections that have already been prepared.

K. Effect of Transaction Related to Divisive Reorganization on Controlled Securities

40. To the extent substantive guidance is promulgated in this area, guidance should clarify/confirm that (i) in the case of Disregarded Modifications, Controlled debt that is otherwise Qualified Property received in the Divisive Reorganization should remain Qualified Property that is eligible to be transferred pursuant to 361(c)(3); and (ii) in the case of Nonrecognition Modifications (*i.e.*, where nonrecognition property is received (or deemed received) in exchange for Controlled debt that was otherwise Qualified Property received in the Divisive Reorganization), such nonrecognition property should remain Qualified Property that is eligible to be transferred pursuant to 361(c)(3).

41. We recommend eliminating Representation 29 of Revenue Procedure 2024-24 and to, at most, require taxpayers to provide information regarding any Taxable Modification that would occur in connection with the separation transaction.

L. Amount and Timing of Information Required to Be Submitted under Revenue Procedure 2024-24

42. We recommend the Service revisit the information and analytical submissions required under Revenue Procedure 2024-24, be mindful of timing and commercial realities, and tailor the requirements in a manner that would allow taxpayers to satisfy them.

III. REVIEW OF PRIOR REPORT RECOMMENDATIONS

A. 2020 Report

The 2020 Report focused primarily on issues relating to Revenue Procedure 2018-53,[10] which, prior to the issuance of Revenue Procedure 2024-24, set forth the Service's 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) in creditor transactions.

The 2020 Report discussed specific considerations, case studies, and recommendations for PLR guidelines related to (i) the plan of reorganization and timing aspects of section 361 in both creditor transactions and shareholder transactions involving distributions of Section 361 Consideration to shareholders and (ii) debt allocation limitations in creditor transactions, many of which are referenced herein. The 2020 Report made the following general recommendations:

1. The Service should apply the plan of reorganization limitation and statutory limitations under sections 357 and 361 in a manner consistent with the overarching purpose of section 355.

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[10] 2018-43 1.R.B. 667.

2. 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.

3. 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.

The recommendations in the 2020 Report were based on three guiding principles for administering the PLR program under Revenue Procedure 2018-53:

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 retained Controlled 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**").

Third, where the Debt Allocation Principle is satisfied, the mechanics used to effectuate creditor transactions 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**").[11]

The Guidance generally declines to incorporate the recommendations and guiding principles suggested in the 2020 Report. As noted above, we continue to believe the foregoing recommendations and guiding principles are appropriate. Furthermore, we believe they should apply to any substantive guidance Treasury and the Service may issue.

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[11] *See* the 2020 Report, at pp. 18-20.

B. Prior 2024 Report

The Prior 2024 Report primarily addressed issues pertaining to creditor transactions and retained equity, including (i) the transfer by Distributing of Controlled stock or securities to its creditors in connection with a Divisive Reorganization in a "**Debt-for-Equity Exchange**" or "**Debt-for-Debt Exchange**" and (ii) the mechanics for implementing such exchanges, including the "**Direct Issuance Model**" and the "**Intermediated Exchange Model**". As relevant to this Report, the Prior 2024 Report recommended that:[12]

1. The Service continue to rule favorably with respect to the Direct Issuance Model, or if our recommendation to retain the Direct Issuance Model is not adopted and Treasury and the Service return to the Intermediated Exchange Model, that published guidance articulate precise timing and other requirements for implementing the exchange.

2. The period of time afforded to complete Debt-for-Equity Exchanges be extended to 18 months.

3. 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.

4. The prior practice of granting "**Backstop Retention Rulings**" (*i.e.*, protective rulings under section 355(a)(1)(D)(ii)) be continued to provide taxpayers certainty that their Spin-off qualifies.

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

None of these recommendations were adopted in Revenue Procedure 2024-24.

In Revenue Procedure 2024-24, the Service decided to dispense with the Direct Issuance Model. However, the Service further declined to provide clear guidelines articulating new standards around timing and sequencing and other requirements for implementing an intermediated exchange. The 12-month parameters around completing a Debt-for-Equity Exchange remained unchanged, and the Guidance imposes novel restrictions serving to limit transactions that may be considered to be entered into in pursuance of the plan of reorganization. Variable pricing agreements are disfavored, as are any "dribble out" mechanics (regardless of the chosen exchange model). Lastly, as discussed at length below, the Service has overhauled the ruling standards for purposes of evaluating whether a retention is permissible and will no longer be granting Backstop Retention Rulings.

IV. GENERAL RECOMMENDATION

As stated above and discussed more fully below, Revenue Procedure 2024-24 raises significant issues and uncertainty. We also understand from public comments by government

[12] The Prior 2024 Report also included a recommendation with respect to treating a pension as a creditor.

officials that forthcoming substantive guidance may provide for greater flexibility. Even if the friction created is temporary, it nonetheless disrupts the planning and execution of ongoing transactions. Due to the substantial uncertainty that Revenue Procedure 2024-24 introduces, both with respect to the PLR process and the broader impact on public commercial transactions, we urge Treasury and the Service to accelerate drafting and release of a modified revenue procedure that will address the issues that have been identified.

If it is determined not to be feasible to issue a modified revenue procedure on an expedited basis, we request that Treasury and the Service consider reverting to the standards of Revenue Procedure 2018-53 while continuing to examine issues raised in the Guidance. This pathway also could include establishment of no-rule positions with respect to one or more issues discussed in the Guidance and addressed in this Report. This approach has precedent; for example, in 2013, the Service, in its annual PLR revenue procedure, established a no-rule policy with respect to three areas impacting Spin-Offs (pre-Spin-off acquisitions of Section 368(c) control of Controlled, direct issuance transactions, and so-called "north-south" transactions).[13] Specifically, if, as we expect, direct issuance is a primary source of Treasury's and the Service's discomfort, re-establishment of the no-rule position provided in Revenue Procedure 2013-3 could be considered. Taking this path would be less disruptive, allowing the Service to continue to rule on the remaining Spin-off qualification questions while the government deliberates regarding definitive resolution of applicable issues raised by the Guidance.

V. PLAN OF REORGANIZATION AND RETENTION OF CONTROLLED STOCK

A. Background

1. Statutory Framework

In 1918, the first enactment of the reorganization provisions provided nonrecognition treatment to the exchange of stock or securities "in connection with a reorganization, merger, or consolidation" without defining the terms "reorganization, merger, or consolidation."[14] In 1921,

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[13] *See* Rev. Proc. 2013-3, 2013-1 C.B. 113, sections 5.01(9)-(10) and 5.02(2). The no-rules pertaining to pre-Spin-off acquisitions of control and north-south transactions were subsequently lifted upon the conclusion of the Service's study of these areas and issuance of guidance reflecting such study. *See*, respectively, Rev. Proc. 2016-40, 2016-2 C.B. 228 (section 6); Rev. Rul. 2017-9, 2017-21 I.R.B. 1244. With respect to direct issuances, the Service lifted its no-rule prohibition while continuing to study the issue after determining that PLRs in this area would be in the interest of sound tax administration (*see* Rev. Proc. 2017-38; 2017-22 I.R.B. 1258 (section 3)) and, as discussed in the Prior 2024 Report, modified its ruling policies with respect to direct issuances in Revenue Procedure 2018-53, presumably after concluding its five-year study on the issue.

For other examples of the Service pausing rulings on areas under study, *see, e.g.,* "IRS statement regarding private letter rulings on certain corporate transactions" (Oct. 13, 2017), *available at* https://www.irs.gov/newsroom/irs-statement-regarding-private-letter-rulings-on-certain-corporate-transactions (announcing the Service's (i) reconsideration of its views regarding certain issues as to which it had provided favorable rulings in the past, including "drop-spin-liquidate" transactions; (ii) study of such issues and the potential for new guidance to be issued; and (iii) guidelines for processing ruling requests pending the outcome of such study, including new standards or no-rule areas).

[14] Revenue Act of 1918, P.L. 65-254, 40 Stat. 1057 (1919). Shareholders in a divisive "split-up" and "split-off" transaction were accorded nonrecognition treatment under this legislation.

this provision was revised to provide nonrecognition treatment to the exchange of stock or securities "in the reorganization," with the term "reorganization" defined to ***include*** three categories of transactions: a "[(i)] merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), [(ii)] recapitalization, or [(iii)] mere change in identity, form, or place of organization of a corporation, (however effected)."[15] The history of the definitional requirements for a "reorganization" reflects Congress' intention that a reorganization properly afforded nonrecognition treatment may be structurally implemented in a multitude of manners.

In 1924, Congress expanded nonrecognition treatment to shareholders in a Divisive Reorganization[16] and introduced the phrase "plan of reorganization", which applies interchangeably for both acquisitive reorganizations and Divisive Reorganizations.[17] The Code provides no guidance as to the phrase's scope, and the Treasury Regulations are not only somewhat uncertain in this regard, perhaps intentionally, but also outdated insofar as they do not account for legislative changes clearly contemplating that components of the plan of reorganization may include transaction steps unnecessary to qualify as a section 368 reorganization.[18] In the first instance, the Treasury Regulations appear to suggest that its scope is limited to exchanges that are necessary prerequisites for definitional qualification as a reorganization under section 368. In particular, Treas. Reg. § 1.368-2(g) defines the term "plan of reorganization" as having reference "to a consummated transaction specifically defined as a reorganization under section 368(a)." According to such Treasury Regulation, "[t]he 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)."[19]

The Service and the courts, however, have recognized that section 368 is definitional in nature and generally does not describe the specific form of exchanges or distributions that a

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[15] Revenue Act of 1921, P.L. 67-98, 42 Stat. 227 (1921) (emphasis added).

[16] From 1934 to 1951, Spin-off transactions temporarily were excluded from the reorganization provisions. *See* Revenue Act of 1934, P.L. 73-216, 48 Stat. 680 (1934) (sec. 112); Revenue Act of 1951, P.L. 82-183, 65 Stat. 459 (1951) (sec. 317).

[17] Revenue Act of 1924, P.L. 68-176, 43 Stat. 253 (1924) (section 203). The legislative history describes this phrase as "minor changes in phraseology" without otherwise explaining its meaning or the reason for the change from the prior references to exchanges "in connection with the reorganization" (Revenue Act of 1918, sec. 202(b)) or "in the reorganization" (Revenue Act of 1921, sec. 202(c)(2)). *See* H. Rep. 68-179, at p. 13 (Feb. 11, 1924).

[18] Specifically, Treas. Reg. § 1.368-1(c) identifies only two specific nonrecognition exchanges under the Operative Provisions (defined below) (sections 354(a) and 361(a)) and does not reflect the repeal of *General Utilities* (through the addition of section 361(c)) and reversal of *Minnesota Tea* (through the additions of sections 361(b)(3) and (c)(3))).

[19] Treas. Reg. § 1.368-2(g).

particular reorganization must include.[20] Rather, upon a finding of a reorganization under section 368, certain Code provisions are applicable (and limited) to specified transactions that occur "in pursuance of the plan of reorganization" even if they are not specifically described as, or required for, a section 368 reorganization. These provisions include sections 354, 355, and 361, which set forth tax consequences with respect to such transactions (collectively referred to as the "**Operative Provisions**").[21] This nearly century-old framework demonstrates Congress' intent that a reorganization may encompass various transaction components and contemplates that an identified subset of those steps undertaken as part of the reorganization be afforded nonrecognition treatment even if other steps are not protected by the Operative Provisions. Consistent with the foregoing, Treas. Reg. § 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***. ***Such transaction*** and ***such acts*** must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise."

Consistent with relevant legislative history and the Service's published guidance, we believe a transaction (or series of transactions) undertaken as part of an overall, integrated plan may be viewed as "pursuant to the plan of reorganization" even if the transaction (or series) is not required for section 368 qualification or described in the Operative Provisions and, therefore, would be taxable (or potentially tax-free under another of the Code's nonrecognition provisions).[22] For example, in Revenue Ruling 69-142,[23] pursuant to the plan of reorganization, the acquiring

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[20] For example, a section 368(a)(1)(A) reorganization is defined simply as "a statutory merger or consolidation" and does not prescribe any particular exchanges or distributions by any party to the reorganization or its shareholders. As another example, prior to the enactment of section 368(a)(2)(G) in 1984, a section 368(a)(1)(C) reorganization did not reference any distributions to the target shareholders or creditors although the Service recognized that a liquidating distribution could be in pursuance of the plan of reorganization for such a transaction. *See, e.g.*, Rev. Rul. 57-518, 1957-2 C.B. 253.

[21] Consistent with the legislative history of the reorganization provisions (*see supra* n. 17) and the position expressed by the Service in Revenue Procedure 2024-24 (*see* Rev. Proc. 2024-24, section 2.01(3)(b)), we believe that the scope of transactions "pursuant to," "in pursuance of," and "in connection with" the plan of reorganization are coextensive. *See also* 2020 Report, at n. 14.

[22] *See* Staff of the Joint Committee on Taxation, General Explanation of The Deficit Reduction Act of 1984 (H.R. 4170, 98th Congress; Public Law 98-369) (the "**1984 JCT Report**"), at p. 190 (Dec. 31, 1984) ("The Congress did not intend to preclude C reorganization treatment to a transferor corporation merely because it does not distribute the property received from the acquiring corporation, and the other property held by it immediately after the reorganization, so long as it distributes either such property ***or any property received on the sale or exchange of such property*** during the distribution period, and <u>***so long as any such sale or exchange is in pursuance of the plan of reorganization***</u>***. There is no inference, however, that any such sale or exchange would itself be tax-free***.") (emphasis added). *See also, e.g.*, Rev. Rul. 2002-85, 2002-2 C.B. 986 (involving a contribution of assets following an acquisitive section 368(a)(1)(D) reorganization "pursuant to the plan of reorganization" and concluding that the continuity of business enterprise requirement was satisfied); Treas. Reg. § 1.368-1(d)(5), Exs. 6–8 (concluding that various post-reorganization transfers occurring "as part of the plan of reorganization" did not cause the reorganization to violate continuity of business enterprise); Rev. Rul. 69-142, 1969-1 C.B, *modified and superseded by* Rev. Rul. 98-10, 1998-1 C.B. 643.

[23] 1969-1 C.B, *modified and superseded by* Rev. Rul. 98-10, 1998-1 C.B. 643. *See also* Rev. Rul. 78-408, 1978-2 C.B. 203 (involving a section 368(a)(1)(B) reorganization and an exchange of warrants "pursuant to the plan of

corporation acquired (i) all of the stock of the target corporation in exchange for voting stock in a section 368(a)(1)(B) reorganization, and (ii) all of the outstanding debentures of the target corporation in exchange for newly issued debentures of the acquiring corporation in a section 1001 exchange. This ruling was subsequently modified and superseded by Revenue Ruling 98-10,[24] in which the Service concluded that section 354 applied to the exchange of debentures on substantially identical facts. In so ruling, nonrecognition treatment under the Operative Provisions was extended beyond those transactions that are a necessary component of section 368 qualification, demonstrating that the category of transactions that are "in pursuance of the plan of reorganization" is broader than the category of transactions necessary to qualify as a reorganization.[25] Thus, the availability of nonrecognition treatment under an Operative Provision with respect to any transaction (or "act") consummated as part of a plan that includes a section 368 reorganization entails a three-step process: (i) determining the existence of transfers, distributions, or exchanges that result in qualification as a reorganization under section 368, (ii) determining which transactions, in addition to the qualification steps, occur "in pursuance of the plan of reorganization," and (iii) determining which of those transactions referenced in clause (ii) are described by and subject to the Operative Provisions.[26]

2. *Commissioner v. Gordon*: Multi-Step Distributions of Control

In *Commissioner v. Gordon*,[27] the Supreme Court considered whether a series of steps could appropriately be viewed as together resulting in a qualifying section 355 transaction. Pacific Telephone and Telegraph Company ("**PacTel**") was owned approximately 90% by American Telephone and Telegraph Company, with PacTel's remaining stock being publicly held and traded on public stock exchanges. On September 29, 1961, PacTel distributed short-term, transferable rights to its shareholders to purchase 57% of the stock of a wholly-owned subsidiary ("**Northwest**"). The 1961 rights offering contemplated transferring, and succeeded in transferring, about 57% of the Northwest common stock to PacTel shareholders. On June 12, 1963, PacTel distributed short-term transferable rights to its shareholders to purchase its remaining stock of Northwest. The rights in each offering set forth a purchase price less than the fair market value of such stock. The taxpayer-distributees reported the 1961 and 1963 transactions as qualifying under

reorganization" governed under section 1001), *modified by* Rev. Rul. 98-10 (section 354 applies to the exchange of warrants provided they constitute securities); Rev. Rul. 70-41, 1970-1 C.B. 77 (involving an exchange of target corporation debentures for acquiring corporation voting stock "[a]s part of the same plan" as a section 368(a)(1)(B) reorganization governed under section 1001), *modified by* Rev. Rul. 98-10 (section 354 applies to the exchange of debentures for stock in Revenue Ruling 70-41).

[24] 1998-1 C.B. 643.

[25] This is further evidenced by Congress' amendments to section 361(b)(3) and (c)(3), which contemplate transfers (of property to creditors) not described under section 368.

[26] *See also W.N. Fry. V. Commissioner*, 5 T.C. 1058 (1945) ("However, the answer to the question of whether or not the distribution was one 'in partial liquidation' is not determinative of the tax consequences of the distribution here involved if such distribution was pursuant to a plan of reorganization and there was a reorganization in fact thereunder... The first question arising in natural sequence is whether or not there was a reorganization").

[27] 391 U.S. 83 (1968), *rev'g and remanding*, 382 F.2d 499 (2d Cir. 1967), *aff'g Baan v. Comm'r*, 45 T.C. 71 (1965) (Baan was a consolidated proceeding in the Tax Court involving two taxpayers).

section 355 with respect to the distributions of the Northwest stock received upon exercise of the transferable rights. The Court, however, held otherwise due to the failure to satisfy the distribution requirement of section 355(a)(1)(D).[28] In analyzing that requirement and whether steps should be integrated solely for that purpose, the Court stated:

> The Code requires that 'the distribution' divest the controlling corporation of all of, or 80 [percent] control of, the controlled corporation. Clearly, if an initial transfer of less than a controlling interest in the controlled corporation is to be treated for tax purposes as a mere first step in the divestiture of control, it must at least be identifiable as such at the time it is made. ***Absent other specific directions from Congress, Code provisions must be interpreted so as to conform to the basic premise of annual tax accounting. It would be wholly inconsistent with this premise to hold that the essential character of a transaction, and its tax impact, should remain not only undeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen.*** This requirement that the character of a transaction be determinable does not mean that the entire divestiture must necessarily occur within a single tax year. It does, however, mean that if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps [which collectively satisfy the distribution requirement].[29]

Binding commitments are frequently subject to various contingencies such as regulatory approvals and shareholder votes. In a Spin-off, Distributing is effectively subject to a binding obligation to distribute at least 80% of Controlled's stock to its shareholders under applicable corporate and securities laws due to, among other things, filings with the Securities and Exchange Commission setting forth the plan for the separation based upon which Controlled's stock and securities will trade, Distributing's representations to the Service (if a PLR is obtained), board approvals, etc., and the potential consequences of failing to fulfill such commitments. The presence of these commitments should mitigate any annual accounting considerations and concerns of *Gordon* as such factors are tantamount to a binding commitment. Other than the satisfaction of the distribution requirement, the binding commitment test is unnecessary to preserve the basic premise of annual tax accounting as all taxpayers required to account for the tax consequences of the separation (*i.e.*, each of Distributing, Controlled, and Distributing shareholders and securityholders) will have the necessary information to timely file their tax returns for all tax years during which the separation occurs. In addition to the "annual tax accounting" overlay on the distribution requirement, the Ninth Circuit in *Gordon* also articulated a further requirement that "such distributions [that are necessary to complete the satisfaction of the distribution requirement] must not extend over any greater period of time than is ***reasonably necessary considering the practical problems involved in completing such distributions***."[30] This

[28] *Id*. at 94.

[29] *Id*. at 96 (emphasis added).

[30] *Comm'r v. Baan*, 382 F.2d 485, 498 (9th Cir.1967) (emphasis added). For this reason, the Ninth Circuit held that the distribution requirement was not satisfied as the delay was entirely within PacTel's control. *See id*. at 498 ("It did not require the nearly two-year period which transpired in the instant case to distribute the percentage of Northwest

requirement for the diligent prosecution for the satisfaction of the section 355(a)(1)(D) distribution requirement generally also has been applied for the prosecution and completion of each of the steps contemplated by a plan of reorganization to be treated as occurring "in pursuance of such plan of reorganization."[31]

The courts have applied the traditional "end result" formulation of the step transaction doctrine to determine whether a transaction step qualifies for tax-free treatment under the Operative Provisions.[32] In this regard, we believe *Gordon* is appropriately viewed as providing an alternative form of step transaction analysis (*i.e.*, the binding commitment test) solely for the purpose of determining whether the steps undertaken satisfy the distribution requirement where annual tax accounting considerations are implicated with the consequent potential for the transaction to be "not only undeterminable but unfixed for an indefinite and unlimited period of time."[33] Indeed, the issue of whether each distribution is part of or "in pursuance of the plan of reorganization"[34] is relevant only upon a determination that the requirements of a Divisive Reorganization, including the section 355(a)(1)(D) distribution requirement as interpreted by *Gordon*, are satisfied in the first instance.

3. Scope of the Operative Provisions: "In Pursuance of the Plan of Reorganization"

The "plan of reorganization" requirement of the Operative Provisions applies to all reorganizations – single-entity reorganizations, acquisitive reorganizations, and Divisive Reorganizations. There is no indication of any Congressional intent that the meaning of the phrase should differ in any particular context.[35] Under section 368(a)(1)(D), a Divisive Reorganization

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stock required to fit within the provisions of section 355. The only apparent reason for this delay was Pacific's lack of need for additional capital at the time of the original distribution.").

[31] *See infra* Part V.A.3.ii.

[32] *See, e.g.*, *King Enterprises, Inc. v. U.S.*, 418 F.2d 511, n. 8 (Ct. Cl. 1969); *W.N. Fry. v. Commissioner*, 5 T.C. 1058 (1945). *But see Dunlap and Assocs. Inc. v. Commissioner*, 47 T.C. 542 (1967) (declining to integrate a merger (which qualified under sections 368(a)(1)(A) and (F)) with two section 368(a)(1)(B) reorganizations under the mutual interdependence test based on the unique policy considerations underlying section 368(a)(1)(F) reorganizations and the inappropriate benefit of claiming duplicate surtax exemptions; due to these unique considerations, the step transaction standard invoked in *Dunlap and Associates* appears irrelevant to the determination of whether a step qualifies for tax-free treatment under the Operative Provisions).

[33] *Gordon*, 391 U.S. at 96.

[34] The phrase "in pursuance of the plan of reorganization" is not reflected in the statutory language providing for the section 355(a)(1)(D) distribution requirement.

[35] *See, e.g.*, *Commissioner v. Keystone Consol. Indus., Inc.*, 508 U.S. 152, 159 (1993) ("It is a normal rule of statutory construction that identical words used in different parts of the same act are intended to have the same meaning. Further, the Code must be given as great an internal symmetry and consistency as its words permit." (internal quotations and citations omitted)); *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 87 (1934) ("[T]here is a natural presumption that identical words used in different parts of the same act are intended to have the same meaning." (quoting *Atlantic Cleaners & Dyers, Inc. v. United States*, 286 U.S. 427, 433 (1932)); *CUNA Mut. Life Ins. Co. v. United States*, 169 F.3d 737, 741 (Fed. Cir. 1999) (to the same effect).

generally is defined as a transfer by a corporation of assets to a controlled corporation if, "***in pursuance of the plan***," stock or securities of the controlled corporation are distributed in a transaction that qualifies under section 355.[36] Upon the finding of a Divisive Reorganization, the Operative Provisions governing the tax treatment of Distributing with respect to the receipt and certain dispositions of Controlled stock, Controlled securities, money, or other property are set forth in section 361.

Numerous authorities have considered the relationship between multiple steps in evaluating whether such steps are undertaken as part of or "in pursuance of the plan of reorganization" for purposes of section 368.[37] These authorities address a variety of different circumstances and at times implicate varying policy considerations. Nevertheless, to address the Service's expressed concern with respect to "**Delayed Distributions**"[38] following the date on which Distributing has distributed an amount of Controlled stock constituting "control" within the meaning of section 368(c) (the "**Control Distribution**" and such date, the "**Control Distribution Date**") and the role of the plan of reorganization requirement,[39] the following discussion summarizes certain principles derived from the authorities with a particular focus on the application of the Operative Provisions to transactions undertaken as part of the overall plan of reorganization.[40]

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[36] Section 368(a)(1)(D) (emphasis added).

[37] *See* 2020 Report, at pp. 4-6.

[38] A Delayed Distribution means a Distribution (*i.e.*, a distribution, or one of a series of planned distributions, of Controlled stock, or of Controlled stock and securities, intended to qualify under section 355(a) (or so much of section 356 as relates to section 355) and section 355(c) or a Divisive Reorganization (a "**Section 355 Transaction**")) that takes place after the First Distribution Date (*i.e.*, the date of the earliest Distribution in a series of planned Distributions) and is intended to be "part of the Distribution" (within the meaning of section 355(a)(1)(D)) or "in pursuance of the plan of reorganization" (within the meaning of section 361), as applicable. *See* Rev. Proc. 2024-24, Appendix, sections 2.12.

[39] *See* Notice 2024-38, section 2.02(4) ("In particular, the Treasury Department and the IRS view the Plan of Reorganization requirement as helpful to ensure that Delayed Distributions are not used to avoid the application of the repeal of *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).").

[40] The step transaction doctrine has been applied to other categories of circumstances in the context of reorganizations such as to determine (i) whether multiple transactions satisfy the definitional requirements of a particular section 368 reorganization, and (ii) the impact of a transaction on a series of other transactions that in isolation would qualify as a section 368 reorganization. *See, e.g.*, *Gordon v. Commissioner*, 391 U.S. 83 (1968) (discussed in the text, *supra*), *rev'g and remanding*, 382 F.2d 499 (2d Cir. 1967), *aff'g Baan v. Comm'r*, 45 T.C. 71 (1965); *American Potash & Chem. Corp. v. United States*, 399 F.2d 194 (Ct. Cl. 1968) (declining to integrate a first step stock acquisition with a planned second step liquidation for purposes of testing as a section 368(a)(1)(C) reorganization due to failure of the first step to qualify as a section 368(a)(1)(B) reorganization); *Anheuser-Busch Inc. v. Commissioner*, 40 B.T.A. 1100, 1106-7 (1939), *aff'd* 115 F.2d 662 (8th Cir 1940) (effectuation of subsequent drop-down of assets by the acquiring corporation was pursuant to the plan of reorganization since it was a "contemplated possibility under the plan"); *Campbell v. Commissioner*, 15 T.C. 312 (1950) (no evidence that subsequent drop-down of stock by the acquiring corporation was contemplated as part of the plan of reorganization); Rev. Rul. 2008-25, 2008-1 C.B. 986 (involving a first step reverse subsidiary merger that failed to qualify as a section 368(a)(1)(A) reorganization by reason of section 368(a)(2)(E) due to subsequent liquidation of the target corporation "as part of an integrated plan"). Given the varied contexts in which such issues have arisen, the authorities not surprisingly have

Treasury Regulation section 1.368-2(g) sets forth the guiding principle that "***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***."[41] The Tax Court has stated that "[t]he concept of 'plan of reorganization', as described in section 1.368-2(g) … is one of ***substantial elasticity***."[42]

Establishing an appropriate capital structure through the allocation and satisfaction of liabilities for all types of reorganizations, both acquisitive and divisive, is a fundamental feature and an "ordinary and necessary incident of the conduct" of the businesses of the parties to the reorganization (*e.g.*, Distributing and Controlled). As will be discussed below, we believe transactions contemplated and intended at the commencement of the plan of reorganization – including potential adjustments or alternatives – that are necessary to achieve, or in furtherance of, the business purposes for the reorganization are appropriately respected as "pursuant to the plan of reorganization" if effectuated. The determination of what is necessary or in furtherance of the business purposes properly allows for flexibility during the course of the implementation of the plan.

i. Transactions Pursuant to the Plan of Reorganization May Precede the Consummation of the Reorganization Qualification Transactions

While *Gordon* focused on the application of the step transaction doctrine to a specific requirement for a nonrecognition transaction, *King Enterprises, Inc. v. U.S.*[43] considered the application of the step transaction doctrine more broadly to determine whether a stock acquisition was pursuant to a plan of reorganization. In *King Enterprises*, Minute Maid Corporation ("**Minute Maid**") entered into an agreement on September 3, 1959, to acquire the stock of Tenco, Inc. ("**Tenco**") for a mix of consideration of which Minute Maid stock comprised in excess of 50%. The stock acquisition occurred that same day.[44] On December 10, 1959, Minute Maid's directors

referenced multiple standards in determining the relationship of a given transaction to a potential reorganization. *See also* Elliott Manning, "'In Pursuance of the Plan of Reorganization': The Scope of the Reorganization Provisions of the Code," 72 Harv. L. Rev. 881, 896 (1959); Peter L. Faber, "The Use and Misuse of the Plan of Reorganization Concept," 38 Tax L. Rev. 515, 516 (1983); Sara B. Zablotney, "Sticking to your Resolutions: Acting under a Plan of Reorganization," 163 Tax Notes 29, at 34 (April 1, 2019) ("Interpretations of the plan of reorganization concept by the IRS and the courts have been chaotic, and the requirement is little discussed in treatises."). Part VI.C.3 below provides additional background on the step transaction doctrine more generally.

[41] Treas. Reg. § 1.368-2(g) (emphasis added).

[42] *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75, 96 (1995) (emphasis added).

[43] 418 F.2d 511 (Ct. Cl. 1969).

[44] Although not cited in the opinion, the date of the stock acquisition is set forth in the PLR provided with respect to such acquisition. *See* PLR 6002256580A (Feb. 25, 1960).

approved its general counsel's recommendation of November 24, 1959, to merge Tenco into Minute Maid, and the merger was consummated on April 30, 1960. The court stated that "[i]t is not disputed that there was a Type A reorganization in April 1960 when Tenco and Minute Maid were merged… The disagreement centers on whether the initial exchange of stock was a step in a unified transaction ***pursuant to a 'plan of reorganization***.'"[45] Assuming the stock acquisition was pursuant to an overall plan of reorganization, the taxpayer, a shareholder of Tenco, among other things would be entitled to nonrecognition on the portion of the consideration received consisting of Minute Maid stock. If it were not pursuant to the overall plan of reorganization, as contended by the Service, the taxpayer would recognize gain equal to the excess of the total value of the consideration received over its adjusted basis in its Tenco stock.

The court rejected the Service's contention that *Gordon* precluded the initial stock acquisition from being considered together with the subsequent merger due to the absence of a binding commitment:

> The opinion in Gordon contains not the slightest indication that the Supreme Court intended the binding commitment requirement as the touchstone of the step transaction doctrine in tax law. Nor is there any indication that the Court intended to overrule any prior decisions applying the step transaction doctrine to other types of transactions where there were no binding commitments. On the contrary, the opinion addressed a narrow situation (a D reorganization) involving a specific statutory requirement (divestiture of control), and limited the potential for dilution and circumvention of that requirement by prohibiting the indefinite extension of divestiture distributions. Its interpretation should be so limited. Clearly, the step transaction doctrine would be a dead letter if restricted to situations where the parties were bound to take certain steps.[46]

The *King Enterprises* court applied the end result formulation of the step transaction doctrine and concluded that the merger was "the intended result of the transaction from the outset."[47] The court then held that "the initial exchange and subsequent merger were steps in a unified transaction qualifying as a Type A reorganization, and that petitioner received its Minute Maid stock pursuant to the plan of reorganization,"[48] notwithstanding that its commencement and completion spanned two taxable years and that the final step of the reorganization was not pursuant

[45] *Id*. at 515 (emphasis added).

[46] *Id*. at 518 (emphasis added; citations omitted).

[47] *Id*. at 518-19 ("the record reveals that, prior to the acquisition of Tenco stock, the officers of Minute Maid considered merging its existing subsidiaries into the parent in order to eliminate some of the general ledgers and extra taxes, and to bring about other savings. . . The operative facts in this case clearly justify the inference that the merger of Tenco into Minute Maid was the intended result of the transaction in question from the outset"). The Service has favorably cited *King Enterprises* in two multi-step reorganization revenue rulings. *See* Rev. Rul. 2001-26, 2001-1 C.B. 1297; Rev. Rul. 2001-46, 2001-2 C.B. 321.

[48] *Id*.

to a binding commitment in effect as of the time of the initial acquisition in the earlier taxable year.[49]

J.E. Seagram Corp v. Commissioner[50] also involved the determination of whether a stock acquisition and a subsequent merger of the target occurred pursuant to a plan of reorganization. J.E. Seagram Corp. was the parent of an affiliated group of corporations whose subsidiary ("**JES Tenderor**") was engaged in a competing tender offer with a subsidiary of DuPont for the acquisition of Conoco. At the completion of the dueling offers, the terms of which were amended at various times, DuPont emerged as the victor having acquired shares of Conoco for a combination of cash and shares of its stock. JES Tenderor subsequently tendered the shares of Conoco stock it acquired to DuPont for DuPont stock and took the position that such exchange was taxable, thereby resulting in a loss on the exchange. However, subsequent to this exchange and pursuant to a binding agreement, Conoco was merged into a subsidiary of DuPont. The court noted that no dispute existed as to whether the subsequent merger qualified under section 368(a)(2)(D)[51] and then addressed J.E. Seagram's contention that "the exchange of its Conoco common stock for DuPont common stock was not done in pursuance of a plan of reorganization." This contention was based on the taxpayer's assertion that various contingencies "could well have resulted in DuPont's tender offer closing but not the merger."[52]

In rejecting taxpayer's contention, the Tax Court explicitly stated that "***[t]he concept of 'plan of reorganization' … is one of substantial elasticity***."[53] The court also cited *King Enterprises*, which as noted above, applied the end result test in a transaction that also involved a tender offer and subsequent merger. Although setting forth an elastic test that necessarily would be satisfied based on a much less rigid standard than the binding commitment test, the determination of the existence of a plan on the facts in *J.E. Seagram* was straightforward due to the existence of a binding commitment for the back-end merger.

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[49] Like *King Enterprises*, subsequent cases also have recognized the notion that the step transaction doctrine would be a "dead letter" if *Gordon* were interpreted as a broad adoption of the binding commitment test beyond the specific statutory requirement at issue in *Gordon*. *See e.g., Penrod v. Comm'r*, 88 T.C. 1415, 1429-34 (1987) (quoting "dead letter" language from *King Enterprises*; refusing to step sale of acquiring stock with earlier issuance of acquiring stock in acquisition of target stock based on lack of binding commitment and failure of interdependence test and end-result test as a result of lack of intent by shareholders to sell the acquiring stock at the time of the receipt of such stock in the original acquisition); *H.J. Heinz Co. v. U.S.*, 76 Fed. Cl. 570, 589 n.32 (2007) ("[R]ejecting the application of the step transaction doctrine based upon the absence of such commitments has been viewed as problematic. Recognizing this, the Court of Claims rejected the use of the binding commitment test in *King Enters*…. This view was confirmed by *Falconwood*, 422 F.3d [1339 (Fed. Cir. 2005)] at 1349 n.5."). *See also Redding v. Commissioner*, 630 F.2d 1169, 1178 (7th Cir. 1980) (section 355(a)(1)(D) distribution requirement not satisfied under all three formulations of the step transaction doctrine and, in the context of such requirement, noting the absence of a binding commitment as relevant but not determinative with respect to the distribution of the Controlled stock through issuance and exercise of warrants completed within the same taxable year), *cert. denied*, 450 U.S. 913 (1981).

[50] 104 T.C. 75 (1995).

[51] *Id*. at 93.

[52] *Id*. at 95.

[53] *Id*. at 96 (emphasis added).

ii. Timing Considerations: Delayed Completions of the Plan of Reorganization

At the outset, we agree with the Service[54] that the temporal proximity or simultaneity of an exchange or distribution, alone, is insufficient to invoke the application of the Operative Provisions with respect to such an exchange or distribution.[55] On the other hand, the time period required to effectuate a reorganization is immaterial once it is determined that a step or series of steps in the transaction is in pursuance of the plan of reorganization (*i.e.*, as discussed below, a step or series of steps has been pursued consistently and diligently in a manner taking into account the practicalities of implementing the reorganization and good business judgment exercised for the purpose of optimally achieving its business objectives).[56] Stated differently, the length of time between steps alone is not determinative as to whether a step or series of steps is "pursuant to the plan of reorganization."

In *Douglas v. Commissioner*,[57] under a plan of reorganization agreed upon in 1928, a target corporation transferred its assets to a newly organized acquiring corporation for all 200,000 shares of the acquiring corporation's stock, which were to be issued to the shareholders of the target upon their surrender of the target stock. Due to the non-assignability of the contracts held by the target and disputed claims against it, the target could not immediately dissolve. As a result, the directors of the target corporation adopted resolutions on December 11, 1928, to make a partial distribution of 190,000 shares of the acquiring corporation and to hold the remaining 10,000 shares "in the treasury of this company for further distribution to the stockholders of this company in completion of the plan of reorganization."[58] After the applicable contracts had been completed and the liabilities resolved, the target corporation dissolved and distributed the remaining acquiring corporation stock to its shareholders in 1933. The court held that the 1933 distribution, more than four years after the target corporation adopted resolutions for the "further distribution" of the

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[54] *See* Notice 2024-38, section 2.02(4) ("[I]t is the understanding of the Treasury Department and the IRS that some tax advisors incorrectly view the applicability of the Plan of Reorganization requirement to be potentially obviated by the temporal requirements that were set forth in section 3.04(6) of Rev. Proc. 2018-53.").

[55] *See, e.g.*, *International Telephone & Telegraph Corp. v. Comm'r*, 77 T.C. 60, 77-78 (1981), *aff'd* 704 F.2d 252 (2d Cir. 1983) (target corporation acquired in a triangular "C" reorganization with target debt holders receiving the right to convert acquiring corporation debt into stock of acquiring corporation's parent; "subsequent unilateral action" by holders to convert debt was not part of reorganization; "no evidence that the debenture holders were ever approached to convert their bonds"); *see also* Treas. Reg. § 1.301-1(j).

[56] *See also* 1984 JCT Report, at p. 190 (providing as follows with respect to the addition of the distribution requirement under section 368(a)(2)(G): "The Act does not require that the distribution be completed within a specified time period. However, the Congress anticipated that the distribution will take place ***reasonably promptly*** …") (emphasis added). In 1984, section 368(a)(2)(G)(i) was enacted to provide that "[a] transaction shall fail to meet the requirements of paragraph (1)(C) unless the acquired corporation distributes the stock, securities, and other properties it receives, as well as its other properties, ***in pursuance of the plan of reorganization***." *Cf. Baan*, 382 F.2d at 498 (as to the section 355(a)(1)(D) distribution requirement, notwithstanding any binding commitment, distributions must occur as soon as reasonably practicable without unnecessary delay).

[57] 37 B.T.A. 1122 (1938)

[58] *Id.* at 1125.

remaining 10,000 shares of acquiring corporation stock, was in pursuance of the plan of reorganization as contemplated. The court determined that the plan never changed and therefore the "lapse of time was not decisive."[59] In other words, once it was determined that the plan of reorganization included the distribution of the remaining 10,000 shares and that such plan had not changed, it was irrelevant that there was a delay for such distribution.[60]

Other courts have similarly confirmed that a time delay alone does not preclude an exchange or distribution from being in pursuance of a plan of reorganization assuming a "reasonable cause" exists for the delay. *W.N. Fry. v. Commissioner*[61] involved a transaction that was intended to qualify as a reorganization under the predecessor to section 368(a)(1)(D), which at such time did not require any distribution by the target corporation, whether of the stock of the acquiring corporation or of any other property. Specifically, in 1933, the target corporation ("**Old Bank**") transferred its assets to the acquiring corporation ("**New Bank**") in exchange for stock which it pledged to secure Old Bank debt, rather than distributing the stock to its shareholders immediately upon receipt. Such stock, if any remained, would not be distributed prior to repaying certain indebtedness and the stock being released from the pledge. Approximately 50% of the stock received by Old Bank in the reorganization was released from the pledge in 1939, some six years after the reorganization, and distributed to the Old Bank shareholders.

The taxpayer was a shareholder of Old Bank that received shares in New Bank in the 1939 distribution and asserted the stock of New Bank received in exchange for its Old Bank stock occurred in an exchange that was "pursuant to a plan of reorganization" and therefore tax-free under then section 112(b). Section 112(b)(3), the predecessor to section 354(a), provided that "[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a

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[59] *Id.* at 1128. *See also Spangler v. Commissioner*, 18 T.C. 976, 984 (1952) ("The ***delay*** of 3 months and 10 days in obtaining the necessary endorsements of trustee's receipts ***does not preclude the subsequent stock redemption exchange from being in pursuance of the plan of reorganization***. The plan had included this distribution of Permian stock as evidenced by the letter to the stockholders.") (emphasis added); *Wilson v. Commissioner*, 20 T.C.M. (CCH) 676, 688 (1961) (lapse of three years in the issuance of acquiring stock to target shareholders; "Does this lapse of three years' time prevent the reorganization from qualifying as a statutory C-type reorganization? We do not think so. Neither the statute nor the Treasury Regulations set any time limit within which the reorganization transactions must be completed. In *Douglas*, 37 B.T.A. 1122, the lapse of five years' time from the beginning of the reorganization in 1928 until its completion in 1933 did not prevent a reorganization from coming within a statutory definition similar to the one here in issue. ***The mere lapse of time is not decisive. The important thing is that the steps which are taken evidence a consistent performance of the reorganization plan and purpose.***") (emphasis added); *cf. Carlberg v. U.S.*, 281 F.2d 507, 514 (8th Cir. 1960) (in contest of whether issue of certificates of contingent interest to target shareholders upon merger of two corporations were stock or other property, delay in distribution of the reserve shares "is apparently immaterial, and not itself fatal to their qualification as stock" under section 354(a)(1); citing *Fry, Douglas, Spangler*, and *McAbee*, 5 T.C. 1130, 1150). *See also* PLR 202128001 (Apr. 19, 2021) (described in the text, *infra*). We acknowledge that PLRs are not precedent and cite them only for the purpose of noting the considered views of the Service.

[60] *See also Douglas*, 37 B.T.A. at 1128 ("[T]he act contains no limitation as to time and specifies no time within which an exchange must be made.").

[61] 5 T.C. 1058 (1945).

reorganization are, ***in pursuance of the plan of reorganization***, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."[62]

In analyzing whether the exchanges were pursuant to the plan of reorganization, the Tax Court focused upon a presentation to the Old Bank shareholders at a shareholder meeting documenting the intent of the plan to preserve equity for the shareholders and from which the court quoted extensively.[63] As part of the presentation, it was noted that:

> [T]he committee 'devised one or more plans whereby [it] ***hoped***, * * * to take care of the stockholders of this bank and see, if out of an orderly liquidation of the assets of the old bank, and the formulation of a new bank to take over the deposits * * * we could not save the stockholders their investment in the Bank of Commerce & Trust Company' [(*i.e.*, Old Bank)]; . . . that 'the assets of this bank must be liquidated in a proper and orderly way, * * * in order to ***net the most*** from the liquidation of the old bank so that its debts can be paid and the equity in its assets (***including the equity in the old bank's stock in the new bank***) turned over to you, as stockholders of the Bank of Commerce & Trust Company'; and that 'When the rest of the assets are liquidated and the creditors are paid off, what remains (***including the old bank's stock in the new bank if it remained***) will be distributed to the stockholders.'[64]

Based on the shareholders meeting – particularly the minutes – the court concluded that the 1939 distributions, even though completed six years after the adoption of the plan of reorganization and the consummation of the asset transfer which satisfied the definitional reorganization requirements, were made "pursuant to the plan of reorganization."[65] In concluding that the acquiring corporation stock was distributed in pursuance of the plan of reorganization, the court stated that a "***[m]ere delay in such distribution, where due to reasonable cause, is immaterial, once the existence of a plan is established***."[66]

More recently, in PLR 202128001,[67] the Service blessed a proposed acquisitive section 368 reorganization of a heavily regulated business implemented through a "drop-and-check" structure

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[62] *Id*. at 1066 n.2 (emphasis added). The Service argued that the distribution was in partial liquidation of the Old Bank. The Tax Court noted that the question of whether the distribution is in partial liquidation is not determinative of the tax consequences if there was a reorganization and the distribution was in pursuance of the reorganization, in which case there would be no gain or loss on the distribution.

[63] *See id.* at 1069-1070.

[64] *Id*. (emphasis added).

[65] *Id*. at 1070 ("We think it is apparent from what appears on the minutes of the meeting of the stockholders and the meeting of the board of directors of the old bank, as above recited, and there is nothing in material contradiction thereof, that distributions of the stock of the new bank made to the stockholders of the old bank in 1939, including that made to petitioner, were made as a part of and pursuant to a plan of reorganization and in compliance therewith.").

[66] *W.N. Fry*, 5 T.C. at 1071 (emphasis added).

[67] (Apr. 19, 2021).

where the consummation of the plan potentially required five years to complete. Due to significant temporal requirements anticipated for the requisite multi-step judicial and regulatory approvals as well as the asset transfers on a contract-by-contract basis, the proposed transactions were estimated to take approximately five years to complete, culminating with a legal dissolution of the target corporation (or an entity classification election to treat the target as disregarded).[68] The following representation was provided in support of the ruling, consistent with *Fry* and *Douglas*:

> Taxpayer will execute the Proposed Transactions ***as soon as legally and practicably possible***. Taxpayer will not prolong the Proposed Transactions under the plan of reorganization and will proceed with the Proposed Transactions ***in a commercially reasonable manner*** in accordance with the direction of regulators.

Consistent with the foregoing authorities, the Service favorably ruled that the steps would be treated as occurring in pursuance of the plan of reorganization as required under Treas. Reg. § 1.368-1(c).

There would appear to be no principled basis for adopting a different standard from those applied in PLR 202128001 and the above-discussed precedents to qualify intended distributions of Controlled stock or securities to Distributing shareholders and/or creditors as occurring pursuant to the plan of reorganization in the Divisive Reorganization context. In turn, where such distribution steps of a Divisive Reorganization are prosecuted consistently and diligently, taking into account practicalities of implementing the plan and good business judgment exercised for the purpose of optimally achieving the business objectives motivating the reorganization (*e.g.*, establishing sound capital structures for each of Distributing and Controlled), the consummation of those steps under such circumstances should be respected as occurring pursuant to the plan of reorganization subject to the Operative Provisions notwithstanding any delay occasioned by constraints such as changing financial conditions or market disruptions.[69] To the extent a delay in the completion of the plan of reorganization raises a concern as to whether a genuine separation has been accomplished, it is reasonable to expect extra scrutiny would be applied to the business purpose requirement of Treas. Reg. § 1.355-2(b) (the "**Business Purpose Requirement**") and the non-device requirement under section 355(a)(1)(B) and Treas. Reg. § 1.355-2(d) (the "**Non-Device Requirement**") , which are designed to ensure that the separation is within the intendment of the statute.

iii. Contingencies and Amendments to the Plan of Reorganization

The flexibility intended by the plan of reorganization requirement is evident from the caselaw establishing that temporal proximity (or lack thereof) is not determinative for whether transactions are "in pursuance of the plan of reorganization." Implicit in these authorities is the

[68] From the face of the ruling, it is unclear why the entity classification election could not be made prior to the completion of the asset transfers.

[69] As discussed below in Part V.B, for circumstances involving one or more Delayed Distributions following the Control Distribution Date, we believe the heightened standard of the Non-Avoidance Requirement should potentially apply only upon the determination that one or more of such distributions fails to constitute a transfer that occurs "in pursuance of the plan of reorganization" qualifying for treatment under the Operative Provisions.

principle that, so long as "acts" that otherwise would constitute "in pursuance of the plan of reorganization" (*i.e.*, transactions generally contemplated at the outset that are in furtherance of the non-tax business objectives motivating the overall reorganization) are consistently and diligently prosecuted, taxpayers are afforded flexibility and optionality to implement or modify the particular steps (or "acts" per Treasury Regulation section 1.368-1(c)) in a manner that best achieves the objectives of the separation.

The mere fact that a delay in effectuating a contemplated exchange or distribution may involve the resolution of uncertainties or contingencies does not, by itself, preclude either (i) the existence of a plan of reorganization, or (ii) the delayed exchange or distribution from occurring in pursuance of such plan and thus being governed by the Operative Provisions. As emphasized in *J.E. Seagram*, the existence of contingencies or conditions that could have prevented the completion of the reorganization is irrelevant as long as the intended transaction did in fact close as planned.[70] Similarly, in *Wilson v. Commissioner*,[71] although the parties to a reorganization under the predecessor to section 368(a)(1)(C) were in agreement that the acquiring corporation would issue shares of its stock to the target corporation's shareholders as consideration, the parties did not reach agreement on the precise percentage of shares to be issued as of the time of the property transfer, and such shares were not in fact fixed and issued until approximately three years later. In determining that the property conveyance and share issuance were "***done in pursuance of an existing 'plan of reorganization***,'"[72] the court acknowledged that "the plan was not worked out in every detail," but nevertheless found that the "broad agreements on an assets-for-stock corporate combination show that a 'plan of reorganization' had been adopted prior to the transactions under consideration."[73] In other words, all material terms of a plan of reorganization need not be fixed upon its commencement for the transactions contemplated therein to be pursuant to such plan of reorganization.

Indeed, in *Fry*, the shareholder meeting referenced only the "hope" that assets would remain for distribution to shareholders," and the target corporation was allowed six years to achieve the objective to "***<u>net the most</u>*** from the liquidation of the [target corporation] so that its debts can be paid and the equity in its assets (including the [stock of the acquiring corporation if it remained]) turned over to [shareholders]."[74] In this regard, the objectives of the target corporation

[70] *J.E. Seagram*, 104 T.C. at 94-95.

[71] 20 T.C.M (CCH) 676 (1961).

[72] *Id*. at 687 (emphasis added).

[73] *Id*. ("Although it is obvious this plan was not worked out in every detail regarding the exact amount of stock which would necessarily be involved, . . . it had been agreed that the [target] shareholders would end up with approximately two shares of [acquiring] stock for every one held by the [acquiring] shareholders prior to the merger."); *see also Douglas*, *supra* n. 57, 37 B.T.A. at 1128 (delay in distribution of stock of the acquiring corporation to target shareholders because of a need to complete contracts and resolve certain liabilities before dissolving the target corporation did not preclude the ultimate distribution three years after the contribution from being treated as in pursuance of the plan of reorganization).

[74] *W.N. Fry*, 5 T.C. at 1069-70 (emphasis added); *see also id*. ("When the rest of the assets are liquidated and the creditors are paid off, ***<u>what remains (including [the target corporation's] stock in [the acquiring corporation] if it</u>***

in *Fry* are comparable to those of Distributing to "net the most" of the Section 361 Consideration, whether through transfers to creditors, distributions to shareholders, or other dispositions, in each case, for "reasons germane to the continuance of" Distributing's business. The specifics for ***how*** the objectives in *Fry* could best be achieved, we believe, necessarily involved taking into account practical considerations and good business judgment by the target corporation over the course of the six-year liquidation process.

Thus, even though a step related to those steps described as a reorganization is contingent, it may nonetheless be part of the overall transaction and in pursuance of the plan of reorganization if in furtherance of the objectives of the reorganization.[75] This is consistent with the prior law treatment of a contemplated target corporation liquidation as part of a section 368(a)(1)(C) reorganization being "pursuant to the plan of reorganization" if effectuated,[76] as Congress intended to accommodate both taxable and tax-free dispositions of section 361 Consideration received by the target corporation that are undertaken in pursuance of the plan of reorganization.[77] Subject to the requirement of *Gordon* with respect to qualification of the transaction under section 355 to protect the annual tax accounting premise, affording Distributing the flexibility to react and take into account changing dynamic market conditions and other occurrences in determining how best to achieve the business objectives for the separation is wholly consistent with the intended "substantial elasticity" inherent in the concept of a "plan of reorganization."

B. Distinct Treatments for Delayed Distributions Versus Retentions

1. Notice 2024-38 and Revenue Procedure 2024-24

To the extent Distributing continues to own Controlled stock for some period of time following the Control Distribution Date, Notice 2024-38 provides the following framework:

> The Code provides separate and distinct treatment for three types of instances in which Distributing temporarily continues to hold Controlled stock or securities following the Control Distribution Date. These three instances occur with regard to: (a) a Delayed Distribution of Controlled stock or securities that is "part of the

remained) will be distributed to the stockholders.") (emphasis added). We note the facts of *Fry* are analogous to the facts presented in the PLRs that include Backstop Retention Rulings (defined below) with respect to potential taxable sales of Controlled stock or securities (to the extent not distributed under section 361(c)) following the Control Distribution Date. *See infra* n. 94.

[75] *See also* Rev. Rul. 71-364, 1971-2 C.B. 182. In this ruling, the target corporation in a section 368(a)(1)(C) reorganization retained a small amount of cash to pay dissolution expenses. In the first situation, the distribution of any excess cash that remained following the payment of dissolution expenses to former target shareholders approximately one year following the asset transfer was governed by section 356. In the second situation, the transfer by the target corporation of any excess cash that remained approximately one year following the initial asset transfer to the acquiring corporation was treated as part of the section 361(a) exchange.

[76] *See Muskegon Motor Specialties Co. v. Commissioner*, 45 B.T.A. 551, 558 (1941), *aff'd* 134 F.2d 904 (6th Cir. 1943) ("We regard it as now settled law that an optional procedure 'will be treated as a part of the plan if it is a contemplated possibility under the plan and actually eventuates.'") (citing *Anheuser-Busch Inc. v. Commissioner*).

[77] *See supra* n. 22 (quoting 1984 JCT Report).

> distribution" (within the meaning of § 355(a)(1)(D)); (b) a Delayed Distribution of Controlled stock or securities that is "in pursuance of the plan of reorganization" (within the meaning of § 361); and (c) a Retention.[78] The Treasury Department and the IRS have provided required representations, information, and analysis in Rev. Proc. 2024-24 to reflect the discrete application of the Code to each of these instances.[79]

The revised ruling guidelines set forth in Revenue Procedure 2024-24 with respect to Delayed Distributions and Retentions incorporate this same framework.[80] Under the Service's revised ruling practice, to the extent Distributing expects to own Controlled stock following the Control Distribution Date, the Service will now consider rulings requested under either (i) sections 355(c) or 361(c), or (ii) section 355(a)(1)(D)(ii), but not both, with respect to the same shares of Controlled stock (the "**Pick-a-Lane Ruling Policy**").[81]

The basis for this framework and revised ruling policy, in part, appears to be driven by concerns regarding the level of specificity required by, and the degree of flexibility or optionality allowed in, a "plan of reorganization." In turn, Notice 2024-38 identifies the plan of reorganization requirement as helpful to ensure that Delayed Distributions are not used to avoid the application of the repeal of *General Utilities & Operating Co. v. Helvering*.[82] As a result, Revenue Procedure 2024-24 requires an unprecedented amount of detail and commitment to each aspect of a potential plan of reorganization prior to its commencement to qualify as such for advance ruling purposes,[83] with the stated justification that it is necessitated by concerns of "administra[bility] and enforcement."[84]

i. Substantive Considerations

The failure of the statute to address with specificity what constitutes a "retention" within the meaning of section 355(a)(1)(D)(ii) presents some uncertainty in the context of a Divisive

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[78] As defined in Revenue Procedure 2024-24, a "Retention" is the continued ownership by Distributing of "Retained Controlled Stock (or Securities)" after the Control Distribution Date, and "Retained Controlled Stock (or Securities)" is Controlled stock (or securities) that Distributing does not intend to distribute or otherwise dispose of as part of the distribution (within the meaning of section 355(a)(1)(D)) or in pursuance of the plan of reorganization (within the meaning of section 361). *See* Rev. Proc. 2024-24, Appendix, sections 2.37 and 2.38.

[79] Notice 2024-38, section 2.02(1).

[80] *See, e.g.*, Rev. Proc. 2024-24, secs. 3.01(1)(b), 3.03(2)(a), and 3.03(3). Representations 2 through 6 are required to obtain a ruling that a "Retention" satisfies the requirements of section 355(a)(1)(D)(ii) but are not otherwise required with respect to a ruling that a "Delayed Distribution" is treated as "part of the distribution" (within the meaning of section 355(a)(1)(D)) or "in pursuance of the plan of reorganization" (within the meaning of section 361).

[81] *See* Rev. Proc. 2024-24, section 3.03(3)(a)(ii), (b)(iii).

[82] 296 U.S. 200 (1935).

[83] *See generally* Rev. Proc. 2024-24, section 3.05(1).

[84] *See* Rev. Proc. 2024-24, section 2.01(4)(d).

Reorganization as to the implications of the temporary continued ownership by Distributing of Controlled stock[85] following the Control Distribution Date until its later distribution in pursuance of the plan of reorganization under section 361 (*i.e.*, through one or more Delayed Distributions).[86] The imposition of a heightened burden of proof by reason of the Non-Avoidance Requirement with respect to Controlled stock that is distributed pursuant to the plan of reorganization (or as part of the distribution described in section 355(a)(1)(D)) would be contrary to the very intent of the Operative Provisions to provide nonrecognition treatment to such transactions. This view is validated by the Guidance, which subject only the Controlled stock not disposed of pursuant to section 355(c) or section 361(c) to heightened scrutiny under section 355(a)(1)(D)(ii).

While aspects of the framework set forth in Notice 2024-38 and reflected in Revenue Procedure 2024-24 are directionally correct (*i.e.*, Controlled stock transferred in Delayed Distributions qualifying under section 355(c), that is "part of the distribution," or under section 361(c), that is "in pursuance of the plan of reorganization," in each case whether before after the Control Distribution Date, is not retained stock for purposes of section 355(a)(1)(D)(ii)), the framework otherwise deprives taxpayers of the intended "elasticity" inherent in the reorganization provisions that permits the parties to a reorganization to factor in and respond to changing or developing facts in furtherance of the business purposes for the reorganization.

Notice 2024-38 acknowledges that the "plan of reorganization" requirement incorporates a degree of "transactional flexibility," but indicates that such flexibility is constrained by current Treasury Regulations. It is our understanding that such constraint forms the basis under the Pick-a-Lane Ruling Policy for requiring Distributing to identify and commit, at the outset of the commencement of the plan of reorganization, the Section 361 Consideration that will or will not be transferred under section 361(c). We respectfully believe that such an interpretation of the Treasury Regulations is incorrect. In part, the Treasury Regulations provide:

> "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***. ***Such transaction*** [*i.e.*, the section 368(a) reorganization] and ***such acts*** [*i.e.*, transfers under the Operative Provisions] must be an ***ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise***. . ." [Treasury Regulation section 1.368-1(c).]
>
> ". . . 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***.

[85] Unless the context otherwise requires, references to Controlled stock include Controlled securities, and a distribution in pursuance of the plan of reorganization includes a transfer to a creditor in connection with the plan of reorganization within the meaning of section 361, as applicable.

[86] *See* Prior 2024 Report at p. 37.

Section 368(a) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms." [Treasury Regulation section 1.368-2(g).]

At issue in Notice 2024-38's framework, as reflected in the Pick-a-Lane Ruling Policy, is the transactional flexibility to engage in a disposition of Controlled stock or securities under the Operative Provisions (including the timing for such a disposition) or as a taxable disposition depending on all of the relevant facts and circumstances (*e.g.*, changes during the course of implementing the separation during the course of implementation due to dynamic market conditions, severe deterioration of Distributing's financial condition, etc.). The above Treasury Regulations thoughtfully require that the "requisite acts" for which nonrecognition is claimed must be an ordinary and necessary "incident" of the conduct of the enterprise providing for its continuation. So, the act and whether it is "necessary" is properly evaluated not by reference to a "plan" as initially conceived that cannot contemplate and provide for all changing conditions at the outset of the separation journey, but whether the contemplated act best fulfills the business objectives of the plan of reorganization itself (*i.e.*, "[the] reasons germane to the continuance of the business," including the establishment of an appropriate capital structure and financial health of the enterprise).

In contrast, as noted above and will be discussed below, the Pick-a-Lane Ruling Policy in effect requires taxpayers to designate at the outset, often as early as 12 to 18 months prior to the anticipated commencement of the separation, the specific amount of Controlled stock for which nonrecognition treatment under the Operative Provisions will not be claimed and thus constitutes "Retained Controlled Stock"[87] as a condition for those shares to be eligible for section 355(a)(1)(D)(ii) rulings for PLR purposes. Indeed, with respect to taxpayers who are uncertain that the Distribution Period[88] will be no more than 12 months (the "**12-Month Period**") and therefore cannot provide the required representation (*i.e.*, Representation 1B) for rulings under section 361, it appears that the Service will not entertain the possibility that such Controlled stock would qualify for nonrecognition treatment under the Operative Provisions for PLR purposes notwithstanding the precedents discussed above and the Service's own acknowledgement that timing considerations alone are not determinative for whether a distribution is in pursuance of the plan of reorganization.[89] With respect to taxpayers who plan and intend, for example, for Delayed Distributions following the Controlled Distribution Date to be exclusively comprised of transfers of Controlled stock to creditors in order to reduce leverage, the implementation of such Delayed Distributions instead to shareholders solely as a means of being able to comply with Representation 1B to obtain a PLR would be antithetical to an often critical non-tax deleveraging

[87] "**Retained Controlled Stock**" generally means Controlled stock that Distributing does not intend to distribute or otherwise dispose of (i) as part of the distribution (within the meaning of section 355(a)(1)(D) or (ii) in pursuance of the plan of reorganization (within the meaning of section 361). *See* Rev. Proc. 2024-24, Appendix, section 2.37. We note that this definition of Retained Controlled Stock accommodates the interpretation that even Controlled stock disposed of taxably in pursuance of the plan of reorganization may not constitute a Retention subject to the Non-Avoidance Requirement.

[88] The "**Distribution Period**" means the period of time that begins immediately before the First Distribution and ends immediately after the Final Distribution. *See* Rev. Proc. 2024-24, Appendix, section 2.20.

[89] *See* Notice 2024-38, section 2.02(4).

objective. As discussed in the Prior 2024 Report, because the PLR guidelines, while not law, often have the effect of defining the parameters of what taxpayers and practitioners understand to be acceptable for a Spin-off even if a PLR is not sought,[90] recommendations regarding the substantive implications of the framework set forth in the Notice and reflected in Revenue Procedure 2024-24 are addressed below.

ii. Recommendations

To preserve the intended "elasticity" of a plan of reorganization in affording nonrecognition treatment, we recommend clarifying that all Delayed Distributions, whether before or after the Control Distribution Date, to the extent effected in pursuance of the plan of reorganization and thus subject to section 361, are also treated as part of the distribution (within the meaning of section 355(a)(1)(D)). In other words, any Controlled stock transferred in Delayed Distributions "in pursuance of the plan of reorganization" would not constitute "Retained Controlled Stock" for purposes of section 355(a)(1)(D)(ii). This approach ensures nonrecognition treatment with respect to the receipt of such Controlled stock by qualifying recipients as intended by the plain language of the statute (*i.e.*, recipients eligible to receive Controlled stock or securities tax-free under section 355 are limited to Distributing shareholders and securityholder creditors).[91]

Second, in the case of a transaction otherwise satisfying the requirements under section 355 but which involves Delayed Distributions and does not otherwise contemplate a Retention, we recommend clarification that the Non-Avoidance Requirement may be applicable only if a Delayed Distribution fails to qualify under the Operative Provisions. That is, the mere existence of one or more of the Delayed Distributions following the Control Distribution Date – including those completed more than one year following the First Distribution – alone should not give occasion for the application of the Non-Avoidance Requirement.[92] In such circumstance, upon demonstrating that all Delayed Distributions are either "part of the distribution" subject to section

[90] *See* Prior 2024 Report at pp. 6-7.

[91] If Delayed Distributions to shareholders (or securityholders) under section 361(c) were not treated as "part of the distribution" (within the meaning of section 355(a)(1)(D)), then such treatment could have the anomalous and presumably unintended effect of affording nonrecognition treatment to Distributing under section 361(c) with respect to the disposition of Controlled stock pursuant to the Delayed Distributions, but potentially excluding the receipt of Controlled stock in the Delayed Distributions by those shareholders (or securityholders) from nonrecognition treatment under section 355(a)(1).

[92] In the case of a section 355 transaction, each of section 355(c) and section 361(c) is an express exception to the repeal of *General Utilities* with respect to distributions of "qualified property" where the rigorous requirements under section 355, including the Business Purpose Requirement, are satisfied. As a result, the concern expressed in Notice 2024-38 for the potential to "avoid the application of the repeal of *General Utilities*" appears misguided and contrary to the Service's published guidance. *See, e.g.*, Rev. Rul. 2003-110, 2003-2 C.B. 1083 ("Except as provided in § 355(d) and (e), ***the application of § 355(c) or § 361(c) to distributions that qualify under § 355 is part of the statutory scheme of § 355 and implicit in all such distributions***. Accordingly, the fact that § 355 permits a distributing corporation to distribute the stock of a controlled corporation without the recognition of gain does not present a potential for the avoidance of Federal taxes under § 1.355-2(b). This is further implied by § 1.355-2(b)(3), which provides that the business purpose requirement is not satisfied if the purpose can be achieved through a nontaxable alternative transaction. That is, the distributing corporation is entitled to reject a taxable disposition in favor of a tax-free distribution.").

355(c) or "pursuant to the plan of reorganization" subject to section 361(c) under the normal burden of proof, the requirements of section 355 should be satisfied. Thus, the heightened scrutiny and burden of proof inherent in the Non-Avoidance Requirement should potentially apply only upon a successful challenge by the Service with respect to the qualification of one or more Delayed Distributions under section 355(c) or section 361(c), as applicable.

2. Pick-a-Lane Ruling Policy: Section 361(c) vs. Section 355(a)(1)(D)(ii)

i. Advance Ruling Considerations

The substantial elasticity inherent in a plan of reorganization, which contemplates transactions both within and outside the scope of the Operative Provisions, is complemented by the very structure of section 355, which accommodates gain and loss recognition with respect to Controlled stock through a taxable disposition by Distributing so long as Distributing distributes to its shareholders an amount of Controlled stock constituting section 368(c) control and disposes (*e.g.*, through sales) the remaining Controlled stock within a reasonable time period consistent with, and in furtherance of, the business objectives for the separation.[93] As discussed above, prior to Revenue Procedure 2024-24, the Service had issued protective rulings under section 355(a)(1)(D)(ii) in the event that a Delayed Distribution contemplated at the outset of the adoption of the plan of reorganization either became unavailable or impractical or could not occur within the requisite time period (*i.e.*, Backstop Retention Rulings).[94] As discussed in the Prior 2024 Report, these Backstop Retention Rulings generally serve two separate but related functions. First, such rulings provide confirmation that any Delayed Distribution which in form satisfies the requirements of section 361, but which occurs outside of the requisite time period permitted by a PLR, 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 prevents unexpected taxable sales of Controlled stock or securities that may occur in the event not all of such stock or securities are disposed of in transactions satisfying the requirements of section 361 from jeopardizing the tax-free status of the entire transaction ("**Alternative Transaction Protection**").

While the frequency of such rulings appears to have increased in recent years, this long-standing ruling practice appropriately reflected the significant elasticity of a plan of reorganization

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[93] *See generally* section 355(a)(1)(D). Other than section 355(e), the structure of section 355 has no limitations on a pre-distribution sale or disposition of Controlled stock if section 368(c) control of Controlled is distributed as part of the distribution.

[94] *See, e.g.*, PLR 200301011 (July 2, 2002) (steps (vi) and (ix); rulings (9) (section 355(a)(1)(D)(ii)) and (13) (section 361(c)(3))); PLR 200137011 (June 4, 2001) (step (l); rulings (7) (section 361(c)(3)) and (15) (section 355(a)(1)(D)(ii))). *See also, e.g.*, PLR 201731004 (Feb. 16, 2017) (step 8; rulings (1) (section 355(a)(1)(D)(ii)) and (2) (section 361(c)(1) and (3))); 201634010 (Mar. 1, 2016) (step (9)(ii); rulings (2) (section 355(a)(1)(D)(ii)) and (3) (section 355 and section 361)); PLR 201612012 (Apr. 1, 2015) (steps (lxvii)(f) and (g); rulings (1) (section 355(a)(1)(D)(ii)) and (3) (section 361(c)(1) and (3))); PLR 201330007 (Feb. 5, 2013) (steps (viii), (xiii), and (xv); rulings (8) (section 361(c)(3)), (9) (section 361(c)), (11) (section 355(a)(1)), and (19) (section 355(a)(1)(D)(ii))); PLR 201216023 (Jan. 19, 2012) (steps (4) and (7); rulings (14) (section 361(c)), (15) (section 361(c)), and (16) (section 355(a)(1))); PLR 200944026 (June 29, 2009) (steps (xxix) and (xxx); rulings (95) (section 355(a)(1)(D)(ii)) and (96) (section 361(c))).

but has been abandoned through the Pick-a-Lane Ruling Policy. We believe there is a compelling basis for the Service's advance ruling policy to accommodate the taxpayer's ability to take into account practical considerations and good business judgment in implementing the plan of reorganization to achieve its business objectives. Consider, for example, a circumstance in which Delayed Distributions following the Controlled Distribution Date were intended to be exclusively comprised of transfers of Controlled stock to creditors and in which financial conditions deteriorate far more rapidly than projections had initially indicated following the Control Distribution Date, thus necessitating a prompt taxable disposition of the remaining Controlled stock to a strategic investor. A Backstop Retention Ruling would avoid the uncertainty which otherwise might impact the pricing and timing of such a sale or even the very ability to close the sale itself.

Establishing the appropriate capital structures for each of Distributing and Controlled is a necessary and critical business objective for the continuation of the respective companies and their businesses following the separation. In most circumstances, such capital structures are facilitated by deleveraging Distributing, whether through the satisfaction (with Controlled stock, securities, cash, or other property including non-securities debt of Controlled) or assumption (by Controlled) of liabilities. Substantial non-tax considerations inform (i) the determination to pursue a Debt-for-Equity Exchange, and (ii) once pursued, the ability to successfully accomplish the Debt-for-Equity Exchange and the timing for any such exchange.[95] Due to the inherent complexity and significant stakes in planning and implementing a Divisive Reorganization, a Divisive Reorganization often is contingent upon the receipt of a PLR and contemplates various contingencies, including contingent steps, in recognition of the potential for changes in circumstances that develop over the typically quite lengthy period of planning and implementation (often 24 to 36 months, and sometimes even longer).

The artificial delineations imposed by the Pick-a-Lane Ruling Policy effectively commit a taxpayer to the method and timing for the dispositions of Controlled stock preferred at the commencement of the plan of reorganization and restrict the taxpayer's ability to respond to changes in circumstances that impact how best to accomplish or further the business objectives of the separation. Thus, the Pick-a-Lane Ruling Policy deprives the taxpayer of the substantial elasticity inherent in the concept of a plan of reorganization to exercise its business judgment with respect to the disposition of any remaining Controlled stock that will be held following the Control Distribution Date to accomplish the business objectives for the plan of reorganization. It is not a practical alternative to a Backstop Retention Ruling for taxpayers to seek supplemental rulings for a Delayed Distribution to creditors that either (i) is abandoned for taxable sales within the 12-Month Period, or (ii) cannot be completed during such period, given the uncertain and perhaps unlikely ability to timely secure any such supplemental assurance. In addition, as discussed above, a clean-up distribution to Distributing shareholders of any remaining Controlled stock immediately before the expiration of the 12-Month Period is not a practical alternative to a Backup Retention Ruling where a deleveraging business purpose is a critical non-tax business objective for the separation that is "germane to the continuance of the business of" Distributing.[96]

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[95] *See* Prior 2024 Report at pp. 8-13, 25-26.

[96] Indeed, such a distribution would not only be inconsistent with any deleveraging objectives but would also tend to exacerbate the relative leverage at Distributing by disposing of an asset for no consideration.

We believe that the foregoing establishes the principles that (i) the specifics of a plan of reorganization need not be worked out in every detail,[97] (ii) a plan of reorganization possesses substantial elasticity[98] (including Congress' recognition that transactions "in pursuance of the plan of reorganization" not be limited to those described under the Operative Provisions[99]), and (iii) timing delays for reasonable cause[100] are accommodated in implementing and executing the overall plan of reorganization to achieve its intended business purposes. These principles weigh heavily in favor of abandoning the Pick-a-Lane Ruling Policy.

ii. Recommendations

For all of the foregoing reasons, and as discussed in our Prior 2024 Report, we continue to recommend that the Service make available Backstop Retention Rulings to taxpayers, affording both Extended Timing Protection and Alternative Transaction Protection. Additionally, we reiterate our analysis in the Prior 2024 Report that Backstop Retention Rulings (and the consideration of alternative taxable dispositions of Controlled stock) should not undermine the conclusion that a taxpayer's intended dispositions are "in pursuance of the plan of reorganization."[101] Not only do alternative taxable disposition contingencies not upset a "plan of reorganization," as we discuss in the Prior 2024 Report, but also such dispositions can themselves constitute part of the "plan of reorganization," providing further support for why the Service should consider favorable rulings with respect to Alternative Transaction Protection in the form of Backstop Retention Rulings.

Notwithstanding the foregoing and the recommendations set forth in the Prior 2024 Report, it appears that Treasury and the Service remain concerned with transactions that are completed beyond the 12-Month Period.[102] To address this concern, and if Treasury and the Service are unwilling to resume the prior practice of granting Backstop Retention Rulings, we recommend that (i) the Service issue limited Backstop Retention Rulings to accommodate the potential for taxable dispositions of Controlled stock ***within*** the 12-Month Period pursuant to the plan of reorganization (*i.e.*, Alternative Transaction Protection), with the same set of representations typically accompanying Backstop Retention Rulings prior to Revenue Procedure 2024-24; and (ii) to the extent a taxpayer is uncertain as to whether all of the intended Delayed Distributions following the Control Distribution Date will be accomplished within the 12-Month Period, we recommend that

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[97] *See Wilson*, 20 T.C.M (CCH) at 687.

[98] *See J.E. Seagram*, 104 T.C. at 96.

[99] *See supra* n. 22 (quoting 1984 JCT Report).

[100] *See W.N. Fry*, 5 T.C. at 1071; *supra* n. 56 (quoting 1984 JCT Report). *See also* PLR 202128001.

[101] Prior 2024 Report, at pp. 40-47.

[102] We note that the prosecution of the plan of reorganization over five years or longer due to reasonable delays has been recognized by the courts and the Service, and similarly that the continued ownership of Controlled stock for a period of five years or longer does not preclude a genuine separation under section 355. *See supra* n. 100. *See also* Rev. Rul. 75-469, 1975-2 C.B. 126 and Rev. Rul. 75-321, 1975-2 C.B. 123 (each involving a retention of Controlled stock or securities for an indefinite duration but possibly as long as 15 years in the case of securities).

the Service consider issuing favorable rulings providing qualification under section 361 for Delayed Distributions ***to the extent*** completed within the 12-Month Period. If business exigencies arise within the 12-Month Period that would motivate Distributing to taxably dispose of Controlled stock immediately, it seems beyond question that such transactions lack a tax avoidance motive (as discussed in the Prior 2024 Report). We believe this Alternative Transaction Protection, while falling short of the protection historically afforded by Backstop Retention Rulings, would nevertheless partially mitigate the potential risks inherent in Delayed Distributions that are fundamentally business-driven transactions.

Under this alternative recommended ruling framework, any rulings addressing qualification under sections 355 and 361 for Delayed Distributions completed within such period would be valid to the extent implemented as such, subject to the potential application of the Non-Avoidance Requirement noted below. In other words, the validity of the PLR would be preserved with respect to all aspects of the transaction other than any Delayed Distributions that are completed beyond the 12-Month Period (*i.e.*, qualification as a Divisive Reorganization including, for example, the satisfaction of the Non-Device Requirement, the active trade or business requirement under section 355(b) (the "**Active Trade or Business Requirement**"), and sections 355(d) and (e))[103] assuming all Controlled stock is disposed of in either (i) Delayed Distributions at any time, or (ii) taxable dispositions within the 12-Month Period. If any Delayed Distribution following the 12-Month Period is determined on examination to not have been "in pursuance of the plan of reorganization" (withing the meaning of section 361(c)), or any Controlled stock is otherwise disposed of taxably following the 12-Month Period, then the taxpayer would still (we believe unwarrantedly) be required to satisfy the heightened burden of proof under the Non-Avoidance Requirement for the balance of the PLR to remain intact.

C. Continuing Arrangements

1. Types of Continuing Relationships

Spin-offs are complex processes that often involve the separation of highly integrated businesses. These businesses commonly evolve side by side throughout the life cycle of a company, with centralized and shared functions, and are inextricably tied as a result. As a result, separations require the creation, monitoring, and execution of numerous workstreams (*e.g.*, information technology, regulatory, human resources, legal, business contracts, etc.) involving a variety of stakeholders across a company, and often involving numerous jurisdictions. Breaking apart a company into separate functioning, independent entities takes years. However long, it is never enough time to terminate all entanglements between the companies, regardless of the business reasons necessitating the separation. This commercial reality is demonstrated by the fact that many types of continuing relationships (*e.g.*, those relating to information technology or other transitional support arrangements) are often equally needed in taxable transactions that are generally viewed as "complete separations."

In the context of a public Spin-off, continuing relationships between Distributing and Controlled as a business matter generally are not desired and the parties do everything in their

[103] It remains the case that upon examination, the taxpayer must establish the veracity of all material facts underlying the issuance of any PLR.

power to limit go-forward entanglements. Nonetheless, ongoing relationships, driven by business, commercial, and legal/regulatory realities, are unavoidable. For example, transition services agreements are needed in almost every public Spin-off to provide Controlled with sufficient time to stand up its own back-office and administrative functions that are commonly shared across all business lines (*e.g.*, information technology, human resources, accounting, etc.).[104] Likewise, there is the potential for overlapping directors in almost every Spin-off, as the shareholders of a company prefer some level of continuity while Controlled transitions to becoming a public company.

In addition, certain customary contractual arrangements such as tax and employee matters agreements are required to properly provide for the rights of the parties and govern their responsibilities and obligations following the Spin-off. As another common example, certain types of property (*e.g.*, real estate, leases, or intellectual property) simply cannot be feasibly divided. Thus, agreements such as shared site agreements, subleases, and intellectual property license agreements may be required for an extended period of time (or, in the case of intellectual property, potentially indefinitely).

Certain industries may require more ongoing interconnection than others. For example, some industries may require longer-term commercial arrangements, such as manufacturing and supply agreements, to allow for the provision of an uninterrupted supply of product to customers while new facilities are being acquired or built, or because the use of third-party contractors is common. Likewise, in regulated industries, authorizations to market or distribute a product may not be easily transferred and are dictated by third parties not concerned with the same timing considerations as the parties to the separation. The extent of continuing interconnection may also depend on whether one business was acquired more recently or instead the businesses expanded together over time.

In short, there is not a single blueprint that can be applied to continuing relationships, but they are always driven by bona fide business considerations. The Service, in various PLRs and its historic ruling policy, has long acknowledged this reality, in recognition that continuing relationships ought to be permissible provided their terms do not allow one business control over the other.[105] As discussed in greater detail below, existing law provides a robust framework for

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[104] These agreements provide for the provision of non-core services and most often terminate within two years of a Spin-off. In some cases, transition services agreements necessarily need to extend beyond two years. However, this is very limited in our experience. In addition, because companies most likely do not provide such services to external parties, there are often no third-party analogues on which to base their pricing, and compensation for transition services will instead be determined using an internal cost allocation methodology.

[105] *See, e.g.,* Rev. Proc. 2017-52, 2017- 41 I.R.B. 283, Representation 33 (requiring that "Payments made in connection with all continuing transactions, if any, between Distributing and Controlled after the Distribution will be for fair market value based on arm's-length terms."). Moreover, the Service has historically accepted carve-outs with respect to Representation 33 in acknowledgment that certain services may require cost or cost-plus pricing. *See, e.g.,* PLR 202425001 (Mar. 22, 2024) ("With respect to the External Distribution, instead of the modified Representation 33 that Distributing made in the Prior Letter Ruling, Distributing represents that any payments made in connection with all continuing transactions, if any, between Distributing and Controlled 1 after the External Distribution have been and will be for fair market value based on arm's-length terms or a mutually agreed upon cost-plus pricing arrangement that is commercially reasonable with respect to certain Post-Separation Agreements (other than purchases

analyzing continuing arrangements. Generally, continuing arrangements ought not to impact the qualification of a Spin-off provided they (i) are consistent with business purposes for the Spin-off; (ii) are ancillary to the core functions of the businesses so that each company is still able to set and pursue its strategic direction independently; and (iii) promote, rather than impede, a genuine separation of the businesses.

2. Existing Guidance on Continuing Arrangements

There is no authority providing that the existence of continuing relationships between Distributing and Controlled is *per se* contrary to section 355 qualification, and neither the Code nor the Regulations separately state the requirement that a Spin-off must result in a "complete separation" of the businesses of Distributing and Controlled. However, there are existing requirements under section 355 that effectively police the degree of connection between Distributing and Controlled following a Spin-off.

As an initial matter, a Retention is itself a continuing relationship between Distributing and Controlled that is policed by section 355(a)(1)(D).[106] In addition, the Active Trade or Business Requirement contemplates that each of Distributing and Controlled will continue to operate its business independently and with its separate employees. Continuing relationships can also be a factor tending to show that a section 355 distribution fails to satisfy the Non-Device Requirement.[107] Finally, as observed by the Service in Notice 2024-38, continuing relationships ought to be evaluated for consistency with the stated business purposes for a Spin-off to determine whether a Spin-off satisfies the Business Purpose Requirement).

With respect to the Business Purpose Requirement, Revenue Ruling 2003-74[108] and Revenue Ruling 2003-75[109] analyze the impact of overlapping directors and continuing contractual arrangements, respectively, on the satisfaction of the Business Purpose Requirement. While each

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of Product C at cost pursuant to the Product C Supply Agreement)"); PLR 202419016 (Feb. 9, 2024) ("All of the Continuing Arrangements will be based on arm's-length terms and conditions, including arm's-length pricing, except with respect to certain payments made pursuant to the transition services agreement that may be priced on a cost or cost-plus basis for a period not to exceed c years, other than as required to complete work orders or similar arrangements agreed during the initial period."). Even in the context of services provided by related parties subject to Section 482, the government has provided a safe harbor allowing the use of the "services cost method", which treats certain routine or low-margin services provided at cost with no markup as provided at arm's length. *See* Treas. Reg. § 1.482-9(b)(5).

[106] As the Service notes in Revenue Procedure 2024-24, Revenue Ruling 75-321, 1975-2 C.B. 123, and Revenue Ruling 75-469, 1975-2 C.B. 126, indicate that whether a genuine separation of the corporate entities has been effected is an important factor in determining whether a Retention is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. *See* Rev. Proc. 2024-24, section 2.01(4)(c)(i).

[107] *See* Treas. Reg. § 1.355-2(d)(2)(iv)(C) (providing that there is evidence of device if a business of either Distributing or Controlled is a "secondary business" (*i.e.*, a business of either Distributing or Controlled, if its principal function is to serve the business of the other corporation) that continues as a secondary business for a significant period after the separation).

[108] 2003-2 C.B. 77.

[109] 2003-2 C.B. 79.

revenue ruling addresses these continuing arrangements in the context of a Spin-off undertaken to achieve a fit-and-focus business purpose, the guiding principles articulated therein offer a helpful framework for analyzing continuing arrangements more generally.[110] As discussed below, these authorities indicate that continuing arrangements between Distributing and Controlled should be analyzed under the facts and circumstances of a particular Spin-off to evaluate whether the continuing arrangements are consistent with the stated business purposes for the transaction and facilitate the separation of the Distributing and Controlled businesses.

In Revenue Ruling 2003-74, the Service blessed continuing relationships in the form of overlapping directors between Distributing and Controlled in the context of a fit-and-focus business purpose. Specifically, in Revenue Ruling 2003-74, two of Distributing's eight directors (Directors A and B) were also selected to serve on Controlled's six-person board. Director A was chosen to help with administrative aspects of the transition, while Director B was recognized as an expert in corporate finance, and his presence on the Controlled board was intended to reassure the financial markets by providing a sense of continuity. Director A's term would expire after two years and he could not seek reelection, whereas Director B's terms would expire after six years and reelection was possible. Notwithstanding these continuing relationships and the fact that the business purpose for the distribution was to allow the management of each of Distributing and Controlled to concentrate its efforts on its respective business, the Service held that the distribution of Controlled stock satisfied the Business Purpose Requirement. In doing so, the Service stated as follows:

> Although the continuing relationship between Distributing and Controlled evidenced by the two common directors appears inconsistent with the assertion that the software business and the paper products business require independent management teams, this relationship does not conflict with the business purpose for the separation. Director A will serve for only a short period and will further that purpose by aiding in the creation of two independently administered operations. Director B will assist the separation by calming market concerns that might otherwise adversely affect one or both businesses. Further, the two directors together constitute only a minority of each board.

In Revenue Ruling 2003-75, the Service addressed the treatment of transitional agreements following a separation of two businesses undertaken to eliminate the competition for capital between the two businesses. To facilitate the separation, Distributing and Controlled entered into transitional agreements relating to information technology, benefits administration, and accounting and tax matters. Other than the tax sharing agreement, each of the agreements had a term of two years and could be extended under extraordinary circumstances for a limited period on arm's-length terms. In addition, Distributing provided Controlled an arm's-length loan for working capital for a term of two years. The Service held that the distribution of Controlled stock to resolve a capital allocation problem between Distributing and Controlled satisfied the Business

[110] The Guidance indicates that Continuing Arrangements should be subject to heighted scrutiny where a Spin-off is being undertaken to achieve a fit-and-focus business purpose, given the susceptibility in this context for Continuing Arrangements to be inconsistent with the stated purpose of allowing the management of Distributing and Controlled to focus on its respective business. In this regard, the facts of Revenue Ruling 2003-74 and Revenue Ruling 2003-75 represent the "worst-case scenario" for Continuing Arrangements.

Purpose Requirement. In so doing, the Service reasoned that "the 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 [section] 355," noting that the administrative agreements (other than the tax matters agreement) and the loan were transitional and short-term, and that all of the continuing relationships were designed to facilitate, rather than impede, the separation of the two businesses.

3. Scrutiny of Continuing Arrangements

i. Revenue Procedure 2024-24 and Notice 2024-38

Notice 2024-38 indicates that Treasury and the Service are considering the degree to which connections between Distributing and Controlled (and, as appropriate, the separate affiliated group (as defined in section 355(b)(3)(B)) of each of Distributing and Controlled (the "**DSAG**" and "**CSAG**", respectively)) after the Control Distribution Date would prevent a transaction from qualifying under section 355.[111] In particular, Notice 2024-38 indicates that Treasury and the Service are considering the impact of (i) overlapping key employees between the DSAG and CSAG (determined immediately after the Control Distribution Date), (ii) overlapping directors or officers between Distributing and Controlled (determined immediately after the Control Distribution Date), and (iii) the existence of continuing contractual agreements between the DSAG and CSAG that include provisions that are not arm's-length (referred to herein as the "**Notice Continuing Arrangements**").[112]

In Notice 2024-38, Treasury and the Service express the view that the presence of Notice Continuing Arrangements weighs against a determination of section 355 qualification, particularly if the purported business purpose for a Spin-off is to achieve a fit-and-focus business purpose.[113] It is not altogether clear whether the government's concern regarding Notice Continuing Arrangements is focused on those arrangements arising in Spin-offs involving Retentions or extends to Spin-offs more broadly. As discussed in greater detail below, Revenue Procedure 2024-24 appears to implement the government's scrutiny of Notice Continuing Arrangements solely in the context of Retentions.

As an initial matter, we do not disagree that continuing relationships (whether Notice Continuing Arrangements or other continuing agreements, such as continuing commercial agreements) between Distributing and Controlled must be adequately analyzed. However, we believe that current law (including the existing requirements under section 355 and the companion revenue rulings on continuing arrangements discussed above) adequately addresses the notion of genuine separation in Spin-offs. Furthermore, as discussed above, continuing relationships between Distributing and Controlled are generally driven by business needs and consistent with achieving the business purposes of a Spin-off (*i.e.*, they are needed to enable the separation of Distributing into two companies). In this regard, based on our experience, Revenue Ruling 2003-

[111] Notice 2024-38, section 2.02(2).

[112] *Id.*

[113] *Id.*

74 and Revenue Ruling 2003-75 accurately reflect the business considerations that inform the need for continuing arrangements. These authorities also provide a valuable and technically sound analytical framework for analyzing continuing relationships between Distributing and Controlled. Because a Spin-off necessarily involves the separation of two previously interconnected businesses, each company will need assistance from the other to ultimately operate independently from the other. It is important that the tax law be both flexible and robust enough (as it currently is) to properly evaluate the business realities of each company's unique situation. Accordingly, we recommend that the government leave unchanged the existing standards for continuing arrangements, including Revenue Ruling 2003-74 and Revenue Ruling 2003-75.

ii. Interaction between Continuing Arrangements and Retentions

As noted above, Revenue Procedure 2024-24 indicates the government's view that "the degree of continuing relationships between Distributing and Controlled will significantly inform a determination of whether a Retention would be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax". That determination will be based on the factors described in section 2.01(4)(c)(i) of Revenue Procedure 2024-24 (*i.e.*, whether (i) a genuine separation of the corporate entities will be effected; (ii) the Retention will enable Distributing to maintain practical control of Controlled; and (iii) a sufficient business purpose for the Retention is established).[114]

In addition, as part of a set of representations that must be submitted for a ruling request involving a Retention, a taxpayer is generally required to represent that none of Distributing's directors, officers, or key employees will serve as a director, officer, or key employee of Controlled during the period in which Distributing retains Retained Controlled Stock (or Securities).[115] If this representation cannot be made, the Service may still issue a favorable ruling if a director, officer, or key employee of Distributing serves as a director, officer, or key employee of Controlled solely to accommodate Controlled's business needs, the number of overlapping Distributing directors constitutes a minority of Controlled's board, and the duration of the overlap is for an identified, limited period of time.[116]

Finally, Revenue Procedure 2024-24 sets forth a new factor-based test for determining whether a Retention has a tax avoidance purpose (the "**Retention Factor Test**"). Specifically, section 3.03(3)(e)(ii) sets forth a list of factors that are "significantly indicative of an impermissible Retention". Among these factors are (i) overlapping key employees between the DSAG and CSAG immediately after the Control Distribution; (ii) overlapping directors or officers between Distributing and Controlled immediately after the Control Distribution; and (iii) the existence of continuing contractual agreements between the DSAG and CSAG that include provisions that are not arm's-length (the "**Contractual Agreements Factor**").[117] The Retention Factor Test applies

[114] Rev. Proc. 2024-24, section 2.01(4)(c)(ii).

[115] *Id.*, section 3.03(3)(c)(iii) (Representation 4).

[116] *Id.*, section 3.03(3)(e)(iv)(B) and (C).

[117] *Id.*, section 3.03(3)(e)(ii)(B)-(D).

increasing levels of scrutiny the more factors that are present, with "significantly increased scrutiny" applied to any ruling request regarding a Retention that involves the existence of a single factor.[118] If two or more factors are present, a taxpayer must establish that (i) a business exigency exists that outweighs those factors and directly causes the need for the Retention; and (ii) in light of such business exigency, the Retention should not be viewed as in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.[119]

iii. Recommendations

As an initial observation, Revenue Procedure 2024-24 and the Retention Factor Test appear to incorrectly conflate the presence of continuing arrangements with a tax avoidance purpose. As noted above, continuing relationships are the reality in all public separations and, while we do not dispute the importance of analyzing continuing arrangements, we believe that such analysis should be separate from the inquiry of whether there is a tax avoidance purpose for a Retention. Thus, it does not appear that the Retention Factor Test is needed.

In addition, while the new representations required under Revenue Procedure 2024-24 for a Retention ruling are generally the same as the prior ruling guidelines under Revenue Procedure 96-30 and consistent with existing authorities,[120] the Retention Factor Test appears to introduce a new, heightened business purpose standard for Retentions[121] that underscores the importance of continuing arrangements (which, again, ought to be analyzed separately from whether there is a tax avoidance purpose).

As we commented on at length in the Prior 2024 Report, in our view, this heightened standard is unfounded and unnecessary for the following reasons. First, section 355(a)(1)(D)(ii) statutorily requires only a showing, to the satisfaction of the Secretary, that a Retention is not principally motivated by tax avoidance. Second, when a taxpayer undertakes a Retention with a view to selling the Remainder Shares (or retained Controlled securities) taxably, the potential for tax avoidance, if any, is minimal. Finally, the ruling guidelines under Revenue Procedure 96-30 adequately safeguard against the possibility of using a Retention to circumvent a "true separation" of Controlled and Distributing. We continue to believe the recommendations in the Prior 2024 Report are appropriate.[122] In addition, to the extent the Continuing Arrangements factors in the

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[118] *Id.*, section 3.03(3)(e)(iii)(A).

[119] *Id.*, section 3.03(3)(e)(iii)(B).

[120] For example, we note the required representations and procedures regarding overlapping directors contained in section 3.03(3)(c) and section 3.03(3)(e)(iv) are consistent with the Service's existing guidance on board overlaps in Revenue Ruling 2003-74.

[121] *See also* Rev. Proc.2024-24, section 3.03(3)(c), Representation 3 (requiring that "Each business purpose for the Retention exists as of the time of the Retention and is not speculative or otherwise contingent upon events that potentially could occur after the Control Distribution Date.").

[122] As also noted in the Prior 2024 Report, 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.

Retention Factor Test are present in a Spin-off, as discussed above, they are almost always driven by business needs. Given their irrelevance to the presence of a tax avoidance purpose, we believe the tax law should afford such business-motivated arrangements sufficient deference rather than subject them to enhanced scrutiny.

If the government decides to retain the Retention Factor Test, we recommend that the Contractual Agreements Factor be revised to except short-term transitional services agreements, such as the ones described in Revenue Ruling 2003-75. As Revenue Ruling 2003-75 correctly observes, these commonplace agreements facilitate, rather than impede, a genuine separation of the Distributing and Controlled businesses, even if they are not provided on "arm's-length" terms. In fact, the Service itself has acknowledged that such services need not be priced at arm's length.[123] At any rate, as discussed above, such agreements are the product of business decisions and are not motivated by tax avoidance. In addition, in the public company context, the majority of the board of directors of Distributing and Controlled are "outside" directors (*i.e.*, individuals who are not also employees or officers of Distributing or Controlled) that stand for re-election in the ordinary course. Furthermore, the boards of each of Distributing and Controlled will be subject to their fiduciary duties to separate and distinct businesses and shareholder bases. In this case, the potential for abuse is almost non-existent. Thus, the Retention Factor Test could be revised to except overlap of outside directors whose positions will be subject to normal-course elections after an initial term.

Finally, it is unclear how a "business exigency" differs from a business purpose motivating a Retention and what additional circumstances are necessary to prove an exigency. To the extent the Retention Factor Test is retained, we recommend that the government clarify the factual showing required to demonstrate the presence of a business exigency.

VI. DEBT ALLOCATION LIMITATIONS IN CREDITOR TRANSACTIONS

A. Background

1. Statutory Framework

In the context of Divisive Reorganizations, section 357 and section 361 both provide nonrecognition treatment to certain transactions that effect a reallocation of liabilities between Distributing and Controlled.

Section 357(a) generally permits Controlled to assume a portion (or all) of the liabilities of Distributing in connection with a Divisive Reorganization without the recognition of gain to Distributing. The general rule of section 357(a) is cabined, however, by limitations in section 357(b) and (c). Under section 357(b), if the principal purpose of an otherwise tax-free assumption of liabilities is either (i) the avoidance of Federal income tax, or (ii) not a bona fide business purpose, the full amount of all liabilities assumed in the Divisive Reorganization is treated as money (*i.e.*, boot) received by Distributing in the section 361 exchange.[124] Under section 357(c),

[123] *See supra*, n. 105.

[124] Section 357(b)(1).

as relevant to Divisive Reorganizations, if the amount of liabilities assumed exceeds the total adjusted basis of the property transferred to Controlled pursuant to the section 361 exchange, the excess is treated as gain from a sale or exchange (the "**Section 357(c) Basis Limitation**").[125] For purposes of section 357(c), certain liabilities are generally disregarded, generally including contingent and other liabilities the payment of which would give rise to a deduction.[126]

In related fashion, section 361(b) permits Distributing to receive cash or other boot from Controlled without the recognition of gain, so long as the boot is distributed "in pursuance of the plan of reorganization."[127] Any transfer of boot "in connection with the reorganization" by Distributing to its creditors is treated as a distribution "in pursuance of the plan of reorganization."[128] Working in tandem with the Section 357(c) Basis Limitation, this nonrecognition rule applies only to the extent that the sum of the money and the fair market value of other boot transferred to Distributing's creditors does not exceed the adjusted bases of the assets transferred to Controlled in the section 361 exchange, net of the amount of liabilities assumed by Controlled for purposes of section 357(c) (the "**Section 361(b)(3) Basis Limitation**").

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.[129] "Qualified property" is defined to include any stock (or right to acquire stock) or obligation of Controlled that is received by Distributing in the section 361 exchange.[130] As with section 361(b)(3), section 361(c)(3) provides that any transfer of qualified property to creditors of Distributing "in connection with the reorganization" is treated as a distribution "pursuant to the plan of reorganization" that is eligible for nonrecognition treatment to Distributing. Section 361(c)(3) does not contain a basis limitation analogous to the Section 361(b)(3) Basis Limitation or the Section 357(c) Basis Limitation.

2. Notice 2024-38's and Revenue Procedure 2024-24's Approach to Sections 361 and 357

In Notice 2024-38, Treasury and the Service indicated a focus on the "[s]eparate and distinct relevance and application of [sections] 357 and 361."[131] Based on this asserted separate and distinct relevance, Treasury and the Service appear to have drawn a distinction between the types of obligations which may be assumed pursuant to section 357 and obligations the repayment

[125] Section 357(c)(1).

[126] Section 357(c)(3)(A). Section 357(c)(3)(B) provides an exception to the exception in section 357(c)(3) to the extent the incurrence of the liability has created or increased the basis of property (including cash).

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

[128] Section 361(b)(3).

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

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

[131] *See* Notice 2024-38, section 2.01(9).

of which may be treated as a transfer to creditors for purposes of section 361(b)(3) or (c)(3). In the parlance of Revenue Procedure 2024-24, while "Liabilities" of Distributing, which include non-financial and contingent liabilities,[132] may be assumed pursuant to section 357, only "Debt" of Distributing, which is limited to liabilities pursuant to an instrument or contractual arrangement constituting debt under Federal income tax principles,[133] may be satisfied with Section 361 Consideration for purposes of section 361(b)(3) and (c)(3).

As discussed further in Part VI.C.1, Revenue Procedure 2024-24 also contains strict PLR limitations on the ability to satisfy Distributing Debt incurred on or after the "Earliest Applicable Date,"[134] with no relief for so-called "refinancing" debt.[135] These limitations appear to foreclose the possibility of obtaining a PLR on a debt reallocation transaction involving the satisfaction of *any* short-term Distributing Debt that was not itself in existence before the Earliest Applicable Date.

As support for distinguishing the types of obligations contemplated by section 357 and section 361, Notice 2024-38 quotes a Senate Committee Report that explains the reasons for the

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[132] *See* Rev. Proc. 2024-24, Appendix, section 2.29 (defining "Liability" as "a Debt, a Contingent Liability, or any other fixed or contingent obligation, without regard to whether the obligation otherwise has been taken into account for Federal income tax purposes," excluding any "obligation incurred in the ordinary course of business pursuant to a bilateral contract" unless such an obligation "is reflected in the financial statement of the obligor as a liability, reserve, or similar item"). While outside the scope of the core recommendations of, and issued addressed by, this Report, we also note that the definition of "Liability" in Revenue Procedure 2024-24 warrants further clarity. An obligation "incurred in the ordinary course of business pursuant to a bilateral contract *generally* is not a Liability" per Revenue Procedure 2024-24 (emphasis added). However, "such an obligation *may be* a Liability, in whole or in part, if it is reflected in the financial statement of the obligor as a liability, reserve or similar item" (emphasis added). The use of the permissive "may be" leaves substantial uncertainty regarding the scope of this provision. In particular, it is unclear whether ordinary course trade payables are excluded, or included, within the scope of Liabilities. It will be important for taxpayers to understand the circumstances in which such ordinary course obligations are in fact included as Liabilities. For example, if such short-term payables are "Liabilities," taxpayers would struggle to make Representation 21 with respect to them, even if merely assumed by Controlled. Furthermore, this definition of Liabilities may not be appropriate in all places in Revenue Procedure 2024-24. *See, e.g.*, Representation 8 (requiring a taxpayer to state that "the fair market value of the assets of Distributing and Controlled will, in each case, exceed the Amount of its Liabilities"). It is unclear why ordinary course liabilities should be excluded from this representation.

[133] *See* Rev. Proc. 2024-24, Appendix, section 2.11 (citing Treasury Regulation section 1.1275-1(d)).

[134] The term "Earliest Applicable Date" means the date that is 60 days before the earliest of (i) the date of the first public announcement (as defined in Treasury Regulation section 1.355-7(h)(10)) of the Divisive Reorganization or a similar transaction, (ii) the date of entry by Distributing into a binding agreement to engage in the Divisive Reorganization or a similar transaction, and (iii) the date of approval of the Divisive Reorganization or a similar transaction by Distributing's board of directors. *See* Rev. Proc. 2024-24, Appendix, section 2.23(1).

[135] *See* Rev. Proc. 2024-24, section 3.05(6)(a) (Representation 21: "Distributing incurred each Distributing Debt that will be satisfied with Section 361 Consideration, and each Distributing Liability that will be Assumed by Controlled (except with regard to any Distributing Contingent Liability), before the Earliest Applicable Date."). It should be noted that, by its terms, Representation 21 appears to foreclose the possibility of obtaining a PLR on a Divisive Reorganization involving the *assumption* of newly incurred Refinancing Debt under section 357. Such an approach, if intended, would be in direct conflict with the stated position of the Service in Revenue Ruling 79-258, 1979-2 C.B. 143.

changes to section 361 in the Technical Corrections Act of 1988 (the "**1988 TCA**").[136] In particular, Notice 2024-38 focuses on a statement in the report that: "The bill amends prior law by providing that transfers of property to creditors in satisfaction of *the corporation's indebtedness* in connection with the reorganization are treated as distributions pursuant to the plan of reorganization for this purpose. . . . This overrules the holding in [*Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938)]."[137] Focusing on the report's use of the term "indebtedness," Notice 2024-38 distinguishes between section 357, which it argues applies to "Distributing Liabilities," and section 361(b)(3) and (c)(3), which it argues apply only to Distributing Liabilities that qualify as "Debt."

We disagree with Notice 2024-38's attempt to draw a distinction between the scope of section 357, on one hand, and the scope of section 361(b)(3) and (c)(3), on the other hand. For the reasons set forth below, we believe section 361(b)(3) and (c)(3) are properly interpreted as applying to the same types of liabilities as section 357, including short-term and non-financial liabilities, and we recommend that this interpretation be confirmed in published guidance and adopted in the Service's PLR guidelines.

3. The Development of Sections 357 and 361; *Hendler and Minnesota Tea*

Congress enacted the debt allocation provisions now found in section 357 and section 361(b)(3) and (c)(3) as legislative responses to two landmark Supreme Court decisions: *United States v. Hendler*[138] and *Minnesota Tea Co. v. Helvering*,[139] respectively.[140]

In *Minnesota Tea*, the earlier of the two cases, 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 liabilities of Minnesota Tea that they had assumed in connection with the transaction. Although not directly at issue in the case, *Minnesota Tea* came to stand for the proposition that a transferor corporation recognized gain with respect to property (be it stock or securities of the transferee corporation, cash, or other boot) received in the reorganization if such property was used to satisfy liabilities of the transferor.

Importantly, the legal documents effectuating the shareholders' assumption of liabilities in *Minnesota Tea* swept broadly and included "all the corporate debts of [Minnesota Tea] whether due and payable or not and whether certain or contingent."[141] While the record is unclear as to the

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[136] S. Rep. No. 100-445, at 393 (1988).

[137] Notice 2024-38, section 2.02(9) (emphasis in original).

[138] 303 U.S. 564 (1938).

[139] 302 U.S. 609 (1938).

[140] *See* Prior 2024 Report, at pp. 3–6.

[141] *Id.* at 611.

specific liabilities of Minnesota Tea that were in fact assumed and repaid by its shareholders, it seems beyond doubt, given the nature of Minnesota Tea's business, that non-financial, short-term liabilities (*e.g.*, trade obligations) would have been among them. As a retail grocer, Minnesota Tea presumably incurred trade obligations to its suppliers in the ordinary course of business on an ongoing basis. We have identified nothing in the record that suggests that Minnesota Tea made any general payment to ordinary course trade creditors prior to the shareholders' assumption and repayment of the company's debts.

In *Hendler*, another watershed case decided the very same year as *Minnesota Tea*, the Supreme Court held that a transferee corporation's assumption and prompt payment of a transferor corporation's liability in an acquisitive reorganization was treated as taxable boot to the transferor. The assumed liability in question consisted of certain outstanding "bonded indebtedness" of the transferor. The Court found that the "discharge of liability by the payment of the [transferor's] indebtedness constituted income to the [transferor]," and, citing its earlier decision in *Minnesota Tea*, reasoned that the reorganization provisions in effect at the time only provided for nonrecognition to the extent the transferor realized gain in the form of "stock or securities" or as "money or other property" that was distributed to the transferor's *shareholders* in pursuance of the plan of reorganization.[142]

Very shortly thereafter, Treasury came to realize the pyrrhic nature of the Service's victory in *Hendler* and grew concerned that imposing tax on liability assumptions in otherwise tax-free incorporations and reorganizations would greatly hamper taxpayers' ability to engage in such transactions.[143] In 1939, the year after the *Hendler* decision, Treasury urged Congress to overturn the result in *Hendler* by legislation. Congress responded by enacting section 112(k) of the Internal Revenue Code of 1939 (the "**1939 Code**"), which contained provisions corresponding to those now found in section 357(a) and (b).[144] In enacting these provisions, Congress acknowledged that the ability to reallocate liabilities is critical for any reorganization scheme that would accomplish Congress' intent to afford nonrecognition treatment to incorporations and reorganizations.[145] Congress viewed this result as appropriate notwithstanding the Supreme Court's reasoning in *Hendler* that the economic result of a liability assumption resembles a sale—*i.e.*, that a liability

[142] *Id.* at 566.

[143] *See generally* Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, 7th ed. ¶ 12.33[1].

[144] *See* Pub. L. No. 76-155, § 213(a). These provisions were made retroactive to exchanges under the Revenue Act of 1924 and subsequent acts through the Revenue Act of 1938. *See* Revenue Act of 1939, § 213(f); Social Security Act Amendments of 1939, § 910. *See also* Surrey, Assumption of Indebtedness in Tax-Free Exchanges, 50 Yale L. J. 1, n. 90 (1940) ("Apparently, the only case that satisfies these requirements is the *Hendler* case itself, so that this elaborate modification of § 213(f) is no more than an expression of Congress' desire to relieve Hendler of the tax which he paid.").

[145] *See* H.R. Rep. No. 76-855, 76 Cong., 1st Sess. , at 5 (1939) (describing the provision as one "which permits corporations to continue bona fide business reorganizations without being subject to taxation immediately upon such reorganization by reason of the assumption by one corporation of the debts of the other in the process of reorganization. . . . This change was made in view of the *Hendler* case (303 U.S. 564).").

assumption is no different than if money had been paid to the transferor corporation to the extent of the discharge of indebtedness as part of the asset transfer.

It took several decades before Congress turned to the task of overturning *Minnesota Tea*, which it first did via amendments to section 361 as part of the Tax Reform Act of 1986 (the "**1986 TRA**").[146] As discussed in the Prior 2024 Report,[147] these amendments presented numerous technical challenges and, as a result, two years later, Congress made further amendments to section 361 as part of the 1988 TCA, including the enactment of section 361(b)(3) and (c)(3).[148] These amendments retained the repeal of *Minnesota Tea*, allowing boot and Controlled stock or securities to be transferred to the transferor corporation's creditors on a tax-free basis.[149]

A careful examination of the facts and reasoning of *Minnesota Tea* and *Hendler* sheds light on the types of liabilities contemplated by the nonrecognition provisions that each case inspired. As an initial matter, although the legislative repeal of *Hendler* came many years before the legislative repeal of *Minnesota Tea*, the Supreme Court in *Hendler* recognized the economic parity between assumptions and debt repayments, citing *Minnesota Tea* as support for its conclusion.

Furthermore, as discussed above, the liability at issue in *Hendler*, "bonded indebtedness," clearly constituted financial indebtedness for borrowed money. By contrast, *in Minnesota Tea*, the liabilities assumed and promptly repaid by Minnesota Tea's shareholders almost certainly included short-term trade payables, and the relevant legal documents expressly referenced contingent liabilities (and *all* other corporate debts) of Minnesota Tea. Although the record does not shed light on the extent to which any short-term or non-financial liabilities were in fact repaid, what is clear is that Minnesota Tea, prior to its acquisition, was operating a grocery business, a going concern which presumably purchased inventory on credit in the ordinary course of business. As discussed above, the legislative history of section 361(b)(3) and (c)(3) states a clear Congressional intent to overturn, *in toto*, the result of *Minnesota Tea*,[150] and in no way is this intent limited to financial indebtedness.

Section 357 applies to a broad range of liabilities, including liabilities having a short tenor and those of a non-financial nature.[151] Yet if one were to refer solely to the facts of *Hendler* and

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[146] Pub. L. No. 99-514, § 1804(g).

[147] *See* Prior 2024 Report, at pp. 4-6.

[148] Pub. L. No. 100-647, § 1018(d)(5)(A).

[149] The legislative history of the 1988 TCA is explicit that the amendment would overrule the result in *Minnesota Tea*. S. Rep. No. 100-445, at 393 (1988); H.R. Rep. No. 100-795, at 372 (1988).

[150] *See supra* note 149.

[151] *See, e.g.*, Rev. Rul. 68-637, 1968-2 C.B. 158 (assumption of an acquired corporation's unexercised warrants and stock options qualified as a liability assumption under section 368(a)(1)(C) and did not constitute boot); Rev. Rul. 95-45, 1995-1 C.B. 53 (short sale obligation assumption subject to section 357 in an amount equal to the initial sale proceeds); *cf.* Rev. Rul. 95-74, 1995-2 C.B. 36 (assumption of a contingent liability in a section 351 exchange liability ignored for purposes of section 357(c) per the section 357(c)(3) exception; transferee stepped into the shoes of the transferor for purposes of a later deduction (or capitalization) on crystallization of the liability).

Minnesota Tea, one might be tempted to conclude that section 357 should be limited to assumptions of financial indebtedness and that section 361(b)(3) and (c)(3) should sweep more broadly to include non-financial liabilities and trade payables of the types almost certainly involved in *Minnesota Tea*. Thankfully, no such distinction is necessary. As the plain language of the statute, explicit Congressional intent, economic reality, and the integrated nature of the statutory framework all make clear, these two sets of provisions are, and should be, coterminous.

4. Parity of Sections 357 and 361 and General Observations on the Reorganization Scheme

i. Statutory Parity

Considering the common subject matter and shared animating policies of section 357, section 361(b)(3), and section 361(c)(3) with respect to the treatment of liabilities in Divisive Reorganizations, the scope of liabilities that may be assumed under section 357 necessarily should not differ from the liabilities that may be satisfied with Section 361 Consideration under section 361. Consistent with the parallel structure of section 357 and 361, the Section 361(b)(3) Basis Limitation expressly takes into account liabilities assumed under section 357(c). In other words, liabilities assumed under section 357(c) and transfers to creditors under section 361(b)(3) both implicate a common and explicitly linked set of basis limitation provisions because both provisions contemplate the same types of liabilities.

Further support comes in the form of the legislative history related to the Section 361(b)(3) Basis Limitation, which was enacted as part of the American Jobs Creation Act of 2004 (the "**2004 AJCA**").[152] The legislative history of the 2004 AJCA makes clear that Congress' intent in enacting the Section 361(b)(3) Basis Limitation was to equalize treatment with an economically similar liability assumption under section 357(c), and that Congress drew no distinction between the types of liabilities that may be assumed under section 357 and those that may be satisfied with Section 361 Consideration under section 361. For example, the Senate Committee Report on the 2004 AJCA expressed a concern that a taxpayer undertaking a Divisive Reorganization could avoid the rules requiring gain recognition if Controlled "assumes liabilities of the transferor that exceed the basis of the assets transferred to [Controlled]."[153] The Senate Committee Report continues that this result:

> could occur because of the rules of section 361(b), which state that the transferor [*e.g.*, Distributing] can receive money or other property from the transferee [*e.g.*, Controlled] without gain recognition, so long as the money or property is distributed to creditors of the transferor. For example, a transferor corporation could receive money from the transferee corporation (*e.g.*, money obtained from a

[152] Pub. L. No. 108-357, § 898.

[153] S. Rep. No. 108-192, 108th Cong., 1st Sess., at 185 (Nov. 7, 2003).

borrowing by the transferee) and use that money to pay the transferor's creditors, without gain recognition.[154]

The Senate Committee Report notes that this result "is economically similar to the *actual* assumption by the transferee of the transferor's liabilities" and that the two transaction formats were taxed differently prior to the enactment of the Section 361(b)(3) Basis Limitation.[155] This explanation demonstrates Congress' awareness that liability allocations occurring pursuant to section 361 may be equivalent, as an economic matter, to an "actual" assumption of liabilities by Controlled, strongly supporting a direct linkage in the types of liabilities that may be allocated via sections 357 and 361.[156]

Consistent with the parallelism in the statutory scheme itself, Congress has made statements in the legislative history equating "liabilities" and "debts" of the transferor corporation in a reorganization. For example, the Senate Finance Committee, in describing efforts to restore parity between section 361 and section 357 in the lead-up to the legislative repeal of *Minnesota Tea* in the 1986 TRA, noted that section 357 generally permits the tax-free assumption of a "liability" and then asserted that "no clear public policy is served by requiring assumption, rather than payment, of outstanding debt."[157]

Legislative history preceding the 1986 TRA went even further in demonstrating the sensible and intended parity between section 357 and section 361. The proposal to repeal *Minnesota Tea* originated in a study by the staff of the Senate Finance Committee, the first draft

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[154] *Id.* at 185.

[155] *Id.* at 185 (emphasis added).

[156] *See also* 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 498–99 (May 31, 2005).

[157] Staff on S. Comm. On Finance, 98th Cong., 1st Sess., The Reform and Simplification of the Income Tax of Corporations, at 95.

Note also that in the lead-up to the 1986 TRA changes, Congress noted that it was motivated, at least in part, by proposals from academics and practitioners that urged the law to be revised to equalize the treatment of liabilities under section 367 and 361. An American Law Institute report in 1982 explained the disparity that existed at the time, noting:

> Under the existing law governing boot in reorganizations, it has been held that a distribution of nonqualifying consideration must be to stockholders, not creditors, in order to avoid recognition of gain to the corporate transferor. *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1939). This makes it impossible for an acquiring corporation to provide cash with which a transferor can pay off its debts, without triggering recognition of gain. Even an assumption of debt or an acquisition of assets subject to the transferor's debts was once thought to involve undistributed boot on which the transferor would be taxable. *See United States v. Hendler*, 303 U.S. 564 (1938). The statute was amended soon after Hendler to permit an assumption of transferor debts. Section 357(a). A payment of funds to the transferor, however, with which it can pay its debts, would still be taxable.

of which was released in September, 1983.[158] The Committee staff prepared a preliminary report which included a proposal permitting the tax-free transfer of boot to creditors of a target corporation in a reorganization.[159] In the introduction to its report, the Committee staff described how then-current law operated in the context of reorganizations under section 368(a)(1)(C), noting that "[i]n a C reorganization, on any consideration which is not distributed to shareholders, including stock of the acquiring corporation distributed to creditors, gain is recognized to the acquired corporation."[160] Succinctly stating its proposal, the Senate Finance Study indicated that "[u]nder the proposal, such boot could be distributed to creditors without recognition of gain. Thus the *Minnesota Tea* case would be overruled."[161]

In advocating for the proposed changes ultimately enacted in the 1986 TRA, and the 1988 TCA, the Finance Committee Staff noted that:

> Present law distinguishes between an assumption of a liability, which is generally permitted under section 357, and the payment of creditors with boot received on a sale of assets….. In carryover basis transactions, no clear public policy is served by requiring assumption, rather than payment, of outstanding debt. Moreover, the inability to pay off creditors in an asset sale places undue emphasis on the form of an acquisition in determining tax consequences. Finally, such a rule may impede legitimate transactions which must proceed as asset acquisitions for business purposes.[162]

A final report from the staff of the Senate Finance Committee went even further, noting that:

> Under current law, boot received by a target corporation in a C reorganization that is distributed to creditors results in the recognition of gain to the target. *A more coherent rule* would produce the same result whether the target's liabilities are paid by the acquiring corporation, or by the target corporation or its shareholders with funds provided by the acquiring corporation.[163]

These passages show clear legislative intent to harmonize section 357 and section 361, based on commercial and practical realities, including the facilitation of meaningful business transactions. Notably, although not explicitly stated, neither passage appears to draw a distinction

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[158] Staff of S. Comm. on Finance, 98th Cong., 1st Sess., The Reform and Simplification of the Income Tax of Corporations.

[159] *Id*. at 95.

[160] *Id. at* 12.

[161] *Id*. at 64.

[162] *Id.* at 95.

[163] Staff of S. Comm. on Finance, 99th Cong., 1st Sess., The Subchapter C Revision Act of 1985 at 44-45 (emphasis added).

between a "liability" and the obligation owed to a "creditor." Furthermore, the legislative history of the 2004 AJCA focuses solely on "liabilities" of Distributing and appears to draw no distinction between the types of liabilities that may be assumed under section 357 and those that may be satisfied with Section 361 Consideration under section 361. As discussed above, Congress acted specifically to impose a basis limitation on transactions governed by section 361(b)(3), with a stated rationale of conforming that provision to section 357.

ii. The Distribution Requirement Under Section 368(a)(1)(C) and Unassumed Liabilities

The parallelism between the types of liabilities that may be assumed under section 357 and those subject to section 361(b)(3) and (c)(3) is further supported by legislative developments regarding the distribution requirement under section 368(a)(1)(C).

In 1984, Congress enacted the distribution requirement for a reorganization under section 368(a)(1)(C) (*i.e.*, section 368(a)(2)(G)(i)), a provision that effectively requires the transferor corporation to liquidate in pursuance of the plan of liquidation.[164] The legislative history of the 1986 TRA describes the 1984 legislation and its interaction with the *Minnesota Tea* principle:

> The Act generally required that all property be distributed in a "C" reorganization. Nevertheless, if the transferor corporation uses money or other property to satisfy *its liabilities,* the transferor corporation may be treated as realizing gain on the transfer to the acquiring corporation.[165]

Consistent with the anti-*Minnesota Tea* amendments to section 361, the 1986 TRA amended section 368(a)(2)(G) to provide that "[f]or purposes of the [distribution requirement], if the acquired corporation is liquidated pursuant to the plan of reorganization, *any* distribution to its *creditors* in connection with such liquidation *shall* be treated *as pursuant to the plan of reorganization*."[166] This amendment was necessary following the 1984 addition of section 368(a)(2)(G)(i) because any liabilities not assumed by the transferee corporation in the reorganization would now need to be liquidated by the transferor corporation.[167] The 1986 TRA's legislative history makes clear that a "creditor" can be owed any type of "liability" (not just some supposed subset of liabilities constituting "indebtedness") and that Congress viewed the two terms as coterminous.

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[164] *See* Deficit Reduction Act of 1984, § 63(a) (providing that "[a] transaction shall fail to meet the requirements of paragraph (1)(C) unless the acquired corporation distributes the stock, securities, and other properties it receives, as well as its other properties, in pursuance of the plan of reorganization.").

[165] S. Rep. 99-313, at 914 (May 29, 1986) (citing *Minnesota Tea).*

[166] Tax Reform Act of 1986, sec. 361(c)(2) (emphasis added).

[167] *Cf.* H.R. Rep. No. 76-855, at 19 (legislative history to the Anti-*Hendler* legislation provides: "In typical transactions changing the form or entity of a business it is not customary to liquidate the liabilities of the business and such liabilities are almost invariably assumed by the corporation which continues the business.").

As discussed above and further below, the 1988 TCA's legislative history references the term "indebtedness" in describing that legislation's technical amendments to section 361(b)(3) and (c)(3). Notice 2024-38 cites this legislative history as the basis for limiting the types of liabilities that may be satisfied under section 361(b)(3) and (c)(3). However, those 1988 amendments mirrored the 1986 amendment to section 368(a)(2)(G)(i) to provide that "*any* transfer . . . by the corporation to its *creditors* in connection with the reorganization shall be treated as a *distribution in pursuance of the plan of reorganization*."[168] Further, there is simply no evidence that any distinction was intended by the legislative history's reference to the term "liabilities" in 1986 from the term "indebtedness" in 1988. Absent any expressly stated distinction, no difference in meaning should be attributed to these synonyms in the nontechnical descriptions of the intended changes. Such an artificial distinction would undermine the clear Congressional intent to afford nonrecognition treatment on the liquidation of all liabilities not assumed (under section 357) with qualified property (*i.e.*, the transferee corporation's voting stock) by the transferor corporation in a section 368(a)(1)(C) reorganization.

iii. The Use of the Term "Indebtedness" in the Legislative History

Notice 2024-38 appears to rely heavily, if not exclusively, on the use of the term "indebtedness" in the 1988 TCA's legislative history as evidence that liabilities that may be satisfied with Section 361 Consideration under section 361(b)(3) and (c)(3) are limited to Liabilities constituting Debt. This heavy emphasis seems misguided.

a. "Indebtedness" References in the Section 357 Context

Notwithstanding the apparent narrowing interpretation given to the term "indebtedness" by Notice 2024-38, the term "indebtedness" has frequently been used broadly and/or interchangeably with the term "liability" in the Congressional record over the years. For example, in 1933, the House Ways and Means Subcommittee issued a report recommending the elimination of tax deferral in connection with corporation reorganizations, a recommendation that was ultimately never adopted. Notably, the report noted that "[i]n many corporate reorganizations, while cash is not involved, the acquiring corporation generally assumes some of the *indebtedness* of the old corporation, which indebtedness is regarded as the equivalent of cash."[169]

Likewise, the legislative history of section 112(k) of the 1939 Code, the predecessor to section 357, makes clear that Congress understood the term "indebtedness" to encompass the broad range of obligations that a business may incur. In connection with the 1939 legislation, Representative Jere Cooper noted that "[t]his bill includes a provision which permits corporations to continue bona fide business reorganizations without being subject to tax by reason of the assumption by the corporation of the outstanding *indebtedness* of another corporation involved in the reorganization . . . . This was made necessary by the decision of the Supreme Court in the so-called *Hendler* case."[170] Relating to the same legislative proposal, Representative Frank Buck

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[168] Pub. L. No. 100-647, § 1018(d) (emphasis added).

[169] 73d Cong., 2d Sess., H. Rept. (Dec. 4, 1933) (emphasis added).

[170] Cong. Rec. Vol. 84, 157,465 (emphasis added).

noted that "[t]he practical effect of the *Hendler* case is to say that an assumption of a *liability* is property in the sense that it may be taxable immediately to the first corporation."[171]

In 1943, in the Revenue Act of 1943, Congress amended section 112(k) of the 1939 Code to specify that the liability assumption rule was also applicable to transactions described in section 112(b)(10) of the 1939 Code (relating to transactions involving the transfer of property to a reorganized corporation). The House Conference Committee Report describes section 112(k) of the 1939 Code as "relating to assumption of *indebtedness*."[172]

Similarly, in 1983, in discussing section 357 and potential reforms thereof, the staff of the Senate Finance Committee noted that "[i]n general, corporations may assume *indebtedness* or acquire property subject to a *liability* pursuant to a reorganization without the corporation that is released from liability recognizing income (section 357)."[173]

The above examples demonstrate that Congress has interchangeably used the terms "indebtedness" and "liability" in the context of section 357 liability assumptions, suggesting that the use of the term "indebtedness" in the section 361 legislative history should not be interpreted as narrowing the universe of liabilities described.

b. "Indebtedness" as a Broader Term in Other Related Contexts

i) Section 351(d)(2)

The term "indebtedness" has been used as a term that broadly encompass liabilities not only in section 357 itself but also in other contexts. One clear instance of this usage is in the legislative history accompanying amendments made to section 351 by the Bankruptcy Tax Act of 1980 (the "**1980 BTA**").[174] The 1980 BTA added section 351(d)(2) to the Code, which provides, in relevant part, that "stock issued for . . . indebtedness of the transferee corporation which is not evidenced by a security . . . shall not be considered as issued in return for property."[175] In discussing the amendment to section 351(d)(2), both the House Ways and Means Committee and the Senate Finance Committee described that:

> [U]nder present law [(*i.e.*, prior to the enactment of section 351(d)(2))], if property is transferred to a corporation controlled by the transferor, no gain or loss is

[171] Cong. Rec. Vol. 84, at 7481–82 (emphasis added).

[172] H.R. Rep. No. 78-1079 (1943) (emphasis added); *see also* S. Rept. 627, 78th Cong. 1st Sess. (same).

[173] Staff on S. Comm. On Finance, 98th Cong., 1st Sess., The Reform and Simplification of the Income Tax of Corporations, 12.

[174] Pub. L. 96-589 (1980).

[175] *Id.* § 5(e).

recognized on the transfer. . . . For this purpose, property includes . . . indebtedness of the transferee corporation not evidenced by a security.[176]

The Congressional committees' references to Revenue Ruling 77-81 are notable and instructive of Congress' understanding of the general meaning of the term "indebtedness." In Revenue Ruling 77-81, corporation X issued new voting common stock to certain of X's "trade creditors" (presumably vendors or other ordinary course, non-financial claimants) in exchange for the creditors extinguishing their claims against X pursuant to a bankruptcy proceeding. The Service concluded that "the issuance of the new voting common stock of X to X's creditors in exchange for X's creditors extinguishing of their claims against X is an exchange subject to section 351(a) of the Code." Section 351(d)(2) was enacted specifically in response to Revenue Ruling 77-81, to overturn the conclusion that a corporation's own trade payables could be transferred to that corporation tax-free under section 351. Given the motivation for the amendment, the references to "indebtedness" in both the legislative history and statutory text of section 351(d)(2) clearly encompass trade payables and other similar, less formal obligations.[177] Accordingly, at least in 1980, in the closely related context of section 351, Congress used the term "indebtedness" in its committee reports to encompass trade creditors.[178]

ii) Section 368(a)(1)(G)

Because of the significant involvement of creditors in bankruptcy proceedings, and because reorganizations described in section 368(a)(1)(G) involve section 361 exchanges, section 368(a)(1)(G) is particularly relevant to the interpretation of the term "creditors" in section 361(b)(3) and (c)(3). Section 368(a)(1)(G), which was added to the Code pursuant to 1980 BTA,[179] generally applies to a transfer of assets by one corporation to another corporation in a case under title 11 of the United States Code (or a receivership, foreclosure, or similar proceeding in a Federal or State court) if stock or securities of the transferee corporation are distributed in pursuance of the plan, including to "creditors" of the corporation transferor corporation.[180]

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[176] H. Rep. No. 96-833, 96th Cong., 2d Sess. at 38 (Mar. 19, 1980) (citing Rev. Rul. 77-81, 1971-1 C.B. 97; *Duncan v. Commissioner*, 9 T.C. 468 (1947), *acq.* 1948-2 C.B. 2); *see also* S. Rep. No. 96-1035, 96th Cong., 2d Sess. (Nov. 25, 1980).

[177] Rev. Rul. 77-81, 1977-1 C.B. 97, *obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 388.

[178] We note that ascribing a meaning to the term "indebtedness" that narrowly includes only financial debt would severely restrict the scope of section 351(d)(2). If "indebtedness" were somehow interpreted to mean only financial indebtedness for borrowed money, section 351(d)(2) would apply only to obligations within that narrow set of financial debt which are not evidenced by a security. This result would be clearly at odds with the specific intent of Congress to overturn Revenue Ruling 77-81.

[179] Pub. L. 96-589, § 4(a) (1980).

[180] Treas. Reg. § 1.368-1(e)(6)(i) ("A creditor's claim against a target corporation may be a proprietary interest in the target corporation if the target corporation is in a title 11 or similar case (as defined in section 368(a)(3)) or the amount of the target corporation's liabilities exceeds the fair market value of its assets immediately prior to the potential reorganization"); *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942) (for purposes of

The House Ways and Means Committee Report accompanying the 1980 BTA included the following example explaining the application of section 368(a)(1)(G):

> Assume that Corporation A is in a bankruptcy case commenced after October 1, 1979. Immediately prior to a transfer under a plan of reorganization, A's assets have an adjusted basis of $75,000 and a fair market value of $100,000. A has a net operating loss carryover of $200,000. A has outstanding bonds of $100,000 (on which there is no accrued but unpaid interest) and trade debt of $100,000.
>
> Under the plan of reorganization, A is to transfer all of its assets to Corporation B in exchange for $100,000 of B stock. Corporation A will distribute the stock, in exchange for their claims against A, *one-half to the security holders, and one-half to the trade creditors*. A's shareholders will receive nothing.
>
> The transaction qualifies as a reorganization under section 368(a)(1)(G) of the Code, since all the creditors are here treated as proprietors for continuity of interest purposes. Thus, A recognizes no gain or loss on the transfer of its assets to B.[181]

The use of the term "trade creditors" to describe holders of "trade debt" clearly evidences Congressional intent that the term "creditor" encompasses holders of short-term, non-financial trade payables, consistent with Congress' longstanding, expansive understanding of "creditor" as not limited to a defined set of securities or other financial debt.

Congress introduced and enacted section 368(a)(1)(G) only a few years before the anti-*Minnesota Tea* amendments to section 361 and so presumably would have been aware of the expansive definition given to "creditor" in this closely related setting. Moreover, section 361(b) and (c) are both operative provisions relevant for transactions qualifying as reorganizations under section 368(a)(1)(G)—*e.g.*, to prevent asset gain from a reorganizing debtor where transfers of cash from an acquiror is used to satisfy claims by claimants against the reorganizing debtor. Thus, Congress presumably had in mind the relevance of the term "creditor" for purposes of section 361 when it expressed its understanding of the term creditor under section 368(a)(1)(G). Congress' expansive usage of the term "creditor" in a closely related context to include not only financial debt but also trade obligations should inform how we understand Congress' use of the term "creditor" for purposes of section 361(b)(3) and (c)(3). If Congress had intended a narrower meaning of "creditor" in section 361(b)(3) and (c)(3), given its prior broad usage of the term in the context of section 368(a)(1)(G), it would have been incumbent on Congress to make that clear, either through explicit statutory language or in the legislative history. No such limiting intention may be discerned.

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satisfying the continuity of interest requirement, creditors of an insolvent corporation who have effective command over the assets of the corporation treated as shareholders because they stepped into the shoes of the stockholders).

[181] H.R. Rep. No. 96-833 at 34 (1980) (emphasis added).

c. Alternative Explanation for the 1988 TCA's Reference to Indebtedness

As discussed above, the term "indebtedness" and "liabilities" have been used interchangeably, both in the context of sections 357 and 361 and in other closely related areas of the Code. The term "creditor" has also frequently been used expansively to encompass not only holders of financial indebtedness for borrowed money but also a wide array of persons entitled to payment of money, on various bases. Notwithstanding these broad meanings, Treasury and the Service may believe the language in the legislative history of the 1988 TCA nevertheless limits the term "creditor" to holders of financial debt in the section 361 context. After all, it might be argued, if section 361(b)(3) and (c)(3) are intended to have a broad scope, the legislative history would have simply referred to creditors, and not added the additional reference to "the corporation's indebtedness." To give effect to the full expression of Congress' expressed legislative intent, the argument would go, the words "in satisfaction of the corporation's indebtedness" either limit the universe of liabilities that may be satisfied under section 361 or else are pure surplusage.

We believe this interpretive approach is misguided. The express language of section 361(b)(3) and (c)(3) requires only a transfer of Section 361 Consideration to a creditor—that is, the statute expressly only requires a transfer to a person with a certain status. Nowhere in the statute is there a requirement that a transfer of Section 361 Consideration under section 361(b)(3) or (c)(3) actually be made in repayment or satisfaction of an amount owed to a creditor. Absent the explanation in the legislative history, section 361(b)(3) and (c)(3) could be read literally as permitting Distributing to receive cash from Controlled without the recognition of gain, if Distributing uses that cash to purchase an asset from a third party who also happens to be owed money by Distributing (*i.e.*, is a creditor of Distributing) or to make any other payment to a creditor other than in its capacity as such. Such a transaction would clearly be at odds with the policies animating section 361(b)(3) and (c)(3) and would go far beyond the intended repeal of *Minnesota Tea*. When read together with the statutory language, the legislative history's statement that the transfer is "in satisfaction of the corporation's indebtedness," provides meaningful interpretive guidance by clarifying that only transfers *in satisfaction* of obligations owed to creditors are eligible for nonrecognition under sections 361(b)(3) and 361(c)(3). This phrase should not, however, be read as a limitation on the definition of "creditor"—only as limiting the universe of cognizable "transfers" of Section 361 Consideration.

5. Recommendations

For the foregoing reasons, we recommend that the Service revise the PLR guidelines to set forth a single definition of "Liability" that would apply to define the scope of obligations eligible to be assumed under section 357 and satisfied in an exchange described in section 361(b)(3) or (c)(3). Consistent with Revenue Procedure 2024-24's current definition of "Liability," we recommend that the "Liability" definition expressly include indebtedness and other liabilities that are economically attributable to periods preceding the Divisive Reorganization (including indebtedness the proceeds of which are used to refinance any such indebtedness). In addition to indebtedness, Liabilities should include (i) other liabilities that are economically attributable to periods preceding the Divisive Reorganization and include one or more contingent payments (*i.e.*, "Contingent Liabilities" under Revenue Procedure 2024-24), and (ii) short-term and non-financial

liabilities (such as trade debt) that are similarly economically attributable to periods preceding the Divisive Reorganization and are therefore assumable under section 357. To the extent this topic is addressed in Treasury Regulations or other substantive guidance, we likewise recommend that such guidance affirm the parity between section 357, on the one hand, and section 361(b)(3) and (c)(3), on the other hand.

As a policy matter, it is appropriate to treat all liabilities the same for purposes of promoting a successful separation of businesses. Distributing is economically responsible for all liabilities and reports them on public filings and financial statements. Further, all liabilities are treated as debt of Distributing by Standard & Poor's, Moody's Investor Service and Fitch Ratings in determining credit ratings. To create artificial distinctions in a Divisive Reorganization would treat economically similar transactions differently, disadvantaging companies that have non-assumable liabilities, significant contingent or trade liabilities, or limited indebtedness (which may be the case merely as a result of their particular industry or historic commercial decisions).

B. Post-Distribution Payments

In Notice 2024-38, Treasury indicated they are considering the application of the Code to "Post-Distribution Payments". Revenue Procedure 2024-24 defines a Post-Distribution Payment as "the transfer of money or other property by Controlled to Distributing that (1) Distributing receives from Controlled subsequent to the Control Distribution Date; and (2) For Federal tax purposes, constitutes Section 361 Consideration and not, for example, a payment for goods or services separate from the Divisive Reorganization."[182]

In the Guidance, a Post-Distribution Payment is treated as Section 361 Consideration[183] only if the taxpayer establishes that (i) under the *Arrowsmith*[184] relation-back doctrine, the character of the payment is Section 361 Consideration, (ii) the fair market value of Distributing's right to receive the payment was not reasonably ascertainable, within the meaning of *Burnet v. Logan*,[185] at the time of the First Distribution Date, and (iii) the payment will be properly accounted for when received. Under the *Arrowsmith* doctrine, the characterization of subsequent payments is determined based on the posture of the parties as it was at the time of the relevant prior transaction, though the reporting of the subsequent payments occurs in the year of the payment. Under the open transaction doctrine, the tax consequences of a transaction are held open until the

[182] Appendix, section 2.34. We interpret the example properly to exclude from the definition of Post-Distribution Payment any payments for services for a transition period post-Distribution, as well as payments pursuant to supply contracts entered into between Distributing and Controlled.

[183] This statement from Treasury is circular. A Post-Distribution Payment is defined in Revenue Procedure 2024-24, as relevant, as a payment that constitutes Section 361 Consideration. Thus, a Post-Distribution Payment, as defined, includes only such payments that constitute Section 361 Consideration. We therefore interpret the reference to Post-Distribution Payment in Notice 2024-38 to be to post-distribution payments (lower case) that Distributing receives from Controlled, other than payments for goods or services separate from the Divisive Reorganization, and that the Service and Treasury are considering whether such post-distribution payments constitute Post-Distribution Payments, as defined in Revenue Procedure 2024-24.

[184] *Arrowsmith v. Comm'r*, 344 U.S. 6 (1952).

[185] 283 U.S. 404, 413 (1931)

occurrence of certain later events, including the receipt of payments, due to the current inability to determine the value of such payments.

Although the *Arrowsmith* case involved a taxable liquidation, the Service expanded the eponymous doctrine's application to reorganizations in Revenue Ruling 83-73[186] and to Spin-offs in Revenue Ruling 2002-1.[187] In the Divisive Reorganization context, the *Arrowsmith* doctrine is relevant with respect to certain post-Distribution transfers from Distributing to Controlled (*i.e.*, treated as an additional asset contributed under section 361(a), and taken into account for determining relevant basis limitations under sections 357 and 361) and vice versa (*i.e.*, whether the payment is treated as boot distributed by Controlled to Distributing in part exchange for the Controlled business assets). The open transaction doctrine, on the other hand, informs whether to treat Distributing's right to receive the contingent payment as boot, or instead treat as boot the payment only if and when actually and subsequently received. Together, the doctrines help determine the characterization and timing of payments between Distributing and Controlled that occur after the Distribution.

Historically in its advance ruling practice, the Service has applied the doctrines to a variety of payments occurring in the Spin-off context. In PLR 9819048,[188] the Service held that (i) an adjusting payment, due from Distributing to Controlled (or vice versa) if Distributing's indebtedness differed from a previously agreed amount, and (ii) a balancing payment, due from Distributing to Controlled (or vice versa) if Distributing's net worth was different from the previously estimated net worth, in each case, would be treated as occurring immediately before the Distribution (assuming such payments related to a pre-Distribution period and would not become fixed and ascertainable until after the Distribution).[189] In PLR 201438009 (June 4, 2014), *supplemented by* PLR 201516014,[190] the Service assessed whether a distributing corporation's right to contingent additional cash payments, or instead the actual payments when and if received, was properly treated as boot. These additional payments were contractual rights, not represented by a certificate or instrument, were non-transferable, and did not convey any voting, liquidation or preemptive rights. The taxpayer stated that it would segregate the additional payments and would repay creditors within *aaa* months following its receipt. The ruling held that, other than the portion of any additional payment that constitutes interest under section 483, any additional payment received will be treated as "other property or money" within the meaning of section 361(b)(1) received by the distributing corporation in exchange for property it transferred to Controlled.

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[186] 1983-1 C.B. 84.

[187] 2002-1 C.B. 268. Prior to the issuance of Revenue Ruling 2002-1, the Service issued PLRs explicitly applying the *Arrowsmith* doctrine to post-distribution payments. *See, e.g.*, PLR 200035001 (Mar. 28, 2000). Revenue Ruling 2002-1 did not explicitly cite *Arrowsmith*, though it cited to Revenue Ruling 83-73 and its application of a relation-back principle to characterize indemnity payments in the context of the lapse of restrictions on Distributing and Controlled stock years after the distribution.

[188] (Feb. 12, 1998).

[189] The Service's ruling also covered reimbursement payments for pre-Distribution tax liabilities and for indemnification payments with respect to actions causing certain otherwise tax-free transactions to be taxable.

[190] (Dec. 5, 2014).

There are numerous additional examples of non-indemnity post-distribution payments that the Service has addressed, including working capital true-up payments,[191] earn-outs for meeting performance targets,[192] and payments with respect to assets the transfer of which was subject to third-party consent.[193]

The manner in which (and whether) each doctrine applies depends on the specific facts and circumstances surrounding the relevant Post-Distribution Payment. As discussed immediately above, such payments take myriad forms. Certain of such payments broach questions, like whether the right to the contingent payment or instead the payment itself is boot, as discussed above, as well as, in a rare case, whether possessing such right is tantamount to a retention.[194] We do not believe that published guidance is appropriate for such Post-Distribution Payments in light of the variable fact patterns, non-recurring nature, and complex intersection of the relevant legal provisions. Indemnification payments arising in respect of the transaction documents that govern the Spin-off constitute the overwhelming majority of Post-Distribution Payments in the Spin-off context and do not introduce the complications described above with respect to unique arrangements. In all Spin-offs (aside from wholly internal transactions), Distributing and Controlled allocate between themselves responsibility for contingent taxes and other unknown liabilities. Frequently, the external arrangement is unchanged, such that Distributing or Controlled remains the payor with respect to a liability that has been allocated to the other party (*e.g.*, a tax liability legally borne and paid by Distributing but allocated to Controlled). In such case, the relevant transaction document will require the responsible party to indemnify the payor.

Indemnification payments are clearly within the ambit of the *Arrowsmith* doctrine. They are borne from the Spin-off transaction documents and represent the determined amount of economic shifting between Distributing and Controlled. Unless the transaction documents result in the assumption of a liability under section 357(d), indemnity payments, when received, should always be characterized as a contribution by Distributing to Controlled or a payment of Section 361 Consideration by Controlled to Distributing. There is no question that indemnification payments do not result in a retention of an interest in Controlled by Distributing or a receipt by Distributing of boot at the time the contract is entered into. Other than possibly with respect to Indemnity Purges (defined and discussed below), we do not believe that substantive guidance under sections 355 or 361, or related provisions of the Code, is needed to address the more pedestrian issues raised by indemnity payments and the application of the *Arrowsmith* and open transaction doctrines.

Where the indemnitor is Controlled, instead of treating the indemnity payment as a Post-Distribution Payment, the liability giving rise to the indemnity payment could be treated as having been assumed by Controlled under the principles of section 357(d). In such case, Distributing may

[191] *See, e.g.*, PLR 201228030 (Mar. 29, 2012).

[192] *See, e.g.*, PLR 9438022 (June 27, 1994).

[193] *See, e.g.*, PLR 201827006 (Apr. 9, 2018).

[194] The question would seem to be raised only where the right can result in the receipt of Controlled stock or if the right were somehow a Controlled security.

be treated as receiving the payment from Controlled, and making the payment to the external payee, as agent for Controlled; that is, the payment is not treated as Section 361 Consideration or a Post-Distribution Payment. Nevertheless, because we do not interpret the Guidance as addressing this alternative treatment, we do not further address the application of section 357(d) to Post-Distribution Payments in this Report. However, as an alternative to the proposals made below, Treasury and the Service could issue guidance confirming that an indemnification provision results in Controlled assuming Distributing's contingent liability. Such treatment would raise questions of which party is entitled to the deduction for such payments and whether the stock basis in Controlled is reduced by the assumption.

1. Purging Post-Distribution Indemnity Payments

Revenue Procedure 2024-24 requires that the taxpayer submit a representation that "Distributing will use a segregated account to deposit any Post-Distribution Payment that Distributing receives from Controlled" and that, within 90 days of receipt, Distributing will distribute such Post-Distribution Payment, together with any interest earned on the segregated account, to its shareholders or creditors in satisfaction of Distributing Debt in existence as of the Earliest Applicable Date ("**Representation 28**").

In actuality, and as discussed above, most Post-Distribution Payments are payments in respect of indemnities under the transaction documents. Indemnification payments may be made years following the Spin-off, at a time when there is no longer any Distributing Debt in existence as of the Earliest Applicable Date. Further, in many cases, in order to make a timely payment to its creditor, Distributing will repay an outstanding liability with cash on hand, and only later will Distributing be reimbursed by Controlled (an "**Indemnity Purge**").

Case Study 1: Tax Liability Indemnity Purge

> In January of 2025, and immediately prior to Distributing's Distribution of Controlled, Distributing and Controlled enter into a tax matters agreement (the "**TMA**") (among other agreements), allocating certain potential tax liabilities between the two companies. Pursuant to the TMA, Controlled is responsible (and indemnifies Distributing) for pre-Distribution taxes of the Distributing consolidated group attributable to the Controlled business. Under the TMA, payments are due within 30 business days of receipt of an invoice from the demanding party.
>
> Following the Distribution, Distributing prepares to file its tax return for 2024, and \$500X of the Distributing consolidated group's tax liability for 2024 and which is due and payable in 2025 is attributable to the Controlled business. Distributing timely files and pays the Distributing consolidated group's tax liability for its 2024 taxable year, including the \$500X attributable to the Controlled business. Distributing provides an invoice to Controlled, and Controlled pays to Distributing the \$500X in accordance with the terms of the TMA.

The requirements embedded within Representation 28 would obsolete the standard operating procedure with respect to the purge of Post-Distribution Payments and would render most of these purges (*i.e.*, any Indemnity Purge) invalid in the context of a ruling. Specifically, an

Indemnity Purge that constitutes a Post-Distribution Payment would fail to satisfy Representation 28 because (i) the purging distribution occurs prior to the receipt of the Post-Distribution Payment from Controlled, and thus it is not (in form) the Post-Distribution Payment which has been transferred to creditors (at any time, let alone within 90 days post-receipt), and (ii) the Post-Distribution Payment is not made in repayment of Distributing Debt in existence as of the Earliest Applicable Debt, since the liability is contingent in both occurrence and amount.[195] In the example (and in most cases with respect to Post-Distribution Payments), the underlying liability precipitating the Post-Distribution Payment often will not have crystallized by the time of the Spin-off; these liabilities generally are speculative or unknown (*e.g.*, until the tax return filing date) and only later crystallize.[196] We believe that the timely repayment of such liabilities should fall within the ambit of permissible purges of Post-Distribution Payments, even though such liabilities only materialize post-Spin-off (and were not incurred as of the Earliest Applicable Date).[197]

Representation 28 would, in effect, create a misalignment between Post-Distribution Payments and the repayment of the underlying liability, in that taxpayers in most cases cannot pay the third-party liability that gives rise to the Post-Distribution Payment and make the representation. Per the example, whether Distributing uses $500X of cash on hand to pay the liability and later receives the $500X payment from Controlled, or instead receives the $500X payment from Controlled and then pays the $500X liability, each of Distributing and Controlled is left in the same position. Indemnity Purges are most akin to a reimbursement – aligning the two payments is key. It cannot be the case that paying a pre-Spin-off tax liability results in gain (and an additional tax liability) to Distributing, particularly when the due dates for such payments and the general occurrence of such payments (*e.g.*, a payment necessitated as a result of a Service audit adjustment) are beyond the parties' control.

We do not believe it was the Service's or Treasury's intention to corner taxpayers into choosing between waiving the right to indemnification, recognizing gain on an otherwise tax-free contribution, or making a sub-optimal capital structure decision by repaying old and cold Distributing Debt it would not repay absent the representation (assuming any such Distributing Debt exists at the time of the indemnification payment). We believe that this misalignment can easily be avoided by revising the representation to address solely Post-Distribution Payments that are indemnification payments, to require an accounting or other documentation describing categories of intended uses of Post-Distribution Payments (in effect, matching the payment with

[195] In fact, whether a particular category of liabilities will be allocated to Controlled may be unknown even at the time the Service is ready to rule on a transaction.

[196] Such liabilities may constitute "Contingent Liabilities" within the meaning of Revenue Procedure 2024-24 because such liabilities may be construed to "include one or more contingent payments."

[197] In addition, Indemnity Purges do not implicate the type of "pre-purge" covered by Representation 25, which requires that Distributing's transfer of boot to shareholders or creditors occur no earlier than the First Distribution Date, nor whatever concern is motivating its inclusion (*e.g.*, whether the purge occurs in pursuance of the Plan of Reorganization).

the liability), and, in the case where Distributing liabilities may be repaid prior to the receipt of a Post-Distribution Payment, noting such potentiality and the need for the particular sequencing.

Matching the payment with the underlying liability precipitating the payment is substantively consistent with the tracing-centric focus ostensibly motivating the representation. While segregation and subsequent transfer of the actual Post-Distribution Payment within 90 days may be simpler from a tracing administrability perspective, the form required by the representation is out of sorts with and ignores commercial realities. Money is fungible, and Indemnity Purges in respect of underlying tax (and other) liabilities are benign uses of section 361(b) boot payments that should not preclude taxpayers from obtaining a ruling.

2. Indemnity Purges Prior to the Control Distribution Date

As described above, Revenue Procedure 2024-24 defines "Post-Distribution Payment" as a transfer of money or Other Property by Controlled to Distributing that constitutes Section 361 Consideration received subsequent to the Control Distribution Date. Accordingly, any payment from Controlled to Distributing that constitutes Section 361 Consideration received prior to the Control Distribution Date is not a Post-Distribution Payment within the meaning of Revenue Procedure 2024-24. Given the chosen defined term, that is not surprising; "Post-Distribution Payment" does suggest that the payment must be made after a Distribution. And, indeed, as applied to Spin-offs, the *Arrowsmith* doctrine stands for the proposition that subsequent payments should be characterized in accordance with the pre-Distribution posture where Distributing owns Controlled (and thus such payments should be characterized as contributions or distributions, depending on direction). For payments running from Controlled to Distributing that occur prior to the Distribution, the *Arrowsmith* doctrine is therefore not applicable, nor is it needed.

Consistent with our view that any new guidance should (at most) establish a framework to address Indemnity Purges that are Post-Distribution Payments, we believe that indemnity payments from Controlled to Distributing that constitute Section 361 Consideration but which are received after the contribution of assets to Controlled and *prior* to any Distribution (let alone the Control Distribution Date) should likewise be permitted.

Case Study 2: Pre-Control Distribution Date Purge

The facts are the same as in Case Study 1, except that Distributing forms Controlled and contributes to Controlled all of the assets related to the Controlled Business, in advance of (i) an initial public offering ("**IPO**") of up to 20 percent of the Controlled stock and (ii) Distributing's subsequent Distribution of its remaining Controlled stock six months following the IPO.

Following the IPO but prior to the Distribution, Distributing prepares to file its tax return for the prior taxable year, and $500X of the Distributing consolidated group's tax liability for such year is attributable to the Controlled business. Distributing timely files and pays the Distributing consolidated group's tax liability for the prior taxable year, including the $500X attributable to the Controlled business. Distributing provides an invoice to Controlled, and Controlled pays to

Distributing the $500X in accordance with the terms of the TMA prior to the Distribution.

As shown in the case study, the concept of an Indemnity Purge is not constrained to Post-Distribution Payments; Indemnity Purges can occur prior to the First Distribution Date. Although Representation 28 applies only to Post-Distribution Payments, Representation 25 prevents the transfer of boot to shareholders or creditors prior to the First Distribution Date and thus would apply to preclude any Indemnity Purge occurring prior to the First Distribution Date. Representation 25 is ostensibly motivated by a concern that such payments may not be in pursuance of the Plan of Reorganization. An indemnification payment that arises in respect of the Spin-off transaction documents is clearly part of the Plan of Reorganization. We believe that pre-Control Distribution Date (and pre-First Distribution Date) Indemnity Purges should be permitted, in order to avoid creating the misalignment described above.

3. Information Required with respect to Post-Distribution Payments

As support for Representation 28, Revenue Procedure 2024-24 requires that the taxpayer submit information and analysis to establish (i) that, in character, the Post-Distribution Payment constitutes Section 361 Consideration and not a payment for goods or services, (ii) whether the fair market value of Distributing's right to receive the Post-Distribution Payment will be reasonable ascertainable, and whether the payment will be property accounted for when received, and (iii) whether Distributing will account for the right to receive the payment under the installment method.[198] We understand that the concern motivating the demand for such support is rooted in the Service's unease ruling with respect to components of transactions (*i.e.*, Post-Distribution Payments) for which they do not have in their view sufficient line of sight.

The provision can be interpreted to require taxpayers to submit a detailed description covering the potential universe of Post-Distribution Payments. This will often prove impossible in practice. The agreements which provide for continuing arrangements which most commonly give rise to Post-Distribution Payments (*e.g.*, tax matters agreement), at best, may be in early draft form (or not yet exist in any form) at the time a ruling request is submitted. The exact contours of such arrangements also may be unknown, even by the time the Service is prepared to otherwise rule on the transaction, which is typically well in advance of actual execution. Nevertheless, the nature of most Post-Distribution Payments is generally known and limited, as discussed above—that is, for most transactions, indemnification payments will comprise the majority of Post-Distribution Payments.[199]

We understand that the Service may nonetheless be able to issue a ruling on the transaction generally, even if such required information cannot be submitted, but that the Service may be

[198] Section 3.05(10)(c)(ii).

[199] Payments for services or product arising under a transition services agreement or longer-term manufacturing and supply agreement are not Post-Distribution Payments. With respect to other payments which may constitute Post-Distribution Payments, like earn-outs and true-up payments (discussed above), taxpayers are almost certain to submit a supplemental ruling request, describing in detail such payments, given their uniqueness and variability from transaction to transaction.

disinclined in such case to provide a ruling specifically with respect to the treatment of Post-Distribution Payments. This ruling, which taxpayers commonly request, is a valuable mechanism with respect to general administration of the tax law, in that it would provide certainty to taxpayers and avoid taxpayer-favorable characterizations that could disadvantage the Service. Without such ruling, Distributing and Controlled would have uncertainty with respect to the proper treatment of these payments, with the potential for deductions and income for payments that relate back to the Spin-off. In light of the importance of obtaining this specific ruling, and the general unavailability of the information needed to meet the letter of the requirement, we recommend that the Service and Treasury relax the requirement to provide the aforestated information and analysis and instead accept a broad description of categories of potential Post-Distribution Payments.

C. Refinancings

1. Background on Debt Allocation Transactions Involving Refinancing Debt

Although not explicitly stated in the Guidance, based on the absence of explicit relief for refinancing debt in Revenue Procedure 2024-24 and certain public statements from Treasury and Service officials, the government now appears poised to take an unfavorable view of refinancing debt for purposes of PLRs addressing Divisive Reorganizations.

In a basic refinancing fact pattern, Distributing uses the proceeds of a newly incurred debt obligation ("**Refinancing Debt**") to retire historic or "old and cold" Distributing Debt that was, in Revenue Procedure 2024-24's terminology, outstanding before the Earliest Applicable Date ("**Refinanced Debt**"). Thereafter, Distributing uses boot or Controlled stock or securities to retire the Refinancing Debt in an exchange described in section 361(b)(3) or (c)(3).

Prior to the issuance of Revenue Procedure 2024-24, the common understanding among taxpayers and practitioners, and the Service's longstanding position for PLR purposes, was that Refinancing Debt—even if incurred in anticipation of the Spin-Off (in the sense that Distributing has begun planning for the Spin-Off)—is nevertheless eligible to be satisfied with Section 361 Consideration because the proceeds of the Refinancing Debt are used to repay the Refinanced Debt, which existed prior to the Earliest Applicable Date. Revenue Procedure 2018-53 itself specifically indicated that debt incurred after that date may nonetheless be eligible to be satisfied with Section 361 Consideration if:

> the taxpayer . . . establish[es] that, based on all the facts and circumstances, the borrowing and the assumption or 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. As one example, the taxpayer may establish that the proceeds of the more recently incurred Distributing Debt were used to satisfy other Distributing Debt that was incurred no later than [Earliest Applicable Date] (cf. Revenue Ruling 79-258 . . .)."[200]

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

The ability to satisfy newly incurred Refinancing Debt with Section 361 Consideration under section 361(b)(3) and (c)(3) mirrors the conclusion of Revenue Ruling 79-258, a foundational ruling in the context of debt allocations in Divisive Reorganizations. In Revenue Ruling 79-258, in the first step of a transaction intended to qualify as a Divisive Reorganization, a corporation ("**P**") desired to transfer one of its two businesses to a newly formed subsidiary ("**S**") in exchange for S 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 were in substitution, and analogous to the assumption, of the insurance company debt that related to the transferred business. Ultimately, the ruling sanctions the substitution of one creditor with another creditor in connection with a Divisive Reorganization and, in effect, treats the new debt as a continuation of the historic debt retired with its proceeds. Although the ruling by its terms applies only to section 357, practitioners and the Service alike have historically applied its principles to debt allocation transactions pursuant to section 361(b)(3) and (c)(3).[201]

In stark contrast to Revenue Procedure 2018-53, Revenue Procedure 2024-24's guidelines regarding the recency of Distributing Debt to be satisfied or assumed in the Divisive Reorganization contains no explicit reference to Refinancing Debt or the principles of Revenue Ruling 79-258. In particular, Representation 21 requires that "Distributing incurred each Distributing Debt that will be satisfied with Section 361 Consideration, and each Distributing Liability that will be Assumed by Controlled (except with regard to any Distributing Contingent Liability), before the Earliest Applicable Date."[202]

Although there is no express statement that a transaction involving the satisfaction of Refinancing Debt with Section 361 Consideration is ineligible for a PLR, we understand that Treasury and the Service currently view the required representations as foreclosing PLRs on Refinancing Debt. This dramatic departure from the Service's prior PLR guidelines and ruling practice appears to apply even to Refinancing Debt that is not issued as part of a so-called "direct issuance" transaction implicating the technical concerns articulated in Notice 2024-38 with respect to direct issuance transactions (*i.e.*, even where the Refinancing Debt is not issued directly to an intermediary that itself exchanges the Refinancing Debt for Section 361 Consideration). We refer to Refinancing Debt of this type as "**Regular Refinancing Debt**."

[201] *See* Rev. Proc. 2018-53, section 3.04(4); *see also, e.g.*, PLR 202218002 (Nov. 19, 2021); PLR 201835001 (June 1, 2018); PLR 200701010; (Sept. 1, 2006); PLR 200629001 (Apr. 7, 2006).

[202] Revenue Procedure 2024-24, 2024-21 I.R.B. 1214, § 3.05(6)(a). *See also* Rev. Proc. 2024-24, section 3.05(5)(b)(ii)(B) (Alternative Representation 17B: "All Distributing Debt directly acquired by an Intermediary from Distributing (that will be satisfied with Section 361 Consideration) will be acquired before the Earliest Applicable Date.").

2. The Parity of Section 357 and Section 361

As discussed above, notwithstanding statements to the contrary in the Guidance, section 357 and section 361 are properly interpreted as coextensive provisions, based on express legislative intent and clear, longstanding administrative interpretations, among other things. Given the analysis and conclusion of Revenue Ruling 79-258 and the facts of the *Hendler* case, we believe this similar interpretation compels the view that Regular Refinancing Debt should be considered a permissible source of repayment with Section 361 Consideration.

The refinancing of historic Distributing Debt and Distributing's subsequent repayment of Refinancing Debt with cash received from Controlled does not resemble a tax-free sale of a portion of Controlled that skirts the intent of section 361.[203] Where Distributing refinances its historic debt and uses cash from Controlled to satisfy the Refinancing Debt, the transaction appropriately results in an allocation of historic debt. As discussed above in Part VI.A.3, nonrecognition treatment is intentionally provided under the reorganization scheme to permit the tax-free allocation of group liabilities between Distributing and Controlled.[204] Where historic debt is concerned, Distributing and Controlled do not achieve an aggregate increase in the level of group liabilities or a net influx of cash, and thus a disguised sale characterization is inapt. Indeed, a reallocation of historic Distributing Debt—like in the case study above—is wholly consistent with the nonrecognition scheme set forth in section 361.[205]

Furthermore, even by analogy to section 357, the argument that refinancing of existing Distributing Debt, followed by its repayment with Section 361 Consideration, economically resembles a taxable sale for cash of the assets transferred to Controlled, followed by the satisfaction of Distributing Debt with such cash, fall short. At first blush, one might argue that an assumption of Refinancing Debt by Controlled (as explicitly permitted by Revenue Ruling 79-258) is less sale-like than a satisfaction of Refinancing Debt with Section 361 Consideration in that the former, unlike the latter, does not involve the actual retirement of the assumed Refinancing Debt (which remains in existence as an obligation of Controlled following the assumption).[206] Yet such an argument is clearly inconsistent with the intent of section 357. For example, under the facts of

[203] *Cf.* Notice 2024-38, section 2.02(8) (describing a similar concern with respect to the replacement of Distributing Debt satisfied with Section 361 Consideration, noting the "replacement of Distributing Debt that is satisfied with Section 361 Consideration can be used as an artifice for increasing the aggregate Debt and other Liabilities of Distributing and Controlled . . . replicat[ing] a tax-free sale of a portion of Controlled").

[204] *See supra* n. 145 and accompanying text.

[205] *See supra* Part VI.A.4 (describing not only the parity of sections 357 and 361 but also the similar and integral role such sections play in rounding out the reorganization provisions' ability to permit appropriate allocations of debt between parties to the reorganization).

[206] We note, however, that even though the assumed Refinancing Debt remains outstanding as an obligation of Controlled, the debt would generally be deemed, for Federal income tax purposes, as having been issued and retired for a new Controlled debt instrument in connection with the assumption. *See* Treas. Reg. § 1.1001-3(e)(4) (significant modification for certain substitutions of a new obligor on certain debt instruments).

Hendler, the debt which was assumed was *immediately* repaid by the assuming corporation.[207] Unlike an assumption of Refinancing Debt in which such debt remains outstanding as an obligation of Controlled following the assumption, the assumption and prompt repayment of a liability, as occurred in *Hendler*, is economically indistinguishable from a sale, by the relieved party, of some of its assets for cash from the assuming party. Nevertheless, Congress clearly sought, in the enactment of section 357, to overturn the results of *Hendler*. Put simply, in rejecting *Hendler*, Congress forcefully and explicitly provided for tax-free treatment of an assumption that actually economically resembled a disguised sale, and it subsequently extended this principle to creditor transactions under section 361(b) and (c) through the legislative repeal of *Minnesota Tea*.

Sections 357 and 361, which have the coextensive aim of addressing allocations of historic Distributing liabilities, both permit the allocation of historic Distributing Debt through the satisfaction or assumption of Refinancing Debt in transactions that superficially resemble taxable sales. Accordingly, we believe any concerns that permitting refinancing transactions in the context of section 361 somehow allow for inappropriate sale-like transactions are unfounded.

3. General U.S. Federal Income Tax Principles Potentially Relevant to Refinancing Debt and Intermediated Exchanges

Notice 2024-38 specifies that Treasury and the Service "are considering the application of the Code, as well as general principles of Federal income tax law (including substance over form, agency, or other relevant theories), to intermediated exchanges and direct issuance transactions."[208] While there is no indication that the technical concerns expressed in the Guidance with respect to intermediated exchanges and direct issuance transactions also apply to debt allocation transactions involving Regular Refinancing Debt, we understand that the Service's new ruling stance with respect to Refinancing Debt (including Regular Refinancing Debt) is in large part related to Treasury's and the Service's concerns regarding direct issuance transactions.

Before delving into the question of how general Federal income tax principles might apply to Refinancing Debt (as well as to direct issuance transactions and intermediated exchanges, topics that are addressed separately in Part VI.D. below), it is important to consider some of the potentially applicable general principles of Federal income tax law identified in Notice 2024-38, including the doctrine of substance over form and tax law authorities on agency.

Presumably, the fundamental concern articulated by Treasury and the Service in its invocation of these principles is a notion that (i) debt issued in close proximity to its retirement may not be respected as debt of Distributing for Federal income tax purposes, and (ii) a creditor that holds such debt (and exchanges it for Section 361 Consideration) consequently may not be respected as a creditor for purposes of section 361(b)(3) and (c)(3).

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[207] *Hendler*, 303 U.S. at 681 ("The Borden Company, through the purchase of some of the bonds and the redemption of the rest, performed its promise to assume the payment of the bonds at a total cost to it of $534,297.40. This sum did not pass through the Hendler Company but was paid directly to the bondholders.").

[208] Notice 2024-38, section 2.02(5).

As a general matter, under Federal income tax principles, the analysis of whether an instrument is respected as debt looks to various characteristics of the instrument and the rights of the holder vis-à-vis the issuer. While there are various factors and tests that courts and the Service have applied, a facts and circumstances analysis is generally required. For example, in *Roth Steel Tube Co. v. Commissioner*,[209] the Sixth Circuit identified sixteen debt-equity factors relied on by the courts and commentators:

> (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the "thinness" of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.[210]

Courts have often contended with whether debt is respected as such in cases involving a maturity date perceived as too far in the future to be treated as not "in the reasonable future" and therefore more characteristic of equity.[211] Similarly, debts are required as a matter of "substantially economic reality" to be "advanced with reasonable expectation of repayment regardless of the success of the venture."[212]

While the question of whether debt has a maturity that is too long is one that has arisen with some frequency (for example, in determining whether purported debt is treated as debt or equity),[213] there is nothing about short-term instruments, as a general matter, that precludes or even weighs against debt treatment. As a commercial matter, taxpayers frequently enter into very short-

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[209] *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986).

[210] *Id.* at 630.

[211] *See John Kelly Co. v. Commissioner*, 326 U.S. 521, 526 (1946). *See also Gilbert v. Commissioner,* 248 F.2d 399, 402 (2d Cir. 1957) (Debt generally involves "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."); *United States v. South Georgia Railway Co.*, 107 F.2d 3, 5 (5th Cir. 1939) (lack of fixed maturity date or right to enforce debt in event of default meant instrument was treated as equity, not debt); *Jewel Tea Co. v. United States*, 90 F.2d 451 (2d Cir. 1937) (instrument that lacked fixed sum due at predetermined maturity date was preferred stock, not debt).

[212] *Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957). *See also Jewell Ridge Coal Corp*., 21 T.C.M. 1048, 1055 (1962), *aff'd*, 318 F.2d 695 (4th Cir. 1963) ("genuine and real expectation that [the obligation] will be repaid at a certain time in all events and regardless of the earnings of profits by the corporation").

[213] *E.g.,* Notice 94-47, 1994-1 C.B. 357 (indicating that an "unreasonably long" maturity may preclude debt treatment).

term debt instruments: commercial paper, overnight bank deposits, short-term bridge financings, and sale-repurchase (or "repo") transactions are just a few examples. Short-term debt is common enough that the Code provisions and Treasury Regulations dealing with the treatment of debt instruments contain rules specifically designed to address short-term debt.[214] Indeed, the Service has even addressed, in various contexts, debt with exceedingly truncated (*e.g.*, overnight) terms to maturity.[215] Accordingly, there is nothing about a short maturity (or short expected lifespan) of an obligation that causes the obligation to be treated or recharacterized as something other than debt for Federal income tax purposes.

One tax law doctrine that can result in potential recasts is the substance over form doctrine, one of the specific principles referenced in the Guidance. Under the substance over form doctrine, courts and the Service have taken the view that the flexibility normally afford taxpayers to choose the form of a transaction is limited when the chosen form does not comport with the underlying economic arrangement of the parties.[216]

As a specific subvariant of substance over form, courts have developed the step transaction doctrine, in which formally separate transactions or steps may be collapsed and treated as a single, unified transaction for tax purposes if the steps are "in substance integrated and focused towards a particular result."[217]

The courts have articulated three versions of the step transaction doctrine: (i) the "binding commitment" test; (ii) the "mutual interdependence" test; and (iii) the "end result" test. Under the binding commitment test, separate steps may be collapsed into a single transaction if, at the time the first step takes place, the parties were under a contractual commitment to complete the remaining steps.[218] Under the mutual interdependence test, a series of transactions may be integrated if the steps are so interdependent that the legal relationships created by one transaction

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[214] *E.g.,* section 1272(a)(2)(C) (addressing short-term obligations with a fixed maturity date of no more than one year from issuance for purposes of the original issue discount ules); section 1281 (requiring accrual method taxpayers and banks to account for yield on short-term obligations on an accrual method).

[215] *E.g.* TAM 8838004 (June 8, 1988) (describing the tax consequences of interest paid on overnight loans between banks; stating that "[a]side from the short-term nature of federal funds transactions, there is little to distinguish these activities from the more traditional deposit-loan cycle that comprises the daily business of commercial banking.").

[216] *See Gregory v. Helvering*, 293 U.S. 465, 467-70 (1935) (Court agreed with the Service that the "reorganization attempted was without substance and must be disregarded. . . . To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."); *Newman v. Commissioner,* 894 F.2d 560, 562 (2d Cir. 1990) ("[I]n reviewing a transaction for tax consequences, the substance of the agreement takes precedence over its form." (citing *Helvering v. Lazarus & Co.*, 308 U.S. 252, 255 (1939); *DeMartino v. Commissioner*, 862 F.2d 400, 406 (2d Cir. 1988))).

[217] *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 98, *aff'd in part and rem'd in part*, 331 F.3d 972 (D.C. Cir. 2003).

[218] *See, e.g., Commissioner v. Gordon*, 391 U.S. 83 (1968); *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995).

would be fruitless without the completion of the entire series.[219] Finally, under the end result test, which is the broadest basis for integration, separate transactions may be integrated if they are part of a single scheme designed to achieve a single ultimate result.[220]

Courts and the Service have subjected the step transaction doctrine to significant limitations. As discussed in the Prior 2024 Report,[221] Revenue Ruling 2017-9 articulates the boundaries of application of the step transaction doctrine. As stated in the ruling, 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.

Moreover, 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.[222] Thus, courts have been reluctant to apply the step transaction doctrine where doing so would merely reorder or ignore steps that have independent economic significance, as opposed to collapsing meaningless or unnecessary steps.[223]

Under a separate line of authorities, courts and the Service have, in limited circumstances, disregarded an entity's involvement in a transaction on the theory that the entity acted as a mere agent or "conduit" on behalf of another party to the transaction. A seminal example of this principle is in *Aiken Industries v. Commissioner*.[224] In *Aiken*, a U.S. subsidiary of a Bahamian corporation, borrowed funds from the Bahamian corporation and issued to the Bahamian corporation a 4% sinking fund promissory note (the "**Promissory Note**"). The Bahamian corporation then formed a wholly-owned Honduran corporation to which it transferred the Promissory Note in exchange for the Honduran corporation's notes, payable upon demand (the "**Honduran Notes**"). The U.S. subsidiary took the position that interest payable on the Promissory

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[219] *See, e.g., Manhattan Building Co. v. Commissioner*, 27 T.C. 1032 (1957), *acq.* 1957-2 C.B. 5; *American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949).

[220] *See King Enters., Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

[221] *See* Prior 2024 Report, at pp. 19–23.

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

[223] *See, e.g.*, *Standard Linen Serv., Inc. v. Commissioner*, 33 T.C. 1 (1959), *acq. in part, nonacq. in part*, 1983-2 C.B. 1; *Pabst Brewing Co. v. Commissioner*, 69 T.C.M. (CCH) 2773 (1995). *See also Sheppard v. United States*, 361 F.2d 972, 978 (1966) ("Useful as the step transaction doctrine may be in the interpretation of equivocal contracts and ambiguous events, it cannot generate events which never took place just so an additional tax liability might be asserted.").

[224] 56 T.C. 925 (1971).

Note was not subject to U.S. withholding tax under the tax treaty in effect between the United States and Honduras at the time.

The court in *Aiken* held that the Honduran corporation should not be respected as the recipient of the interest received on the Promissory Note for withholding tax purposes. The court reasoned that Honduran corporation did not have complete dominion and control over the funds. As a result of the nearly identical terms of the Promissory Note and the Honduran Notes, the court noted, "[the Honduran corporation] obtained exactly what it gave up in a dollar-for-dollar exchange . . . it was committed to pay out exactly what it collected, and it made no profit . . . for its own." In effect, the court concluded that the Honduran corporation was a mere agent and conduit interposed between the U.S. subsidiary and the Bahamian corporation. Therefore, the court disallowed the withholding tax treaty benefits.

Other similar cases have concluded similarly where the participation of an entity in a financing transaction was meaningless or where the entity in question had no profit, assets, or meaningful business activities.[225] In cases in which courts have determined that a participant in a financing transaction had substance and was engaged in business activities through the transaction that resulted in profit and bore real economic consequences, courts have not disregarded or recharacterized transactions.[226]

More generally, courts have significantly limited the circumstances in which a corporation's separate existence (or its role in a transaction) may be disregarded on the grounds that it is a mere agent facilitating a particular transaction. In *Commissioner v. Bollinger*,[227] the Supreme Court stated that the separate existence of a corporation will not be disregarded unless the following agency test is met: (i) the fact that the corporation is acting as an agent is set forth in a written agreement at the time that the transaction is consummated, (ii) the corporation functions as an agent and not as a principal with respect to all facets of the transaction, and (iii) the corporation is held out as an agent and not as a principal in all dealings with third parties related to the transaction.

4. Appropriateness of Refinancings under the Code and Federal Income Tax Principles

With regard to the refinancing of Distributing Debt generally, the Federal income tax principles discussed above support the ability of Distributing to refinance its historic debt and thereafter satisfy the newly incurred Refinancing Debt with Section 361 Consideration under section 361(b)(3) and (c)(3).

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[225] *E.g., Del Commercial Props. Inc. v. Commissioner*, 78 T.C.M. (CCH) 1183 (T.C. 1999), *aff'd,* 251 F.3d 210 (D.C. Cir. 2001); *see also* Chief Counsel Advice 200137005 (May 31, 2001) (back-to-back loans that resulted in a section 956 loan that generated foreign tax credits disregarded under the step transaction doctrine (applying the "end result," "interdependence" and "binding commitment" tests above; disregarding the participation of two entities as "mere intermediaries" and noting that the loans were "solely to achieve a particular tax consequence").

[226] *E.g.*, *Northern Indiana Public Service Co. v. Commissioner*, 115 F.3d 506 (7th Cir. 1997).

[227] 485 U.S. 340 (1988).

As discussed in the Prior 2024 Report,[228] if a short-term instrument bears the hallmarks of debt and is an unqualified obligation to pay a sum certain,[229] the Code and Federal income tax principles treat the instrument as debt. In the Prior 2024 Report,[230] we provided several examples throughout the Code where newly incurred debt that refinances existing debt is treated as a continuation of the Refinanced Debt, including:

- Treasury Regulation section 1.707-5(c), which 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.

- Temporary Treasury Regulation section 1.163-8T(e), which treats, for purposes of allocating interest expense among expenditures, debt that refinances and is used to repay existing debt as allocable to the expenditures to which the repaid debt was allocated.

- section 304(b)(3)(B)(ii) which, for purposes of section 304(b)(3)(B)(i), treats any refinancing of a liability meeting the requirements of that section as also meeting those requirements; and

- section 221(d)(1), which defines a "qualified education loan" to include indebtedness used to refinance debt which qualifies as a qualified education loan.

These examples are instances in which newly incurred Refinancing Debt is not only respected as debt for Federal income tax purposes but also retains in various ways the characteristics of the debt that the Refinancing Debt proceeds are used to satisfy. The common thread of these provisions, as with Revenue Ruling 79-258, is that Refinancing Debt may be treated as a surrogate of Refinanced Debt where such treatment is consonant with the underlying policy objectives of the relevant Code provision or Treasury Regulation. The Code and Treasury Regulations are replete with other, similar examples of Refinancing Debt.[231]

Moreover, there are many examples of short-term debt in common business transactions in the commercial marketplace. For example, bridge financing instruments, overnight and other short-term sale-repurchase transactions, and various other forms of short-term borrowing facilities

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[228] *See* Prior 2024 Report, at p. 23.

[229] *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.").

[230] *See* Prior 2024 Report, at p. 22.

[231] Section 2031(c)(4)(B)(ii) (including in "acquisition indebtedness" for purposes of debt-financed property rules under estate tax rules, debt that extends, renews, or refinances an acquisition indebtedness); section 163(h)(h)(3)(B) (same for acquisition indebtedness definition as relevant for qualified residence interest definition for personal interest deduction disallowance rules); section 279(h) (refinancings of an obligation evidencing a preexisting indebtedness not deemed to be the issuance of a new obligation for purposes of limitation on deductibility of interest paid or incurred on corporate acquisition indebtedness); Prop. Treas. Reg. § 1.988-2(b)(14) (Service may defer gain or loss under section 988 for certain replacements of nonfunctional currency debt instruments that are replaced with other debt denominated in a different currency).

all contemplate borrowings that are not expected to be outstanding for a long period of time (and in many cases are specifically expected or required to be retired in very short order). Absent additional facts implicating substance over form or agency principles, we are not aware of any Federal income tax principles that would treat these types of short-term obligations as anything other than indebtedness for Federal income tax purposes.

Consistent with the authorities regarding the characterization of debt and agency principles under Federal income tax law, the mere fact that debt refinances other debt or is expected to be outstanding for a short and/or limited period of time does not cause it to be disregarded or recharacterized. Rather, so long as the obligation evidences the indicia of debt and the financing transaction is economically meaningful and has substance to the parties, debt is generally respected in accordance with its terms.

Furthermore, the parity between sections 361 and 357, as discussed in Part VI.A.4 above, and the continued effectiveness of Revenue Ruling 79-258, compels the conclusion that the satisfaction of Refinancing Debt is appropriate for section 361(b)(3) and (c)(3) transfers. As the case study below demonstrates, Refinancing Debt typically presents no opportunity for meaningful avoidance or abrogation of the principles and policies animating sections 361(b)(3) and (c)(3).

Case Study 3:

> On January 1, 2025, Corporation X announces its intention to undertake a Spin-Off, which is projected to be completed in 12-15 months. As of the Earliest Applicable Date, Corporation X has certain outstanding debt that will come due in June 2026 ("**Historic Debt**"), shortly following the expected completion of the Spin-Off. Corporation X seeks and receives a PLR from the Service in December 2025, indicating its intent to satisfy the Historic Debt with cash received from Controlled in the Divisive Reorganization. In January 2026, the Spin-Off is delayed for six months for non-tax reasons (including commercial and regulatory restrictions on the timely separation of the business that will be transferred to Controlled). The Historic Debt comes due as scheduled in June 2026, prior to the completion Spin-Off.

Under the facts of the case study, the Historic Debt may not be repaid with Section 361 Consideration prior to the Control Distribution Date. Absent a robust refinancing exception as was contemplated by Revenue Procedure 2018-53, Corporation X will simply lose the ability to reallocate the Historic Debt to Controlled while pursuing a PLR. This result is unwarranted and unnecessary, particularly in light of the facts of the case study.

Consider what Corporation X would have done in the ordinary course of managing its capital structure, in the absence of a contemplated Spin-Off. Because some desired level of debt financing is a *permanent* part of the capital structure of most if not all public corporations, Corporation X, at maturity of the Historic Debt, would likely have refinanced the Historic Debt even if no Spin-Off were contemplated. While the terms of any replacement instrument may have been different, depending on the expected timing of a Spin-Off and any anticipated financing breakage costs, the existence of a debt obligation corresponding to the Historic Debt would have continued with or without a contemplated Spin-Off. The same would also be true if the Historic

Debt consisted of a normalized level of short-term obligations (*e.g.*, commercial paper) that were serially refinanced with new commercial paper after the Earliest Applicable Date.

The facts of the case study contemplate a repayment of the Historic Debt, or directly related Refinancing Debt, with cash boot. It is difficult to construct a potential recast of the refinancing of the Historic Debt and the Refinancing Debt's subsequent repayment with cash received from Controlled that raises meaningful technical or policy concerns. Even if the party loaning the Refinancing Debt were to be treated as an agent of Corporation X, or the Refinancing Debt were somehow disregarded under a step transaction analysis, the effect would be to treat Corporation X as purging the cash received from Controlled to satisfy the Historic Debt itself—a classic reallocation of historic Distributing Debt that satisfies both the letter and spirit of section 361(b)(3).

Case Study 4:

> On January 1, 2025, Corporation Y announces its intention to undertake a Spin-Off, which is projected to be completed in 9-12 months. As of the Earliest Applicable Date, Corporation X has certain outstanding long-term debt ("**Long-Term Debt**") that will not ordinarily come due until well after the completion of the Spin-Off. Shortly before the expected consummation of the Spin-Off, Corporation Y draws on its "rolling" commercial paper (*i.e.*, short-term, unsecured) program to borrow funds that Corporation Y uses to tender for and cause to be extinguished all of the Long-Term Debt. Based on the shorter maturity of the commercial paper borrowing, and due to an unexpected delay in the consummation of the Spin-Off, Corporation Y is required to "roll" its commercial paper borrowings one additional time (*i.e.*, beyond the first commercial paper borrowing's initial maturity) prior to the actual completion of the Spin-Off. In January 2026, very shortly after the consummation of the Spin-Off and the distribution of cash from Controlled to Corporation Y in the Divisive Reorganization, Corporation Y satisfies the outstanding commercial paper borrowings with the cash received from Controlled.

In this case study too, Distributing ultimately repays historic debt (the Long-Term Debt) or directly related Refinancing Debt, with cash boot. Similar to the example above, the recast concerns here are minimal or nonexistent. Note that, despite there being two refinancings from a Federal income tax perspective (the initial commercial paper refinancing the Long-Term Debt *and* the "roll" of the commercial paper borrowing itself), any step transaction or similar analysis would again result in a mere satisfaction of historic Long-Term Debt with cash. Again, the result here is consistent with a reallocation of historic Distributing Debt as the statute (and accompanying legislative purpose) envisioned. Furthermore, the fact that the Long-Term Debt is repaid well in advance of its maturity date, pursuant to a consensual tender offer between holders and Distributing, is of no import. Debt repaid with section 361 consideration effects a reallocation of debt, consistent with the policies of section 361, regardless of whether the repaid debt is coming due imminently or far from maturity. Spin-off transactions are transformational events in the life of corporation, and there is no policy reason, or statutory or regulatory justification, for permitting or prohibiting a debt reallocation transaction based on the vagaries of existing capitalization structure and maturities.

5. Recommendations

We recommend that the Service continue to issue, or resume issuing, favorable PLRs in circumstances where Refinancing Debt incurred after the Earliest Applicable Date is satisfied with Section 361 Consideration. Continued recognition of Refinancing Debt in this context is wholly consistent with and supported by Congressional intent, the principle of achieving tax parity among economically similar transactions, and even the Service's recent administrative practice. In particular, where the amount of Refinancing Debt does not exceed Distributing's aggregate historical average debt level—a result that is ensured by other requirements of Revenue Procedure 2024-24[232]—and where the terms of such new debt satisfy the requirements to qualify as indebtedness for Federal income tax purposes generally, the Service should be willing to provide rulings regarding transfers of Section 361 Consideration to creditors in satisfaction of Refinancing Debt. As discussed more fully in Part VI.D.4, we continue to believe Refinancing Debt should be eligible under section 361(b)(3) and (c)(3) even if the Section 361 Consideration is transferred to the initial lending entity in an integrated direct issuance transaction.

Alternatively, if potential recast or principal-agent concerns in the context of direct issuance transactions continue to trouble Treasury and the Service, we recommend at a minimum that the Service continue to issue (or resume issuing) favorable PLRs with respect to (i) Regular Refinancing Debt and other Refinancing Debt that is not issued as part of a Covered Direct Issuance Transaction (as defined below), regardless of whether the debt is satisfied with boot pursuant to section 361(b)(3) or with Controlled stock or securities pursuant to section 361(c)(3), and (ii) all Refinancing Debt (whether or not issued as part of a Covered Direct Issuance Transaction) that is satisfied with cash.

Debt allocation transactions involving Regular Refinancing Debt effectuate a reallocation of historic Distributing Debt to Controlled and are fully consistent with the statutory requirements and underlying policies of section 361(b)(3) and (c)(3). All of the reasons that lead us to recommend an approach that sanctions direct issuance transactions (as discussed in the Prior 2024 Report,[233] in the 2020 Report,[234] and in Part VI.D.4 below) likewise support the ability to satisfy Refinancing Debt with Section 361 Consideration in circumstances where the Refinancing Debt is not issued directly to an Intermediary that itself exchanges the Refinancing Debt for Section 361 Consideration shortly after the debt's issuance. Furthermore, where the creditor receiving the Section 361 Consideration is not the same entity that initially loaned the Refinancing Debt (or an entity related to the initial lender), the mere fact that the Refinancing Debt may have been issued with an expectation that it would later be satisfied with Section 361 Consideration does not itself

[232] *See* Rev. Proc. 2024-24, section 3.05(8)(a) (Representation 23: "The total Amount of Distributing Debt that will be satisfied with Section 361 Consideration or Assumed by Controlled will not exceed the historical average of the total Amount of Distributing Debt owed to persons other than Distributing Related Persons. This historical average of the total Amount of Debt was determined pursuant to section 3.05(8)(b) of Revenue Procedure 2024-24.").

[233] *See* Prior 2024 Report, at pp. 19-25.

[234] *See* 2020 Report, at pp. 25-26.

provide a technical basis for recasting the transaction steps in a manner that would preclude the application of section 361.

Likewise, in any situation where Distributing receives *cash* from Controlled and uses that cash to repay Refinancing Debt, there is no credible recast that would preclude the cash boot purge from qualifying under section 361(b)(3). The analysis of a refinancing vis-à-vis section 361(b)(3) is in noted contrast to the situation where Distributing incurs new debt in anticipation of a Spin-off, *retains* the proceeds, and then uses cash received from Controlled to repay the new debt. In that scenario, a straightforward recast could disregard the new borrowing by Distributing and may properly cause the transaction steps to be viewed as (i) the receipt of cash from Controlled, and (ii) the retention of that cash for Distributing's unfettered use—a transaction that clearly fails the requirements for nonrecognition under section 361(b)(3).

The repayment of Refinanced Debt with the proceeds of Refinancing Debt, however, eliminates any ability to recast a cash boot purge in a way that returns the parties to the same economic position. Moreover, as discussed above, there is no way to view a cash boot purge with respect to Refinancing Debt as a disguised sale of Controlled stock or securities (or anything else) to the exchanging creditor, regardless of whether it is the initial lending entity or a different party. Accordingly, when Distributing does not retain the proceeds from Refinancing Debt, but instead deploys them in satisfaction of Refinanced Debt, the subsequent repayment of the Refinancing Debt with cash is and should not be susceptible to a recast, including in fact patterns that might technically be viewed as direct issuance transactions within the meaning of the Guidance.

D. Debt-for-Equity Exchange/Recast Issues

1. Revenue Procedure 2024-24's and Notice 2024-38's Views on Intermediation; Direct Issuance; and Recast Issues

In addition to Revenue Procedure 2024-24's unfavorable position on Refinancing Debt, the Guidance generally take a skeptical view of intermediated exchanges and direct issuance transactions in particular. As noted above, Notice 2024-38 explains that Treasury and the Service are focused on the application of "general principles of Federal income tax law (including substance over form, agency, or other relevant theories), to intermediated exchanges and direct issuance transactions."[235] Notice 2024-38 more specifically asserts that:

> With regard to a so-called direct issuance transaction in which Distributing Debt is issued to an Intermediary and redeemed in close temporal proximity, it is the view of the Treasury Department and the Service that general principles of Federal income tax law could recast the transaction such that the Intermediary (that is, the direct holder) is not treated as a creditor described in § 361(b)(3) or (c)(3). Similarly, general principles of Federal income tax law potentially could recast an intermediated exchange, or treat the Intermediary engaged in that exchange as an agent of Distributing, such that Distributing likewise would not be treated as exchanging Section 361 Consideration for Distributing Debt.

[235] Notice 2024-38, section 2.01(5).

Consistent with such skepticism and presumably as a result of what Notice 2024-38 articulates as the potential applicability of general principles of Federal income tax law, Revenue Procedure 2024-24 (i) unequivocally forecloses the possibility of obtaining a PLR with respect to a direct issuance transaction, and (ii) requires a taxpayer to submit numerous representations and potentially voluminous supporting information in connection with a transfer of Section 361 Consideration to an intermediary in an intermediated exchange. Specifically:

- Representation 16: "No holder of a Distributing Debt that will be satisfied with Section 361 Consideration, or of other Distributing Liability (including a Distributing Contingent Liability) that will be Assumed by Controlled, will hold the Debt or other Liability for the benefit of Distributing, Controlled, a Distributing Related Person, or a Controlled Related Person."[236]

- Under the heading "Direct issuances generally prohibited," Revenue Procedure 2024-24 requires one of the following:

    - Alternative Representation 17A: "An Intermediary will not acquire Distributing Debt (that will be satisfied with Section 361 Consideration) from Distributing, from Controlled, or from any Distributing Related Person or Controlled Related Person."[237]

    - Alternative Representation 17B: "All Distributing Debt directly acquired by an Intermediary from Distributing (that will be satisfied with Section 361 Consideration) will be acquired before the Earliest Applicable Date."[238]

- Representation 18: "Each exchange of Section 361 Consideration for Distributing Debt between Distributing and an Intermediary will be effectuated based on terms and conditions arrived at by the parties bargaining at arm's length."[239]

- Representation 19: "Neither Distributing, nor Controlled, nor any Distributing Related Person or Controlled Related Person, will participate in any profit gained by Intermediary upon an exchange of Section 361 Consideration; nor will any such profit be limited by agreement or other arrangement."[240]

- Representation 20: "The Intermediary will (i) act for its own account, and (ii) bear the risk of loss with respect to (A) the Distributing Debt and (B) any subsequent sale or

[236] Rev. Proc. 2024-24, section 3.05(5)(b)(i).

[237] *Id.*, section 3.05(5)(b)(ii)(A).

[238] *Id.*, section 3.05(5)(b)(ii)(B). Here, Revenue Procedure 2024-24 clarifies that, "[f]or the avoidance of doubt, one example of a direct acquisition of Distributing Debt by an Intermediary from Distributing would be an issuance by Distributing of a Distributing Debt to the Intermediary in exchange for cash."

[239] *Id.*, section 3.05(5)(b)(iii).

[240] *Id.*, section 3.05(5)(b)(iv).

> other disposition of Section 361 Consideration transferred to the Intermediary to satisfy the Distributing Debt."[241]

Representation 17 effectively forecloses the repayment of debt issued from Distributing to an Intermediary, if such debt is issued after the Earliest Applicable Date (a "**Rev. Proc. 2024-24 Direct Issuance**").

In addition to the above representations (collectively, the "**Intermediation Representations**"), Revenue Procedure 2024-24 requires the taxpayer to "provide analysis to establish that the terms of all agreements, understandings, and arrangements with an Intermediary, and all activities by that Intermediary, are consistent with" the Intermediation Representations.[242] Revenue Procedure 2024-24 further states that the Intermediation Representations will not be treated as furnished by the taxpayer "unless the taxpayer provides analysis that establishes that the Intermediary is a creditor of Distributing and participates as a principal for its own account in the exchange with Distributing, and that the transfer of Section 361 Consideration to the Intermediary should be respected and not recast or recharacterized under any principles of Federal income tax law (including the substance over form doctrine), agency, or any similar theory."[243] While Revenue Procedure 2024-24 provides some additional guidance on how this analysis is to be accomplished (for example, describing that, while the shortness of time during which an Intermediary holds Distributing Debt will not be considered inconsistent with the Intermediation Representations, the analysis must establish that the expected short time "should not cause the form of the transactions to be recast for Federal income tax purposes"[244]), there are no uniform bright-line rules or safe harbors available to satisfy this analysis under general principles of Federal income tax law.

2. Brief Background on Intermediated Exchanges and Relevant TAMs

The Prior 2024 Report discusses in detail the history of the Intermediated Exchange Model,[245] a mechanic for effectuating a Debt-for-Debt Exchange or Debt-for-Equity Exchange in which (i) an investment bank (the "**Bank**") acts as an intermediary for Distributing to buy outstanding Distributing Debt, and (ii) Distributing subsequently transfers Controlled stock or securities to the Bank in satisfaction of that purchased debt.

To summarize, prior to the issuance of Revenue Procedure 2018-53, taxpayers typically effectuated these intermediated exchanges in accordance with timing guardrails that developed

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[241] *Id.*, section 3.05(5)(b)(v). Revenue Procedure 2024-24 indicates that this representation cannot be made if the Intermediary enters into any variable pricing agreement or similar arrangement with Distributing, Controlled, or related persons, including agreements providing for "true-up" payments, forward exchange agreements or similar arrangements. *Id.*

[242] *Id.*, section 3.05(5)(d)(i).

[243] *Id.*

[244] *Id.*, section 3.05(5)(d)(iii).

[245] Prior 2024 Report, at pp. 16–18.

over time in the administration of the PLR program. 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 retained Controlled stock 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 retained Controlled stock or Controlled securities would occur at least 14 days following the intermediary Bank's purchase of Distributing Debt (the "**5/14 Standard**").

As discussed in the Prior 2024 Report,[246] the 5/14 Standard developed specifically out of the Service's own administrative guidance and sought to provide periods of ownership that were sufficient to demonstrate (at least for the PLR purposes) that the intermediary Bank was a true creditor that held Distributing Debt for tax purposes, bearing at least five days of price and event risk and at least 14 days of overall execution and credit risk. The Service issued many PLRs referencing the 5/14 Standard.[247]

The 5/14 Standard originally developed out of a series of technical advice memoranda ("**TAMs**") issued by the Service in 1987.[248] To avoid taxable income under the law at the time, a 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 intermediary was respected as holding the taxpayer's debt, 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

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[246] *See* Prior 2024 Report, at pp. 16-18.

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

[248] TAM 8738003 (May 22, 1987); TAM 8735007 (May 18, 1987); TAM 8735006 (May 18, 1987).

guidance).[249] 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 the taxpayer's debt on its own behalf and purchased and sold the taxpayer's 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 was economically exposed to the Distributing Debt such that it would be treated as a creditor for purposes of section 361(c)(3).

In each of the TAMs, the following salient elements (collectively, the "**TAM Factors**") appeared to be present: (i) the exchange agreement stated the underwriter was acting on its own behalf (as a principal) to acquire the debt being retired and not as the taxpayer's agent; (ii) the taxpayer did not provide the funds to the intermediary for the acquisition of the debt; (iii) the taxpayer did not guarantee the debt; (iv) the taxpayer did not indemnify the intermediary for any potential loss or expense incurred in connection with the acquisition of taxpayer's stock and the exchange, other than limited indemnification in the event the taxpayer was unable to entertain the underwriter's offer to engage in the exchange because of regulatory impediments; (v) the intermediary acquired the taxpayer's debt prior to execution of the exchange agreement; (v) the profit from the sale of the taxpayer's debt created profit for the intermediary, not the taxpayer; and (vi) no third party could look to the taxpayer for specific performance or damages on any contract entered into with the intermediary (*i.e.*, on the acquisition of the taxpayer's debt or the issuance of the taxpayer's stock).

The Prior 2024 Report also highlighted two pricing variations sometimes utilized in connection with Debt-for-Equity Exchanges (the "**Variable Pricing Models**"). In one Variable Pricing Model, the exchange agreement provides that Distributing will deliver Controlled stock to the intermediary in satisfaction of Distributing Debt, based on the market price of Controlled stock on the date of the exchange agreement, with a "true-up" amount to be paid by the intermediary to Distributing or vice versa in an amount based on the volume-weighted average price of Controlled stock over some period of time following the date of the exchange.[250] Under the other Variable Pricing Model, Distributing and an intermediary enter into an exchange agreement which provides that the intermediary will exchange Distributing Debt for Controlled stock on the settlement date at a ratio based on the volume-weighted average price of Controlled stock for the period between

[249] 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.

[250] *See* Prior 2024 Report, at pp. 27–28.

the signing of the exchange agreement and the settlement date.[251] The Prior 2024 Report recommended that both alternative pricing models are acceptable transactional forms on which the Service should rule.[252]

3. Recommendations Regarding Regular-Way Intermediated Exchanges

The recommendations discussed below relate specifically to the Intermediated Exchange Model and do not pertain to Debt-for-Debt Exchanges and Debt-for-Equity Exchanges effected as direct issuance transactions, which are addressed separately in Part VI.D.4 below.

Generally, we recommend that the Service continue to provide PLRs where taxpayers are, by reference to the TAM Factors, able to establish the intermediary's status as a creditor acting for its own account and that the form of an intermediated exchange is respected under substance over form principles. These inquiries are necessarily fact-intensive given the nature of the analysis, but continued reliance on the TAM Factors would further consistency and soundness in the administration of the tax law. Given the fact-intensive nature of what are essentially substance over form and agency determinations, we believe formal published guidance in this area would struggle to provide meaningful guideposts without running the risk of being over- and under-inclusive. Accordingly, save for the one exception outlined below, we believe the qualification under the Intermediated Exchange Model should continue to be determined on a case-by-case basis in the Service's administration of the PLR program.

Intermediated exchanges are typically structured to satisfy all of the specified TAM Factors, which we believe are an essentially correct distillation of the key facts relevant to the principal-agent analysis in this context. The main remaining uncertainty in this analysis, not specifically spelled out in the TAM Factors, is the minimum duration of ownership exposure to the Distributing Debt (if any) that is required to support an intermediary's creditor status. While we understand that Treasury and the Service have rejected the 5/14 Standard as a *de facto* safe harbor for respecting intermediated exchanges, we believe the creation of a bright-line minimum period of ownership similar to the 5/14 Standard (a "**Minimum Ownership Period**") would further the interests of sound tax administration. We recommend formal PLR guidelines confirming what, if any, designated Minimum Ownership Period is required to establish an intermediary's status as a creditor of Distributing for purposes of section 361(c)(3).[253]

As a general matter, if the taxpayer establishes an intermediary's creditor status under agency principles, we believe the form of an intermediated exchange should not be subject to recharacterization (*e.g.*, as a purchase of Controlled stock or securities by the intermediary for cash and a repayment of Distributing Debt by Distributing with that cash) under a step transaction or other substance over form analysis. Any attempt to impose such a recast would require the Service to ignore the transactions actually undertaken and create fictitious ones that are plainly inconsistent

[251] *See* Prior 2024 Report, at pp. 28–29.

[252] *See* Prior 2024 Report, at pp. 29–30.

[253] If Treasury and the Service decline to prescribe a Minimum Ownership Period, we recommend guidance confirming that satisfaction of all of the TAM Factors is sufficient to establish an intermediary's creditor status.

with the economic reality of the situation.[254] Additionally, consistent with the fundamental restraints on the step transaction doctrine articulated in Revenue Ruling 2017-9, intermediated exchanges involving historic Distributing Debt, or Refinancing Debt issued to retire historic Distributing Debt, (i) are fully consistent with the policies animating section 361(c)(3); (ii) do not avoid—and in fact are merely a mechanic to achieve—a particular result intended by section 361(c)(3), namely a reallocation of historic Distributing Debt to Controlled; and (iii) do not produce results that are in any way inconsistent with the underlying intent of section 361(c)(3).

As discussed in the Prior 2024 Report, Variable Pricing Models may be necessary when markets are volatile or Controlled stock is trading poorly due to other factors. Consistent with the recommendations of the Prior 2024 Report, we believe that such pricing models ought not be viewed as undermining the intermediary's position as a principal with respect to a Debt-for-Equity Exchange. Nevertheless, Representation 20 of Revenue Procedure 2024-24 seems to prohibit the use of a Variable Pricing Model in an intermediated exchange. This prohibition would be an unfortunate result that would deprive taxpayers of sensible pricing mechanics consistent with other real-world commercial transactions.

Finally, as discussed in Part VI.C.5 above, if Treasury and the Service decline to adopt our general recommendation of sanctioning direct issuance transactions, we recommend that the Service continue to issue (or resume issuing) favorable PLRs with respect to Regular Refinancing Debt that is not issued as part of a direct issuance transaction, including Regular Refinancing Debt that is satisfied with Controlled stock or securities in a Debt-for-Debt Exchange or Debt-for-Equity Exchange. As a practical matter, such transactions would often need to be structured as intermediated exchanges. We recommend that the Service permit intermediated exchanges involving Regular Refinancing Debt where the taxpayer establishes the intermediary's creditor status under the generally applicable standard described above. We do not believe intermediated exchanges involving Regular Refinancing Debt raise any different or heightened technical or policy concerns (including from a principal-agent and substance over form perspective) as compared to intermediated exchanges involving Distributing Debt that was outstanding before the Earliest Applicable Date.

4. Direct Issuance Transactions

The Prior 2024 Report describes in detail the mechanics of a typical direct issuance transaction in which Distributing (i) issues new debt (*i.e.*, Refinancing Debt) to a Bank for cash, (ii) uses the proceeds of the Refinancing Debt to retire historic Distributing Debt, and (iii) delivers Controlled stock or securities to the Bank in satisfaction of the Refinancing Debt. Based on the views expressed in Notice 2024-38, Treasury and the Service appear to be concerned that the step transaction doctrine may apply to disregard the Refinancing Debt as transitory, such that the transaction should be viewed as a sale of Controlled stock or securities by Distributing for cash (*i.e.*, the Refinancing Debt proceeds), notwithstanding Distributing's use of that cash to retire Refinanced Debt. As discussed in Part VI.D.1 above, Revenue Procedure 2024-24 unequivocally

[254] *See supra* notes 222–223 and accompanying text.

forecloses the possibility of obtaining a PLR with respect to this particular mechanic for reallocating historic Distributing Debt to Controlled.

This Report does not comprehensively revisit the evolution of the Service's ruling practice over time as it relates to direct issuance transactions or the reasons why we believe direct issuance transactions are a sensible and appropriate way to achieve debt exchanges under section 361, topics that are discussed at length in the Prior 2024 Report.[255] We do, however, fully stand by our prior recommendation that the Service should rule favorably with respect to direct issuance transactions, consistent with the Service's ruling practice at it developed under Revenue Procedure 2018-53. Accordingly, while we understand Treasury's and the Service's heightened vigilance with regard to direct issuance transactions, we believe the appropriate response is not to rule out an entire category of statutorily appropriate and commercially efficient transactions; rather, additional consideration should be given to formulating concrete and clear guidance as to the circumstances in which such direct issuance transactions should be permitted for PLR purposes, including adherence to the TAM Factors and any designated Minimum Ownership Period. A flat prohibition against PLRs on direct issuance transactions (other than direct issuances that occurred before the Earliest Applicable Date) overly excludes from the PLR program appropriate transactions that are permitted under the Code and does not serve the interests of sound tax administration.

We also believe that the scope of Revenue Procedure 2024-24's prohibition on "direct issuance" transactions sweeps far more broadly than is necessary to address concerns of the Treasury and the Service. If, consistent with our recommendation above, the repayment of Refinancing Debt is generally permitted outside of the context of a "direct issuance," the exact contours of what transactions are "direct issuances" will take on increased importance. As written, Representation 17 of Revenue Procedure 2024-24 prohibits the repayment of any debt issued by Distributing to an Intermediary at any point after the Earliest Applicable Date (i.e., Rev. Proc. 2024-24 Direct Issuances). Typically, however, an Intermediary financial institution has an existing, longstanding lending relationship with Distributing (which may in fact be one of the reasons a particular financial institution is selected as the Intermediary). As a result, the Intermediary is likely to participate as one member of a syndicate of lenders routinely looked to for Distributing's financing needs, including as a potential source of commercial paper or other Refinancing Debt. It would seem unnecessary and unwarranted to require Distributing to reconstitute an existing lending syndicate to exclude its chosen Intermediary in these circumstances. Additionally, Notice 2024-38 itself describes a direct issuance transaction as one in which directly issued debt is redeemed "in close temporal proximity" to its issuance. In contrast to this "close temporal proximity," Rev. Proc. 2024-24 Direct Issuances include any and all debt issued after the Earliest Applicable Date, which in many cases will be well more than a year prior to the Controlled Distribution Date.

In light of these economic realities, we recommend that the Service define prohibited direct issuance transactions narrowly, providing specific rules that adequately take into account commercial considerations and thus do not unintentionally cause taxpayers to have to forego efficient structures that do not raise the policy concerns underlying the prohibition on direct issuance transactions. For example, taking these considerations together, a "**Covered Direct**

[255] *See* Prior 2024 Report, at pp. 19–25.

Issuance Transaction" could be defined as a Debt-For-Debt Exchange or Debt-For-Equity Exchange with respect to Distributing debt issued to the participating Intermediary within a specified number of days of the subsequent exchange of the debt for Section 361 Consideration (in effect, requiring a Minimum Ownership Period in the direct issuance context).[256] Consistent with the limitations in Revenue Procedure 2024-24, Covered Direct Issuance Transactions could also be explicitly limited to those transactions in which the Intermediary participating in the Debt-for-Debt Exchange or Debt-For-Equity Exchange is the same party (or an affiliate of the party) that is the initial lender on the Distributing debt ultimately satisfied in the subsequent exchange.

While we also considered other factors that might be used to identify or exclude prohibited direct issuance transactions, we believe a concrete time-based restriction of the type described above is appropriate, standing alone, to police any concerns about the Intermediary's status as a creditor of Distributing. As one example, we believe that there are limited technical or policy-based rationales for prohibiting what is in form (or what might be described as) a direct issuance transaction where the Intermediary is a member of a broader syndicate of historic lenders that Distributing calls upon to lend Refinancing Debt following the Earliest Applicable Date in the ordinary course. While in such circumstances the Intermediary (which also happened to be a historic lender) continues to lend to Distributing under the Refinancing Debt, such a transaction would not appear to present the same concerns that Treasury and the Service have identified with respect to direct issuance transactions, and thus should not be treated with similar disfavor. Nevertheless, scrutiny of the identity of each member of a historic lender group may lead to artificial and anomalous distinctions if relied on as a rigid rule of exclusion or inclusion, and such an approach would be much more difficult to administer than a Minimum Ownership Period requirement with little discernible policy benefit.

E. Representation 37

Revenue Procedure 2024-24 requires taxpayers to represent that "[n]o proposed transaction or series of transactions will have as a principal purpose the avoidance of any requirement or limitation in [section] 357 or [section] 361" ("**Representation 37**").[257]

The intended scope of Representation 37 is not entirely clear. Section 357 and section 361 each contain a host of requirements and limitations, some of which do not perfectly overlap. For example, section 361(b)(3) and 357(c) impose basis limitations on, respectively, the amount of boot that may be received from, and the amount of liabilities that may be assumed by, Controlled without the recognition of gain to Distributing. Section 361(c)(3), as discussed above, contains no such basis limitation on the receipt or transfer of Controlled stock or securities to Distributing's creditors. Many taxpayers that avail themselves of section 361(c)(3) do so in large part because they have insufficient basis to effect a reallocation of Distributing's liabilities under section 361(b).

[256] *See, e.g.,* Prior 2024 Report, at p. 24 (recommending that consideration be given to requiring a 5/14 Standard for PLRs on direct issuance transactions in the event the Service did not accept our principal recommendation of sanctioning direct issuances generally). Given the heightened technical concerns with respect to direct issuance transactions that have been expressed by Treasury and the Service, a period longer than the 5/14 Standard (*e.g.*, 15 days prior to entering into the exchange agreement) could be considered.

[257] Rev. Proc. 2024-38, § 3.05(14)(a)(ii) (Representation 37).

The frictions and transaction costs of a Debt-for-Debt Exchange or Debt-for-Equity Exchange are generally much higher than the costs of repaying Distributing liabilities with cash, so many taxpayers would prefer to repay debt with cash, if sufficient basis were present. Without more guidance on the intention of Representation 37, it will be difficult for taxpayers to represent that a debt-for-debt or debt-for-securities exchange does not have as a principal purpose the "avoidance" of the Section 361(b)(3) Basis Limitation.

Given Revenue Procedure 2024-24's otherwise in-depth treatment of Debt-for-Debt Exchanges or Debt-for-Equity Exchanges, we do not believe Representation 37 is or should be read as preventing taxpayers from undertaking these transactions when Distributing has insufficient basis in the assets transferred to Controlled. Any such reading would have the effect of prohibiting express reliance on statutory directives established by Congress in the context of PLR requests. Furthermore, from the perspective of sound administration of the PLR program, a broad statement like Representation 37, with limited interpretive gloss or express exceptions, materially limits the extent to which a taxpayer may rely on the PLR. We do not believe the PLR program will be well served if a taxpayer's reliance on a PLR depends on a broadly worded representation invoking unspecified limitations that by statute do not apply to the taxpayer's chosen transactional form.

Accordingly, we recommend that the Service provide further guidance on the scope of this anti-avoidance representation and make clearer the types of actions that would be viewed as having a principal purpose of inappropriately avoiding the requirements or limitations in sections 357 or 361. Additionally, any such guidance should explicitly provide that merely structuring a transaction to fall within a particular provision of section 357 or 361 will not be considered as having a principal purpose to avoid another provision of those sections.

F. Replacement of Distributing Debt

1. Debt Replacement Concern Expressed in Notice 2024-38

Notice 2024-38 indicates that Treasury and the Service are "considering the application of the Code to borrowings by Distributing that replace Distributing Debt satisfied with Section 361 Consideration in a Divisive Reorganization."[258] As an example, Notice 2024-38 cites a transaction where, as of the date on which the Controlled business is transferred to Controlled, Distributing "anticipates entering into a borrowing that reverses the de-leveraging" that was effectuated in the Divisive Reorganization, "rendering such de-leveraging as merely transitory and without real economic effect."[259] Notice 2024-38 expresses the view that, in certain circumstances, this sort of "re-leveraging" transaction could be "used as an artifice for increasing the aggregate Debt and other Liabilities of Distributing and Controlled . . . replicat[ing] a tax-free sale of a portion of Controlled" (the "**Debt Replacement Concern**").[260] The references in Notice 2024-38 to "transitory" transactions "without real economic effect" that are "used as an artifice" suggest that

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[258] Notice 2024-38, section 2.02(8).

[259] *Id*.

[260] *Id*.

the Debt Replacement Concern is an anti-abuse concern not relevant to re-leveraging transactions undertaken for legitimate business purposes unrelated to any de-leveraging occurring pursuant to the Divisive Reorganization. In other words, Notice 2024-38 appears to recognize that there are non-abusive transaction structures that, though resulting in new Distributing borrowing, should be afforded nonrecognition treatment under Section 361.

Not only do we believe such non-abusive transactions involving re-leveraging transactions exist, but we also believe they represent the vast majority of Divisive Reorganizations. It is a near certainty that, at some point in time subsequent to the de-leveraging that occurs in connection with a Divisive Reorganization, Distributing will determine it is commercially desirable to engage in a new borrowing transaction. That determination will be made based on a number of considerations, most of which, even if anticipated or reasonably foreseeable at the time of the de-leveraging, are not known with certainty and are subject to change based on factors outside of the taxpayer's control (*e.g.*, cost of debt and equity capital, return on capital, cash flow, cash needs, volatility, etc.). Even where a post-separation borrowing transaction is "committed,"[261] there are a variety of reasons why it would be non-economic and commercially undesirable to leave Distributing's existing indebtedness outstanding (in lieu of de-leveraging and later consummating the committed borrowing). Debt comes in many flavors, even relatively short-term variations in a company's debt capitalization may have material economic consequences, and the treasury function must maintain flexibility to fund real-time capital needs using the instruments that are best suited in light of current facts and circumstances. These decisions as to how to appropriately address prospective and fluid capital needs are independent from the determination of the proper allocation of historic liabilities of the combined company. In other words, in most cases, borrowing is not being used as a planned replacement for previously retired debt. Particularly where the borrowing and/or the timing or the terms thereof are not planned or known at the time of the de-leveraging, an alternative structure whereby Distributing would retain all or a portion of the Section 361 Consideration it receives (leaving an equivalent amount of historic debt outstanding) would not only be expected to result in substantial economic differences, but would be expected to be ill-suited to address the nature and timing of the capital needs underlying the new borrowing. We believe it is a rarity that a Divisive Reorganization is part of a series of interdependent steps that includes a non-economic de-leveraging and an artificial re-leveraging. In light of these realities, the Debt Replacement Concern, any guidance addressing such concern, and any limitations on re-borrowings in the context of administering the PLR program, in each case, should be narrow – limited in relevance to abusive form-driven transaction structures that contravene the policies underlying section 361.[262]

Notice 2024-38 further indicates that "[t]ax advisors have provided feedback consistent with this view following the publication of Revenue Procedure 2018-53, in particular with regard

[261] We note that even a "committed" borrowing is not certain to occur. Rather, committed credit facilities reflect a commitment by the *lender* to lend on pre-agreed terms, but typically do not bind the borrower to borrow. There are a variety of reasons why a "committed" borrowing may never occur, *e.g.*, a failure to consummate a transaction that was meant to be funded by the borrowing.

[262] This approach is consistent with the statutory regulatory authority in Section 361(b)(3), which permits Treasury to "prescribe such regulations as may be necessary to prevent avoidance of tax through *abuse* of" section 361(b)(3) and section 361(c)(3). Section 361(b)(3).

to section 3.04(7) . . . ."[263] Section 3.04(7) of Revenue Procedure 2018-53 required taxpayers to represent that Distributing would not replace any Distributing Debt assumed or retired with Section 361 Consideration with "previously committed borrowing," with an exception for "borrowing in the ordinary course of business pursuant to a revolving credit agreement or similar arrangement."[264] Taxpayers relying on the revolver exception were required to establish that neither the establishment of, nor any increase in available borrowing under, the revolver was related to the Divisive Reorganization.[265] In our 2020 Report, we indicated our belief that, in the context of formulating required representations to support a PLR for a transaction involving a Divisive Reorganization, the "previously committed" standard "[struck] a reasonable balance," although we discussed the possibility that a broader ruling standard could be developed to address non-committed borrowings. Our prior recommendations, and our separate recommendations regarding substantive guidance related to the Debt Replacement Concern (as distinct from related procedural guidance), are discussed further below.

2. Debt Replacement Concern and Future Substantive Guidance

The Debt Replacement Concern arises from the principle that Divisive Reorganizations are intended to facilitate the allocation of historic Distributing liabilities between Distributing and Controlled and are not intended to facilitate an increase in the aggregate liabilities of Distributing and Controlled (*i.e.*, the Debt Allocation Principle, discussed in the 2020 Report).[266] As described in the 2020 Report, Divisive Reorganizations involving an overall plan to (i) utilize Section 361 Consideration to retire Distributing debt and (ii) increase the aggregate liabilities of Distributing and Controlled by re-levering Distributing and replacing the retired indebtedness may be more akin to a partial sale of the Controlled business than an allocation of historic Distributing debt.[267] We continue to believe that the Debt Allocation Principle properly reflects the intention of section 361 and thus, as a general matter, the Debt Replacement Concern expressed in Notice 2024-38 is valid.

Case Study 5: Partial Sale of the Controlled Business

> 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 business line to a domestic Controlled in a Divisive Reorganization in exchange for Section 361 Consideration, 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 2024, and the Divisive Reorganization and

[263] Notice 2024-38, section 2.02(8).

[264] Rev. Proc. 2018-53, section 3.04(7).

[265] *Id.*

[266] *See* 2020 Report, at p. 10.

[267] *Id.*

Distribution occur in September of 2024. As part of the Divisive Reorganization, Distributing receives $100X of cash (funded with new Controlled borrowing) as Section 361 Consideration and retains the cash for general corporate purposes.

Case Study 6: Reborrowing Pursuant to a Previously Committed Financing

Same facts as Case Study 5, except, as part of the Divisive Reorganization, Distributing utilizes the $100X received as Section 361 Consideration to repay historic Distributing Debt.[268] In June of 2024, Distributing and third party lenders entered into a committed financing arrangement pursuant to which, in October 2024, Distributing will borrow $100X, the proceeds of which will be retained or used for general corporate purposes (*i.e.*, for no business purpose other than to replace the retired historic Distributing Debt).

Case Study 7: Reborrowing Pursuant to an Overall Plan to Unwind De-Leveraging

Same facts as Case Study 5, except, as part of the Divisive Reorganization, Distributing utilizes the $100X received as Section 361 Consideration to repay historic Distributing Debt. In June of 2024, Distributing and third party lenders enter into a discussions regarding a post-Spin-off borrowing pursuant to which Distributing would borrow $100X, the proceeds of which would be retained or used for general corporate purposes (*i.e.*, for no business purpose other than to replace the retired historic Distributing Debt). At no time prior to the Spin-off is there a commitment or other agreement between Distributing and the lenders regarding the post-Spin-off borrowing, however, Distributing intends to re-lever post-Spin-off. In October of 2024, Distributing borrows $100X from third-party lenders, with the proceeds being retained or used for general corporate purposes.

Case Studies 5, 6 and 7 highlight the similarities between a partial sale of the Controlled business, on the one hand, and the replacement of Distributing indebtedness satisfied with Section 361 Consideration through either a previously committed borrowing or a non-committed but planned borrowing intended to re-lever (and not supported by a separate business purpose), on the other hand. In all three Case Studies, the overall transaction results in (1) Controlled debt increasing by $100X and Distributing's leverage remaining unchanged, representing an increase in the aggregate liabilities of Distributing and Controlled by $100X, (2) a transfer by Distributing to Controlled of the Controlled business, and (3) Distributing's cash increasing by $100X. This result replicates a sale by Distributing of a portion of the Controlled business for cash raised through new Controlled borrowing. Under the Debt Allocation Principle, whether effectuated through an actual partial sale of the Controlled business (Case Study 5) or a synthetic sale pursuant to a pre-Spin-off commitment (Case Study 6) or plan to replace the retired Distributing Debt (Case Study 7), any of these three scenarios should not be afforded nonrecognition treatment under section 361(b) and should instead result in gain recognition to the extent of the cash retained (or

[268] In all case studies and other fact patterns discussed herein, the repayment of historic Distributing Debt may occur pursuant to the Divisive Reorganization but after the Control Distribution Date. Our recommendations apply equally regardless of whether the de-leveraging transaction that occurs pursuant to the Divisive Reorganization occurs prior to, at, or after the Control Distribution Date. See *infra* n. 271 regarding the import of the passage of time between the de-leveraging and re-leveraging transactions.

replaced and retained). Case Study 5 would clearly result in gain recognition (to the extent of boot) under section 361(b) as a result of the failure to distribute the boot to shareholders or transfer it to creditors pursuant to the plan of reorganization. Notice 2024-38 appears to be raising the question as to whether, under current law, Case Studies 6 and 7 and similar fact patterns would be treated equivalently under section 361(b).[269]

As noted in the 2020 Report, neither section 361 nor any other related statutory provision or Treasury Regulation limits Distributing's ability to engage in transactions that result in the replacement of any Distributing liabilities that were satisfied with Section 361 Consideration. Accordingly, section 361 would not appear to impose gain recognition in Case Studies 6 and 7. However, while we continue to believe that the step transaction doctrine generally should not be employed where the overall result is consistent with the policies underlying section 361,[270] where the overall result of a transaction involving a replacement of Distributing indebtedness is, as in Case Studies 6 and 7, contrary to the Debt Allocation Principle, we believe it would be appropriate to apply relevant anti-abuse principles, including substance over form.[271] In other words, we

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[269] Each of Case Studies 5, 6 and 7 involves de-leveraging with Section 361 Consideration in the form of cash. Where Section 361 Consideration is in the form Controlled stock or securities transferred to creditors, then, outside of Direct Issuances, the Debt Replacement Concern should not be relevant – there is no transfer of cash from Controlled (replicating a partial sale of the Controlled business) and there is no transfer of cash from the creditor to whom Controlled stock or securities are transferred (replicating a sale of such Controlled stock or securities). However, a Direct Issuance coupled with a re-borrowing could implicate the Debt Replacement Concern, as the recipient of Controlled stock or securities (the Bank) is the creditor who has transferred cash to Distributing. If, similar to Case Studies 6 and 7, in connection with the Debt-for-Debt Exchange or a Debt-for-Equity Exchange, Distributing borrows post-Spin-off for no independent business purpose other than to replace the Bank debt satisfied with Controlled stock or securities, a similar concern is raised regarding the qualification of the transfer of Controlled stock or securities under section 361(c): should the proceeds of the re-leveraging be treated as having satisfied the Bank debt, with the Bank treated as delivering cash to Distributing in exchange for Controlled stock or securities in a sale transaction? The same analysis should apply with respect to the Debt Replacement Concern in a scenario involving a Direct Issuance coupled with a re-borrowing (and our recommendations apply equally in that scenario).

[270] *See* 2020 Report, at p. 10.

[271] We note that the duration of time between the retirement of Distributing Debt with Section 361 Consideration and the replacement of such Distributing Debt is relevant to the question of whether the transaction is appropriately recast pursuant to substance over form or other general principles of tax law. For example, consider the result in Case Study 7 if, despite Distributing's intent to replace its liabilities immediately after the Spin-off, it was ultimately unable to effectuate a reborrowing for 12 or more months after the retirement of its debt with Section 361 Consideration. The terms of the debt incurred in the later reborrowing might reflect materially different economics compared to the retired Distributing Debt and/or the anticipated terms of the reborrowing at the time of the Divisive Reorganization, depending on fluctuations in interest rates, changes in Distributing's business or financial health, overall macroeconomic conditions, or other relevant factors. While the application of substance over form principles to a particular transaction will need to take into account all relevant facts and circumstances, we generally believe that the longer the duration of time between the de-leveraging pursuant to the Divisive Reorganization and the re-leveraging pursuant to the subsequent reborrowing, and the more significant the differences in the economic terms of the retired Distributed Debt and putative replacement Distributing Debt, the less likely it is that the proceeds of the reborrowing transaction (and not the Section 361 Consideration) should be treated as having satisfied the historic debt for purposes of determining eligibility for nonrecognition treatment under section 361. However, the views expressed in Notice 2024-38 appear to be consistent with this belief, as, ultimately, such a delay suggests that the de-leveraging transaction was not "transitory" or "without real economic effect."

believe that, under current law and without the need for further substantive guidance, fact patterns involving Distributing de-leveraging that is "merely transitory and without real economic effect" and Distributing re-leveraging that is "used as an artifice for increasing the aggregate" liabilities of Distributing and Controlled (the situations underlying the Debt Replacement Concern) would be recast and not afforded nonrecognition treatment.[272]

Moreover, as described in the 2020 Report, fact patterns involving a post-Spin-off re-leveraging transaction intended to replace Distributing Debt retired with Section 361 Consideration (and not supported by an independent business purpose) are likely to be unusual.[273] And, as discussed in the 2020 Report and as further highlighted below, it is difficult to identify clear principles (other than those already embodied in general anti-abuse principles, such as substance over form) on the basis of which future substantive guidance might appropriately distinguish between artificial re-borrowing transactions intended to replace retired Distributing Debt and genuine post-Spin-off borrowing transactions unrelated to the Divisive Reorganization.[274]

Case Study 8: Reborrowing Pursuant to a Previously Committed Borrowing Outside the Ordinary Course but Unrelated to the Spin-Off

Same facts as Case Study 5, except, in June of 2024, Distributing successfully bids on the acquisition, for $100X, of an unrelated corporation engaged in the Distributing business and, in connection with the execution of the acquisition agreement, enters into committed financing arrangements with a syndicate of third-party lenders. The committed financing is fully committed prior to the Divisive Reorganization. As part of the Divisive Reorganization, Distributing utilizes the $100X received as Section 361 Consideration to repay historic Distributing Debt. In October of 2024, the acquisition of the target corporation closes and, in connection with the closing and to fund the acquisition, Distributing borrows $100X from the syndicate of third-party lenders pursuant to the committed financing.

The fact pattern in Case Study 8 involves a post-Spin-off re-leveraging transaction that is both fully committed and planned at the time of the Divisive Reorganization, reverses the de-leveraging that was effectuated through the use of Section 361 Consideration, and, taken together with the Spin-off and related transactions, increases the aggregate liabilities of Distributing and

[272] We believe this is the case regardless of whether the "re"-leveraging transaction follows or precedes the de-leveraging transaction (*i.e.*, Distributing cannot simply avoid a recast with respect to an artificial post-Spin-off re-borrowing that serves no purpose other than to unwind a de-leveraging by accelerating the borrowing transaction to precede the de-leveraging).

[273] 2020 Report, at p. 34 ("it is unlikely that Distributing would undertake a borrowing and retain the proceeds without a specified use (*i.e.*, simply as a replacement for Distributing Debt repaid from boot received) due to negative arbitrage").

[274] *See id*. ("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.").

Controlled. However, the re-leveraging transaction was supported by a business purpose unrelated to the de-leveraging occurring in the Divisive Reorganization, the proceeds of the "replacement" indebtedness are utilized in furtherance of that business purpose, albeit outside the ordinary course of Distributing's business, and, taking into account the acquisition, the aggregate liabilities of the two companies encumber an expanded universe of assets than the assets Distributing held immediately prior to the Spin-off. It would not be economically rational for Distributing to support its acquisition-related capital needs by simply retaining the cash received as Section 361 Consideration and leaving the existing Distributing debt outstanding. At the time of the Divisive Reorganization, the unrelated acquisition is uncertain to occur, and Distributing does not know whether it will require additional capital and consummate the related borrowing transaction, notwithstanding that the lenders are committed to lend if the acquisition closes. Further, it is unlikely that the existing Distributing indebtedness is well-suited to finance the post-closing acquisition, *e.g.*, with respect to the collateral package or repayment terms. At a minimum, the terms of the potential new borrowing will almost certainly diverge from the terms of the existing indebtedness. A recast that would treat Distributing as though it had engaged in a different transaction with different economic consequences and no compelling commercial rationale, *i.e.*, as though it had retained Section 361 Consideration and satisfied its existing indebtedness with the proceeds of the new borrowing, ignores these realities. The re-leveraging transaction in Case Study 8 should not be viewed as an "artifice" for increasing the aggregate liabilities of Distributing and Controlled and should not implicate the Debt Replacement Concern.

Case Study 9: Reborrowing Pursuant to a Previously Committed Revolving Credit Agreement that Would Not Have Occurred Absent the Spin-Off

> Same facts as Case Study 5, except, in June of 2023, Distributing entered into a revolving credit agreement, pursuant to the terms of which Distributing is entitled to borrow, and the syndicated group of lenders is required to lend, up to $100X. The revolving credit agreement has a final maturity date of June of 2033, but amounts borrowed 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. As part of the Divisive Reorganization, Distributing utilizes the $100X received as Section 361 Consideration to repay historic Distributing Debt. In October of 2024, Distributing borrows $100X under the revolving credit agreement in the ordinary course of business, using the proceeds to fund its operational capital needs. Also in October of 2024, the Controlled business outperforms expectations, exceeding cash flow projections by $100X.

Case Study 9 involves a re-leveraging transaction pursuant to a revolving credit agreement that was in existence well in advance of the announcement of the Spin-off where the overall borrowing available under the facility is not increased. While the actual amount borrowed under the facility is increased, the borrowing is incurred in the ordinary course of business unrelated to the Spin-off transaction. Similar to Case Study 8, Distributing did not require additional capital at the time of the Divisive Reorganization and, had it required capital at such time, it is unlikely that the existing Distributing indebtedness (which was not outstanding indebtedness under the revolver) would have been the proper source. However, the borrowing may not have been incurred

in the absence of the Spin-off because, in that case, the cash generated by the Controlled business could have funded Distributing's ordinary course capital needs (without incurring the interest expense associated with the borrowing). Despite that fact, the re-leveraging transaction in Case Study 9 should not implicate the Debt Replacement Concern—it was in furtherance of legitimate business purposes and was not intended to replace the retired Distributing Debt satisfied with Section 361 Consideration.

Case Study 10: Reborrowing That is Reasonably Foreseeable to Occur

> Same facts as Case Study 5, except, as part of the Divisive Reorganization, Distributing utilizes the $100X received as Section 361 Consideration to repay historic Distributing Debt. At the time of the Divisive Reorganization, Distributing does not require additional capital, although it anticipates that, if certain facts were to develop post-closing (*e.g.*, related to reasonably foreseeable industry developments that are not certain to occur), it would require additional capital in March of 2025. It has discussed the possible economic terms of a future borrowing with lenders. However, Distributing does not intend to borrow (and Distributing does not commit to borrow) any amounts until such time as such capital needs may arise. In March of 2025, Distributing determines that it requires additional capital in light of then current facts and circumstances and borrows $100X pursuant to a newly negotiated Distributing credit facility, using the proceeds to fund its operational capital needs.

At the time of the Divisive Reorganization in Case Study 10, Distributing has neither committed to a post-Spin-off borrowing nor has it planned to re-leverage in connection with the Spin-off transaction. Rather, with a view to the specific capital needs of its business that are expected to arise post-Spin-off in certain scenarios, Distributing reasonably foresees that a post-Spin-off borrowing may be desirable. Any post-closing borrowing is not certain to occur at the time of the Divisive Reorganization (and thus, the de-leveraging is not "transitory") and would be intended to address post-closing capital needs not known with certainty at the time of the Divisive Reorganization (and thus, the re-leveraging is not an "artifice"). Case Study 10 should not implicate the Debt Replacement Concern.

Because the results of the transactions in Case Studies 8, 9 and 10 are consistent with the Debt Allocation Principle, we do not believe that general principles of tax law should or would operate to recast the relevant transaction steps such that the utilization of Section 361 Consideration to satisfy historic Distributing Debt would be disregarded. Were Treasury to promulgate substantive guidance intended to clarify that Case Studies 6 and 7 are not afforded nonrecognition treatment under section 361(b), such guidance would need to rely on principles or factors that would not result in the fact pattern in Case Study 8, 9 or 10 failing to come within the ambit of nonrecognition treatment. Factors such as "previously committed," "planned," or "anticipated" borrowings or borrowings that occur "outside the ordinary course" or that "would not have occurred in the absence of the Spin-off" would all fail to isolate the artificial transactions in Case Studies 6 and 7 from the legitimate, non-abusive transactions in Case Studies 8, 9 and 10. Alternatively, reliance on the appropriate application of substance over form principles to fact patterns that are inconsistent with the Debt Allocation Principle adequately polices the Debt Replacement Concern. For these reasons, we do not believe that substantive guidance is necessary

(or well-suited) to identify the artificial transactions that implicate the Debt Replacement Concern, and we recommend that no such substantive guidance be issued.

i. Recommendation: New Borrowing Safe Harbor

We recommend that any substantive guidance regarding the Debt Replacement Concern confirm when a borrowing transaction will *not* be recast in a manner that disturbs the section 361 qualification of the de-leveraging transaction undertaken pursuant to a Divisive Reorganization (a "**De-Leveraging Unwind**"). The common threads in the non concerning fact patterns described above, and, we believe, in all fact patterns that do not implicate the Debt Replacement Concern (and should therefore not be treated as a De-Leveraging Unwind), are (i) a non-tax business purpose supporting the re-leveraging transaction (a "**Borrowing Business Purpose**"), (ii) the utilization of the proceeds of the re-leveraging in a manner consistent with the Borrowing Business Purpose, and (iii) non-tax economic effect of the de-leveraging transaction (*i.e.*, a different economic result than merely retaining the Section 361 Consideration (or, in the case of non-cash Section 361 Consideration in connection with a Direct Issuance, monetizing the Section 361 Consideration), other than U.S. federal income tax consequences ("**Economic Effect**"). Therefore, we recommend that substantive guidance confirm that any borrowing motivated by a Borrowing Business Purpose, where the proceeds of the borrowing are utilized in a manner consistent with such Borrowing Business Purpose and the de-leveraging transaction has Economic Effect, not be subject to recast, under substance over form or other general principles of tax law, as a De-Leveraging Unwind, *i.e.*, as an unwinding of the Distributing debt satisfied with Section 361 Consideration, such that the de-leveraging transaction undertaken as part of the Divisive Reorganization would not qualify for nonrecognition treatment under section 361(b) or (c) (the "**New Borrowing Safe Harbor**").

ii. Recommendation: Relevant Factors

Outside of the New Borrowing Safe Harbor, there are several factors ("**New Borrowing Factors**") that support a finding that a borrowing transaction should not be treated as a De-Leveraging Unwind, and several factors ("**Unwind Factors**") that cut against such a finding. We recommend that guidance provide that the determination of whether a borrowing will be subject to recast as a De-Leveraging Unwind will be made from all of the facts and circumstances, including but not limited to the presence of New Borrowing Factors and Unwind Factors. The New Borrowing Factors should include: (i) the existence of a non-tax business purpose supporting the re-leveraging transaction, (ii) the utilization of the proceeds of the borrowing in a manner consistent with such business purpose, (iii) the absence of a plan to undertake the re-leveraging transaction at the time of the Control Distribution,[275] (iv) the passage of time between the de-leveraging and re-leveraging transactions, (v) the ordinary course nature of the re-leveraging transaction and/or its consistency with historic practices, and (vi) evidence that, as a result of the de-leveraging transaction and without regard to the re-leveraging transaction, Distributing was appropriately leveraged from a capital markets perspective, taking into account the facts and

[275] Even where the de-leveraging transaction occurs after the Control Distribution Date, Distributing will have received the Section 361 Consideration pursuant to the Divisive Reorganization, the same plan of reorganization with respect to which Distributing will transfer such Section 361 Consideration to its creditors. Therefore, consistent with Revenue Procedure 2024-24, we believe it is appropriate to ascertain the relatedness between the de-leveraging and re-leveraging transactions as of the Control Distribution Date.

circumstances known and relevant immediately after the de-leveraging transaction. The Unwind Factors should comprise the following: (i) the lenders with respect to the re-leveraging transaction comprising the same lenders as those with respect to the indebtedness satisfied in the de-leveraging transaction, (ii) the terms of the debt borrowed in the re-leveraging transaction being the same (or substantially similar) to the terms of the debt satisfied in the de-leveraging transaction,[276] (iii) the retention of the proceeds of the borrowing (unless such retention is consistent with the business purpose supporting the borrowing), and (iv) when taken together with the re-leveraging transaction, the absence of economic effect of the de-leveraging transaction.

3. Approach to the Debt Replacement Concern in Revenue Procedure 2024-24

i. Anticipated or Committed Borrowings

To address the Debt Replacement Concern in the context of PLRs, section 3.05(12) of Revenue Procedure 2024-24 requires that, in connection with a ruling for a transaction involving a Divisive Reorganization, taxpayers represent that neither Distributing nor any Distributing Related Person (determined immediately after the Control Distribution) will replace, directly or indirectly, any Amount of Distributing Debt that will be satisfied with Section 361 Consideration with borrowing that Distributing or any such related person "anticipates or is committed to, directly or indirectly, before the Control Distribution Date" ("**Representation 30**").[277] Representation 30 broadens Revenue Procedure 2018-53's approach to the Debt Replacement Concern by taking into account (i) not only previously committed borrowings ("**Committed Borrowings**"), but also borrowings that are directly or indirectly "anticipated" to occur ("**Anticipated Borrowings**"), in each case, before the Control Distribution Date and (ii) borrowings by persons related to Distributing within the meaning of section 267(b) or section 707(b)(1).[278]

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[276] If the terms of the debt borrowed in the re-leveraging transaction would not cause a significant modification of the debt satisfied in the de-leveraging transaction (had such satisfied debt instead been modified to reflect such terms), the terms should be treated "substantially similar" for purposes of this Unwind Factor.

[277] Rev. Proc. 2024-24, section 3.05(12).

[278] We generally agree that a reborrowing by a related person that replicates the economics of a reborrowing (or partial cash sale) by Distributing should be captured. However, we note that it is inconsistent to treat, for purposes of Representation 30, indebtedness incurred by a Distributing Related Person post-Spin-off as "replacing" Distributing Debt that was satisfied with Section 361 Consideration, yet ignore third party indebtedness of a Distributing Related Person outstanding as of the Earliest Applicable Date for purposes of measuring the historical average Distributing Debt eligible to be satisfied with Section 361 Consideration. We recommend that these two standards maintain a consistent approach with respect to the entities whose indebtedness that is treated as historic, or replacement of historic, Distributing Debt. For example, if the Revenue Procedure 2018-53 approach to the calculation of historical average Distributing Debt were followed for purposes of Representation 23, taking into account certain liabilities of members of the Distributing "separate affiliated group" within the meaning of section 355(b), then we would recommend that Representation 30 treat as relevant related persons whose post-closing borrowings are treated as "reborrowings" by Distributing only such members of the Distributing "separate affiliated group." On the other hand, if no debt of related persons is taken into account for purposes of Representation 23, then it is inconsistent to take into account post-closing borrowings by related persons for purposes of Representation 30.

If the taxpayer does not make Representation 30, a favorable ruling will generally only be considered if the taxpayer establishes eligibility for one of two exceptions.

ii. Revolver Exception

First, the taxpayer may establish that the new borrowing "is incurred in the ordinary course of business pursuant to a revolving credit agreement or similar arrangement that is unrelated, and would have been incurred without regard, to the" Spin-off or any related transaction (the "**Revolver Exception**").[279] The revolver must have been in existence as of the Earliest Applicable Date,[280] and the taxpayer must establish that any increase either in the available borrowing under the revolver or the actual amount borrowed thereunder (i) did not occur in connection with the spin-off, (ii) would have occurred without regard to the spin-off or any related transaction, and (iii) occurred in the ordinary course of business (*i.e.*, any increase is demonstrably independent of the spin-off or any related transaction).[281]

iii. Changed Circumstances Exception

Second, the taxpayer may establish that the new borrowing "results from an event, unrelated to the [Spin-off] and not in the ordinary course of business of Distributing, directly arising from changed circumstances that were not anticipated prior to the Control Distribution Date (that is, unrelated to the [Spin-off] or any transaction related to the [Spin-off])" (the "**Changed Circumstances Exception**").[282] The taxpayer must establish that (i) the event (a) occurred outside the ordinary course of business of Distribution, (b) did not occur in connection with the Spin-off, and (c) directly arose from changed circumstances that were unanticipated prior to the Control Distribution Date (*i.e.*, the event is demonstrably independent of the Spin-off or any related transaction) and (ii) the borrowing would have been incurred without regard to the Spin-off or any related transaction.[283]

iv. Recommendations

Arguably, Revenue Procedure 2024-24 should simply address the Debt Replacement Concern by assessing whether the de-leveraging and re-leveraging transactions (regardless of the order in which they occur) are appropriately subject to recast under substance over form principles, *i.e.*, whether the de-leveraging is "merely transitory and without real economic effect" and the re-leveraging is "used as an artifice for increasing the aggregate" liabilities of Distributing and Controlled. We would recommend that the Service make this assessment by replacing Representation 30 with a representation that any planned or anticipated re-leveraging transaction is expected to qualify for the New Borrowing Safe Harbor (the "**New Borrowing**

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[279] Rev. Proc. 2024-24, section 3.05(12)(b)(i).

[280] *Id.*, section 3.05(12)(c)(i)(A).

[281] *Id.*, section 3.05(12)(c)(i)(B).

[282] *Id.*, section 3.05(12)(b)(ii).

[283] *Id.*, 2024-24, section 3.05(12)(c)(ii)(B).

Representation").[284] This representation would apply to all planned or anticipated re-leveraging transactions, whether Committed Borrowings, Anticipated Borrowings, or otherwise and whether occurring in the ordinary course ("**Ordinary Course Borrowing**") or otherwise ("**Non-Ordinary Course Borrowing**").

However, to the extent the Service prefers to maintain a more nuanced approach, in particular with respect to Committed Borrowings, we recommend that Revenue Procedure 2024-24 (i) modify its approach with respect to Anticipated Borrowings and other non-committed borrowings and (ii) expand the exceptions to the general prohibition on Committed Borrowings, as further described below.

a. Recommendations Related to Anticipated Borrowing and Other Non-Committed Borrowing

We recommend that Representation 30 be limited to Committed Borrowings and, with respect to any non-Committed Borrowings (including Anticipated Borrowings), Revenue Procedure 2024-24 should rely on the New Borrowing Representation. As discussed above, the Debt Replacement Concern relates to transactions where, not only does Distributing anticipate that it will reborrow, but, moreover, the reborrowing is not motivated by a separate business purpose. Rather, the reborrowing is used as an artifice to replace the Distributing Debt that was retired with Section 361 Consideration and to allow Distributing to retain the cash proceeds, violating the Debt Allocation Principle and replicating a partial sale of the Controlled business. As discussed above, several factors may suggest that an Anticipated Borrowing, *i.e.*, a post-Spin-off borrowing that is directly or indirectly anticipated[285] at the time of the separation transaction is not, in fact, being used as an artifice to replace retired Distributing Debt. Since the Debt Replacement Concern is an anti-abuse concern that is, in our view, appropriately policed by substance over form and similar principles, mere "anticipations," without more, should be insufficient to implicate the concern. Rather, the ruling standard should seek to ascertain whether any re-leveraging transaction, including an Anticipated Borrowing, is used as an artifice to increase the overall leverage of Distributing and Controlled and renders the de-leveraging without economic effect (*i.e.*, whether the result of the re-leveraging transaction could have been achieved by simply retaining (or monetizing) the Section 361 Consideration received in the Divisive Reorganization and leaving the existing Distributing debt outstanding).

For example, in Case Study 10, discussed above, before the Control Distribution Date, Distributing believes that its future capital needs may require a post-Spin-off borrowing if certain facts and circumstances were to arise (though whether or not such facts and circumstances will be relevant or such borrowing will occur is not known at such time). In that sense, any future

[284] Alternatively, to the extent substantive guidance is promulgated that adopts the New Borrowing Safe Harbor and New Borrowing Factors, and to the extent the Service is willing to rule on the issue of whether a re-leveraging transaction is subject to recast as a De-Leveraging Unwind, Revenue Procedure 2024-24 should require taxpayers to either (i) make a representation establishing the elements of the New Borrowing Safe Harbor or (ii) submit the New Borrowing Factor Analysis (as defined below) to support such a ruling.

[285] The reach of the notion of an "indirect" anticipation is unclear, but, arguably could pick up Distributing's reasonably foreseeable capital needs in certain post-Spin-off scenarios that assume the occurrence of post-Spin-off events, even where those events are neither within Distributing's control nor certain to occur.

borrowing could be viewed as having been "anticipated" before the Control Distribution Date—it was reasonably foreseeable, as were the potential facts and circumstances giving rise to Distributing's capital needs. While the Anticipated Borrowing would not be motivated by an intent to replace the Distributing Debt that was satisfied with Section 361 Consideration, it would, in fact, result in a "re-leveraging" or debt "replacement" (and it might also be true that no such re-leveraging would have been necessary had the retired Distributing Debt remained outstanding in connection with the Spin-off). In other words, the fact pattern of Case Study 10 appears to be inconsistent with Representation 30 and would be regardless of the time that elapses between the Divisive Reorganization and the Anticipated Borrowing. Moreover, Distributing would not qualify for the Revolver Exception or the Changed Circumstances Exception. While, for the reasons discussed above, we do not believe that Case Study 10 raises the Debt Replacement Concern, Revenue Procedure 2024-24 suggests that this fact pattern would not be eligible for a favorable ruling. We disagree with this result.

Instead of relying on an "anticipates" standard that captures non-abusive fact patterns, the Service should address its Debt Replacement Concern with respect to non-Committed Borrowings in the context of the ruling program by ascertaining, through the New Borrowing Representation, whether such non-Committed Borrowings are part of the plan pursuant to which the Divisive Reorganization is intended to unwind the de-leveraging and has the effect of unwinding. Non-Committed Borrowings that are undertaken for a non-tax business purpose and are not intended to eliminate the economic effect of the de-leveraging transaction should be permissible, regardless of whether arising from changed or reasonably foreseeable circumstances, whether occurring pursuant to existing revolving credit agreements or newly negotiated instruments, or whether intended to facilitate ordinary course or extraordinary capital needs (*i.e.*, whether Ordinary Course Borrowings or Non-Ordinary Course Borrowings). This standard is comparable to Revenue Procedure 2024-24's focus on whether the post-Spin-off borrowing is "demonstrably independent of" the Spin-off and related transactions; the "demonstrably independent" standard is not appropriately ascertained solely by reference to pre-Spin-off anticipations, as it is, in effect, assessing whether the substance of the post-Spin-off borrowing, when considered together with the de-leveraging as part of the Divisive Reorganization, supports respecting the transaction in accordance with its form or instead suggests that the two transactions should be recast.

If the Service does not adopt our recommendation with respect to the New Borrowing Representation, then we would recommend that, with respect to non-Committed Borrowings, Revenue Procedure 2024-24 require that the taxpayer submit analysis to establish that, based on the New Borrowing Factors and the Unwind Factors, any planned or anticipated non-Committed Borrowing would not be expected to be subject to recast as a De-Leveraging Unwind (the "**New Borrowing Factor Analysis**"). In that case, we recommend that Revenue Procedure 2024-24 retain the Changed Circumstances Exception[286] in the form of a safe harbor to establish that a non-Committed Borrowing satisfies the New Borrowing Factor Analysis. As shown in Case Study 10, the Changed Circumstances Exception is *an* example of, but not the *sole* example of, a fact pattern involving a non-Committed Borrowing that does not implicate the Debt Replacement Concern.

[286] In the event the Service adopts our recommendation with respect to the New Borrowing Representation, the Changed Circumstances Exception would no longer be relevant to Revenue Procedure 2024-24 and could be eliminated.

However, we believe that the Changed Circumstances Exception (or safe harbor) would need to be expanded to (i) eliminate any requirement that the changed circumstances were not anticipated[287] and (ii) include changed circumstances arising from ordinary course events.[288] Changed circumstances may be reasonably foreseeable (and thus, arguably, anticipated) and may arise in the ordinary course of business (*e.g.*, cyclical or seasonal volatility) without suggesting that a borrowing by Distributing to respond to such circumstances (that are, definitionally, not the circumstances that were relevant at the time of Divisive Reorganization) if and when they should arise was planned at the time of the de-leveraging or is otherwise inconsistent with the Debt Allocation Principle. It is critical to the treasury function of any business to not only contingency plan in light of possible future scenarios, but also to react to those scenarios if and when they actually occur. It is equally important to be able to manage liabilities in a cost-effective manner, *e.g.*, by de-leveraging when appropriate in light of current facts and circumstances but standing ready to re-leverage in response to changed circumstances that are reasonably anticipated but uncertain to occur. This normal course activity is not inconsistent with the debt allocation decisions made in connection with a Divisive Reorganization, including the utilization of Section 361 Consideration to retire existing Distributing Debt.

The Changed Circumstances Exception (or safe harbor) also should not require a showing that the post-Spin-off borrowing would have occurred without regard to the Spin-off or related transactions. As described with regard to Case Study 9 above, this counterfactual and hypothetical state of the world is difficult to establish in light of changed circumstances that suggest that the capital needs of the Distributing business might have been satisfied in a different manner were it still operated under a single corporate structure with the Controlled business. This may be particularly difficult to establish where a Spin-off is motivated by a business purpose related to an internal competition for capital or facilitating Distributing's ability to implement an appropriate capital structure. If Distributing's capital needs have historically been funded by Controlled's cash flow generation, it may not be possible to conclude that Distributing's re-leveraging would have occurred in the absence of the Spin-off. Alternatively, it may be the case that Distributing is able to incur more, or more favorable, indebtedness as a result of the Spin-off. On such facts, a taxpayer would not be able to conclude that *any* new borrowing would have been incurred in the absence of the Spin-off, as the Spin-off was a necessary prerequisite to such borrowing. Neither case, however, suggests that the re-leveraging was solely motivated by an intent to replace the Distributing Debt that was satisfied with Section 361 Consideration. Therefore, we recommend that the Changed Circumstances Exception (or safe harbor) should not require the taxpayer to establish that, in a counterfactual world in which the business separation transaction did not occur, the borrowing transaction would have occurred.[289]

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[287] The Changed Circumstances Exception requires the borrowing to arise from an event "directly arising from changed circumstances that were not anticipated prior to the Control Distribution Date."

[288] The Changed Circumstances Exception requires the borrowing to arise from an event that does not occur in the ordinary course of business.

[289] As discussed below, we make a similar recommendation with respect to the Revolver Exception, which requires the taxpayer to establish that any increase either in the Amount of borrowing provided for in the revolver or

b. Recommendations Related to Committed Borrowings

To the extent the Service retains Representation 30 with respect to Committed Borrowings, we agree with the maintenance of an exception for borrowings pursuant to previously committed revolving credit agreements in place as of the Earliest Applicable Date, consistent with the Service's historic ruling approach and our comments in the 2020 Report. However, as discussed above with respect to Case Studies 8 and 9, the absence of an exception to address Committed Borrowings that are Non-Ordinary Course Borrowings that are independent of the Spin-off, and the limitation of the Revolver Exception to borrowings that would have occurred absent the Spin-off, in each case, may result in transactions involving non-abusive fact patterns being ineligible for a ruling. We recommend that (i) Revenue Procedure 2024-24 include an exception applicable to Non-Ordinary Course Borrowings and (ii) the Revolver Exception should not require a showing that the post-Spin-off borrowing would have occurred without regard to the Spin-off or related transactions.

With respect to Non-Ordinary Course Borrowings that are Committed Borrowings, Case Study 8 provides an example of a non-abusive Committed Borrowing that is ineligible for the Revolver Exception because the borrowing occurs pursuant to a new credit facility and is meant to fund a transaction outside the ordinary course of business. Such a borrowing is equally ineligible for the Changed Circumstances Exception because it is a Committed Borrowing. However, the facts of Case Study 8 clearly establish that the re-leveraging transaction is demonstrably independent of the Spin-off transaction. Because Distributing commits, pre-Spin-off, to a new post-Spin-off borrowing to finance a non-ordinary course acquisition, albeit one that may or may not ultimately close, Revenue Procedure 2024-24 treats the Divisive Reorganization as one that is ineligible for a ruling. This result is inappropriate and unduly punitive to taxpayers engaging in simultaneous, yet independent, transactions. Distributing should be entitled to allocate its historic debt through the first-step de-leveraging transaction while independently planning for future, unrelated transactions that might necessitate additional leverage. Moreover, as discussed above, the Debt Allocation Principle should be agnostic as to additional leverage tied to the expansion of one business through an acquisitive transaction, especially where the acquired business is itself leveraged. To the extent the Service retains Representation 30 with respect to Committed Borrowings, we would recommend that Revenue Procedure 2024-24 contain an exception that permits Committed Borrowing to fund capital needs arising outside the ordinary course as the result of transactions unrelated to the Spin-off.

With respect to the requirement in Revenue Procedure 2024-24 that any increase in (i) the available borrowing and (ii) actual borrowing, in each case, under the revolver would have occurred without regard to the Spin-off or related transactions, the same considerations as described above apply. As highlighted in Case Study 9, the fact that Distributing may not have been required to increase its leverage to address post-Spin-off capital needs in light of the internal capital that would have been available to it as part of a combined company with the Controlled business should be irrelevant to the Debt Replacement Concern. The appropriate inquiry is

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the actual Amount borrowed under the revolver would have occurred without regard to the Spin-off or related transactions.

whether the purpose of the re-leveraging transaction is to replace the Distributing Debt that was retired as opposed to having been motivated by a legitimate, independent business rationale.

G. Solvency and Continued Viability of Distributing and Controlled

1. Solvency Concern Expressed in Notice 2024-38

Notice 2024-38 sets forth the view of Treasury and the Service that section 355 qualification is limited to Divisive Reorganizations after which both Distributing and Controlled are "capable of carrying on sustained businesses after the reorganization," and that nonrecognition treatment is not intended for Divisive Reorganizations that "burden Controlled with excessive leverage, jeopardizing its ability to continue as a viable going concern" (together, the "**Solvency Concern**").[290] The Solvency Concern is relevant only in Divisive Reorganizations, *i.e.*, those involving an allocation of Distributing's assets and liabilities between Distributing and Controlled in connection with the Spin-off, as opposed to section 355(c) Transactions involving mere distributions of stock of existing entities without any related asset or liability allocations. In light of this context, the Solvency Concern appears to be narrower than a general concern about the financial health of the parties to a Spin-off. By its terms, the Solvency Concern does not reach a pre-existing Controlled that may not be economically viable both before and after the Spin-off.[291] Instead, the Solvency Concern is tied to the possibility that a Divisive Reorganization might be structured[292] in a manner that calls into question whether the separated businesses can continue to operate post-Spin-off and whether the separated companies are viable as going concerns. More specifically, the Solvency Concern targets situations where a Divisive Reorganization is intentionally designed to set Controlled up for failure, or some likelihood of failure, due to an inappropriate (in the words of Notice 2024-38, "excessive")[293] allocation of liabilities. As it is

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[290] Notice 2024-38, section 2.02(3). Views similar to the Solvency Concern are expressed in the 2025 Green Book. *See* General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals, Dept. of the Treas. (March 11, 2024) ("2025 Green Book") (in the section entitled "Limit Tax Avoidance Through Inappropriate Leveraging of Parties to Divisive Reorganization," noting that "there are no adequate safeguards to ensure Controlled's adequate capitalization or continued economic viability following its separation from Distributing through a divisive reorganization"). The 2025 Green Book proposes to "[p]revent tax avoidance through the transfer of contingent liabilities to Controlled" by adding "two additional requirements under section 355 that, if not satisfied, would result in gain recognition by Distributing (but not Distributing's shareholders)." *Id.* at 11. Controlled would be required to "be adequately capitalized as a result of the divisive reorganization" and to "be an economically viable entity after the completion of the divisive reorganization." *Id.*

[291] Such a Section 355(c) Transaction could very well be entitled to nonrecognition treatment. *See* Rev. Rul. 85-122, 1985-2 C.B. 118 (Business Purpose Requirement satisfied in circumstances involving the separation of a pre-existing subsidiary that "is nearly bankrupt").

[292] The 2025 Green Book specifically focuses on perceived tax avoidance the transfer of contingent liabilities to Controlled. *See* 2025 Green Book, at pp. 9-11.

[293] It is unclear whether the Notice's concept of "excessive" leverage is tied to the 2025 Green Book's assertion that the "practice" of "transferring contingent liabilities to Controlled . . . can burden Controlled with crippling liabilities and excessive leverage, jeopardizing its ability to continue as a viable going concern." *Id.* Ultimately, the

described in Notice 2024-38, the Solvency Concern appears to be an anti-abuse concept focused on the taxpayer's intent in allocating assets and liabilities in the Divisive Reorganization, rather than an objective concern about solvency (or insolvency).[294]

2. The Solvency Concern and Section 355

Notice 2024-38 expresses the view of Treasury and the Service that section 355 was not intended to apply to transactions implicating the Solvency Concern. None of section 355, the Treasury Regulations thereunder, or the relevant legislative history mention solvency.[295] Rather, in support of this view, Notice 2024-38 cites only legislative history from the 1951 enactment of the predecessor provision of section 355, which states that that provision was drafted "so as to limit its benefits to reorganizations in which all of the new corporations as well as the parent are *intended to carry on a business* after the reorganization."[296] Notice 2024-38 states that this legislative history emphasizes that "all of the new corporations as well as the parent [*must*] carry

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2025 Green Book concludes that this "practice" is "inconsistent with the intent and purposes of the divisive reorganization provisions of the Code, and has resulted in numerous Controlled bankruptcies." *Id.*

The 2025 Green Book's conclusions are supported by its assertion that contingent liabilities assumed by Controlled "are often very large, and typically far exceed their estimated amounts" and that "Distributing can cause Controlled to make payments to satisfy" such liabilities "for an unlimited future period and in an unlimited aggregate amount." *Id.* It is true that the valuation of contingent liabilities is probabilistic in nature, taking into account not only the amount of the liability but also the likelihood of the relevant contingency. The consequences of this probabilistic valuation may well be binary: Controlled may be insolvent if the contingency occurs and solvent otherwise. However, this fact does not bear relation to whether the liability allocation in a Divisive Reorganization is undertaken for legitimate business purposes, *i.e.*, whether it is consistent, or not, with the Debt Allocation Principle. Underlying the 2025 Green Book, and perhaps the Notice, appears to be an assumption that *any* allocation of contingent liabilities to Controlled is inherently nefarious, whether that be a perceived tax avoidance purpose (*see* n. 292 and accompanying text) or failure by design intent. We disagree with this characterization. The Debt Allocation Principle – the principle that Divisive Reorganizations are intended to facilitate the allocation of historic Distributing liabilities between Distributing and Controlled and are not intended to facilitate an increase in the aggregate liabilities of Distributing and Controlled – applies equally to contingent and non-contingent liabilities. The mere fact that the valuation of contingent liabilities is subject to a probability-based assessment, and that the magnitude of the ultimate fixed liability may be materially different (in either direction), should be irrelevant to the application of sections 355 and 368 to a Divisive Reorganization involving an allocation of contingent liabilities.

[294] Indeed, the 2005 proposed "net value" Treasury Regulations that would have limited the application of the reorganization provisions in transactions involving insolvent entities by requiring an objective transfer of net value, *i.e.*, assets in excess of liabilities, were withdrawn in 2017. *See* REG-163314-03; REG-139633-08 (noting that Treasury and the Service "are of the view that current law is sufficient to ensure that the reorganization provisions and section 351 are used to accomplish readjustments of continuing interests in property held in modified corporate form").

[295] While a response to the legislative proposals of the 2025 Green Book, including those related to the Solvency Concern, is beyond the scope of this Report, we note that the 2025 Green Book proposes to address the Solvency Concern in the context of Divisive Reorganizations by adding two *new* requirements under section 355 (violation of which would implicate corporate, but not shareholder, level tax), suggesting that the existing statutory framework under section 355 and 361 does not otherwise contain a solvency requirement. We agree that no such requirement exists today. This Report does not address whether there is authority supporting the promulgation of substantive guidance under section 355 regarding insolvency in the absence of legislative change.

[296] S. Rep. No. 82-781, at 58 (1951) (emphasis added).

on a business,"[297] although no such emphasis appears in the Senate Report itself. Instead, Notice 2024-38 repeats the same sentence of the legislative history that was previously quoted directly, replacing the subjective words "are intended to" with the objective word "must" without any further explanation of why this characterization is appropriate.[298]

We do not believe this is an appropriate interpretation of the legislative history, which clearly refers to the intent of the parties as it pertains to continued post-separation business activity. In fact, two sentences before the quoted portion of the legislative history, the Senate Report notes that the predecessor to section 355 was "included in the bill because [the] committee believes that it is economically unsound to impede Spin-offs which break-up businesses into a greater number of enterprises, *when undertaken for legitimate business purposes*."[299] The achievement or failure to achieve the business purposes motivating the Spin-off is not indicative of whether the Spin-off was in fact so motivated; accordingly the section 355 rules require only that the transaction be "*carried out for* one or more corporate business purposes," (as reflected in the Business Purpose Requirement), with a view to the motivation, or intent, of the parties.[300] Similarly, the success or failure, or capability to continue the business activity, of Distributing and Controlled is not necessarily indicative of whether the companies were *intended* to continue their respective businesses post-Spin-off. Accordingly, as discussed further below, neither section 355 nor related requirements relevant to Divisive Reorganizations[301] seek to ascertain the objective post-closing viability of businesses. The transmogrification of the intent-based inquiry reflected in the legislative history, Code, and Treasury Regulations into an objective requirement manifests in Notice 2024-38's focus on whether the companies are *capable* of carrying on sustained businesses, rather than whether the companies are *intended to* carry on such businesses (and also in Representations 8 and 9 of Revenue Procedure 2024-24, discussed further below).

Notice 2024-38 does not otherwise tie the Solvency Concern to statutory or regulatory provisions underlying section 355 or section 361. It is clear that section 355 is intended to facilitate genuine corporate separations motivated by real and germane corporate business purposes (as

[297] Notice 2024-38, section 2.02(3) (emphasis added).

[298] The 2025 Green Book contains the same mischaracterized quotation, replacing "are intended to" with "must." 2025 Green Book, at p. 10.

[299] S. Rep. No. 82-781, at 58 (emphasis added).

[300] Treas. Reg. § 1.355-2(b)(1) (emphasis added).

[301] This is consistent with the withdrawal of the proposed "net value" Treasury Regulations under section 368, as discussed above. Further, neither section 357 nor section 361, the two key requirements facilitating the allocation of debt among Distributing and Controlled, requires a solvency or viability analysis. Instead, in addition to the anti-abuse provisions of section 357(b), discussed below, in determining whether to impose tax, these rules compare the liabilities assumed (in the case of section 357(c)) or the cash extracted (in the cash of section 361(b)), to Distributing's basis in the Controlled business. Because such basis bears no relation to the current fair market value of the relevant assets (and further because section 357(c) does not account for contingent liabilities), gain recognized under section 357(c) or section 361(b) will not be equivalent to Controlled's insolvency. There is a tenuous substantive link between the Solvency Concern and the purposes of sections 357 and 361.

reflected in the Business Purpose Requirement),[302] is not intended to facilitate a bail out of corporate earnings and profits at capital gains rates (as reflected in the Non-Device Requirement),[303] and applies only where both companies are engaged in the active conduct of a trade or business immediately after the Spin-off (*i.e.*, where the Active Trade or Business Requirement is satisfied).[304] None of these requirements mention solvency or economic viability,[305] though each is consistent with the general notion that section 355 is not meant to provide nonrecognition treatment to transactions not designed to result in the continued operation of historic businesses in modified corporate form. In that sense, we agree that transactions that would purport to qualify under sections 355 and 361, yet evince an intent to inappropriately allocate excess liabilities to Controlled in a manner that simply insulates Distributing from its own liabilities without a compelling business rationale for why and how Controlled would remain a viable active business—abusive transactions—raise a Solvency Concern. However, we believe that existing tax and non-tax (both legal and economic) guardrails adequately police the Solvency Concern,[306] and there is no basis to import a standalone solvency inquiry into the rules governing Divisive Reorganizations.

[302] Treas. Reg. § 1.355-2(b).

[303] *See* section 355(a)(1)(B).

[304] Section 355(b).

[305] The Treasury Regulations implementing the Active Trade or Business Requirement require an active business to comprise activities "for the purpose of earning income or profit" and note that such activities "ordinarily must include the collection of income and the payment of expenses." Treas. Reg. § 1.355-3(b)(2)(ii). However, "income" in this context is generally understood to mean gross, not net, income, and the focus is on the "purpose" of the business activities. Both the 1951 legislative history and the Active Trade or Business Requirement focus on the taxpayer's intent (or purpose) in carrying out its continued business. Neither requires the actual realization of net income or profit or any notion of solvency. *See also* Rev. Rul. 85-122 (indicating that the Spin-off of a business operating at a loss and nearly bankrupt would satisfy the Business Purpose Requirement); PLR 202009002 (Sept. 4, 2019) (ruling that the absence of income collection did not prevent a business from satisfying the Active Trade or Business Requirement).

Separately, Treasury Regulations promulgated under section 355(d) could be read to suggest that satisfaction of the Active Trade or Business Requirement establishes sufficient post-Spin-off economic viability. An exception to the rule that generally treats the acquisition of Distributing or Controlled stock pursuant to section 351 transactions as "purchases" for purposes of section 355(d) applies if the assets transferred in the section 351 transaction in exchange for Distributing or Controlled stock are part of an active trade or business. Treas. Reg. § 1.355-6(d)(3)(iv). This active trade or business requirement can either be satisfied by reference to the Active Trade or Business Requirement under Treas. Reg. § 1.355-3(b)(2) and (3) or, if the five-year requirement cannot be satisfied, by establishing that the trade or business has otherwise "been conducted for a sufficient period of time to establish that it is a *viable* and ongoing trade or business." Treas. Reg. § 1.355-6(d)(3)(iv)(B)(2) (emphasis added). Existing Treasury Regulations, then, imply that satisfaction of the Active Trade or Business Requirement, which does not require a separate solvency showing, establishes sufficient "viability," suggesting that the Solvency Concern is policed by the existing section 355 framework.

[306] This is consistent with the government's conclusion supporting its withdrawal of the proposed "net value" Treasury Regulations, as noted above in n. 301. *See* REG-139633-08.

3. Existing Tax Safeguards

There are a variety of safeguards inherent in sections 355, 368 and related provisions that adequately police the Solvency Concern. The Business Purpose Requirement, Active Trade or Business Requirement, and Non-Device Requirement together ensure that section 355 only provides nonrecognition treatment in respect of legitimate and genuine business separations that are motivated by real and substantial non-tax business purposes where each of the separated companies will conduct a historic business and where the transaction is not intended to facilitate a taxable sale of a business or otherwise allow shareholders to bail out corporate earnings in a basis recovery transaction. In other words, the section 355 regime contains several safeguards against abusive or sham transactions.[307]

Moreover, related tax requirements ensure that Distributing cannot allocate "excessive" leverage to Controlled (the crux of the Solvency Concern). As a starting point, a Divisive Reorganization cannot *create* excessive leverage; rather, a Divisive Reorganization merely effects an allocation of existing leverage, and the relevant question is whether that allocation is appropriate or whether it suggests that the separation transaction is being utilized for purposes inconsistent with the relevant nonrecognition provisions. That question is the same the whether the combined company is under-leveraged, appropriately leveraged, or over-leveraged, taking into account all liabilities across all businesses, prior the separation. Liabilities simply exist, will continue to exist, and one company or the other will need to be obligated to pay them. The mere fact that one or both of the companies (or certain businesses) will be over-leveraged post-separation is not in and of itself abusive or problematic if, prior to the transaction, such company or such business was similarly situated.[308] The Solvency Concern should only potentially be implicated if economic viability is impacted as a result of allocating liabilities in a manner that diverges from the allocation of related assets and businesses.

And, in fact, the Code provisions applicable to Divisive Reorganizations already discourage Distributing from doing so. Under the tax avoidance rule of section 357(b), if the principal purpose of *any* assumption of liabilities by Controlled is to avoid Federal income tax or is not a bona fide business purpose, then the *total* amount of liabilities assumed is treated as taxable boot.[309] Section 357(c)(3), which excludes certain liabilities (in general, liabilities the payment of which would give rise to a deduction, *e.g.*, contingent liabilities) for purposes of applying the basis

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[307] Arguably, the requirements under section 355(a)(1)(A) (that Distributing control Controlled immediately before the distribution) and section 355(a)(1)(D) (that, as part of the distribution, Distributing must distribute stock of Controlled constituting section 368(c) control) inherently require that a leveraged Controlled be solvent. If Controlled were insolvent at the time of the Divisive Reorganization (*i.e.*, at the time it incurred or assumed liabilities), and therefore would not reasonably be expected to repay such liabilities, those liabilities could very well be recharacterized as equity for Federal income tax purposes.

[308] As discussed in n. 293, above, the mere fact that the leverage arises as a result of contingent, as opposed to fixed, liabilities is similarly not inherently indicative of an abusive transaction structure.

[309] Section 357(b); Treas. Reg. § 1.357-1(c). If a taxpayer seeks to establish that, contrary to an Service determination that there is a tax avoidance purpose with respect to any liability assumption, it must prove, by a clear preponderance of the evidence, that the absence of a tax avoidance purpose, or the presence of a bona fide business purpose, is "unmistakable." Section 357(b)(2); Treas. Reg. § 1.357-1(c).

limitation of section 357(c), has no relevance for purposes of section 357(b). Instead, section 357(b) requires strict adherence to the anti-abuse rule with respect to *any* assumed liabilities.[310] In applying section 357(b) in the context of section 355, the Service has looked to the relatedness between the liabilities assumed by, and the assets contributed to, Controlled in assessing whether there is such a tax avoidance purpose.[311] If there is no such relation, section 357(b) requires that the analysis take into consideration "the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made,"[312] which, in the Spin-off context, should include whether the allocation of liabilities was motivated by the corporate business supporting a genuine separation, *e.g.*, establishing an appropriate capital structure for the two companies. Effectively, the anti-abuse rule of section 357 targets the precise fact pattern relevant in the Solvency Concern: the "excessive" leveraging of Controlled, with "excessiveness" measured not in absolute terms—as the Controlled business may have been encumbered by significant liabilities without regard to the Spin-off transaction—but rather by reference to the Controlled business and the circumstances surrounding Distributing's liability allocation decisions.[313] Were Distributing to cause Controlled to assume any liability that failed to meet the tax avoidance rule of section 357(b) because it did not reflect the underlying allocation of the business and was otherwise not supported by a bona fide business rationale, nonrecognition treatment would not be available with respect to any liability assumed in the transaction.

Notably, section 361 does not import section 357(b) in defining the Distributing creditors that can be repaid with Section 361 Consideration. In other words, section 361 leaves room for the possibility that a liability, the assumption of which by Controlled would contravene section 357(b), can be effectively allocated to Controlled via the incurrence of new leverage by Controlled, with the proceeds utilized to satisfy the relevant liability. In the event that liabilities are allocated through new leverage incurred at Controlled followed by a satisfaction of historic Distributing debt, however, the Solvency Concern should not be relevant, as any incurrence of new debt by Controlled will be subject to significant non-tax guardrails (as discussed further below). We do not believe it is appropriate to utilize the section 361 framework, which otherwise does not purport to limit the incurrence of leverage at Controlled (as distinct from the transfer of any proceeds of

[310] This is particularly relevant, as the Guidance appears to be especially concerned with the treatment of contingent liabilities. *See* n. 292 above. The exception in section 357(c)(3) for purposes of section 357(c)(1) should not, however, exacerbate any Solvency Concern. It is section 357(b), and not section 357(c), that addresses this concern. Note also that the Service has indicated that risk reduction, *e.g.*, undertaking a separation to de-risk one business by isolating it from the risks (including contingent liabilities) associated with another business, is a legitimate corporate business purpose for purposes of section 355. *See* Rev. Proc. 96-30 (in describing a valid risk reduction business purpose, noting that Controlled might assume "liabilities that are not included on the taxpayer's balance sheet, that affect the value of the net assets of the risky business").

[311] *See, e.g.*, Rev. Rul. 79-258.

[312] Section 357(b)(1).

[313] *See* Rev. Rul. 79-258 ("Section 357(b) deals with [Distributing's] *purpose* in causing the assumption and by stating that consideration must be given to the 'nature of the liability and the circumstances in the light of which the arrangement for the assumption was made,' requires that the determination of [Distributing's] *purpose* be made from an analysis of all the facts and circumstances.").

such leverage),[314] to second-guess and potentially recast bona fide new Controlled indebtedness incurred in connection with a Spin-off transaction.

4. Existing Non-Tax Safeguards

Importantly, a separation transaction that violates the Solvency Concern would not be expected to be a viable transaction from a non-tax legal or economic perspective. Both economic realities and applicable legal requirements (both of which are better suited than the tax law to measure solvency concepts) already strongly discourage this. It is inconceivable that a public company would affirmatively plan into situations implicating the Solvency Concern, *i.e.*, expected bankruptcy. Under state voidable transfer law, the bankruptcy code and applicable corporate law requirements, dividends (including a distribution by Distributing of Controlled stock and a distribution by Controlled of cash) may be subject to attack and recoupment if the relevant payor is insolvent at the time of the distribution.[315] While Distributing directors generally have no fiduciary or fairness duties to Controlled and can generally make unilateral decisions about the allocation of assets and liabilities, the possibility of insolvency and the attendant risks and legal requirements are as a practical matter a significant governor on the decision-making process. Spin-off transactions typically involve input from third-party financial experts. The directors of Distributing, where Distributing is a public company, commonly receive analysis and an express opinion speaking explicitly to the solvency of Distributing and/or Controlled. An opinion of this type – delivered by an independent valuation firm – is the most natural and substantively aligned governor of the Solvency Concern. And, in any transaction involving new borrowing, the relevant lenders will perform their own credit risk analysis to conclude that the borrower is financeable—the incurrence of third-party indebtedness is inherently inconsistent with a determination that the borrower is insolvent or otherwise economically not viable as a going concern. In addition, under the corporate law of most jurisdictions, Distributing would not be permitted to distribute Controlled stock and Controlled would not be permitted to distribute Section 361 Consideration (both dividends for corporate law purposes) if the relevant payor either did not have sufficient surplus or earnings or were insolvent or rendered insolvent by the payment of the distribution. The securities laws that govern the public disclosure accompanying a Spin-off (*e.g.*, registration and information statements on Form 10) require adequate disclosure of Controlled's business and finances. These non-tax law concepts generally take into account all assets and liabilities, including contingent liabilities.

Moreover, the Solvency Concern is directly tied to capital allocation and structuring decisions that, while relevant for tax purposes, are critical to the success and market acceptance of the transaction separate and apart from any tax-related concepts. In light of the significant non-tax implications of the companies' capital structures, decisions involving liability allocations, whether through assumption or new leverage (paired with de-leveraging), are driven and vetted by non-tax decision-makers to facilitate the appropriate and optimal financial profiles of the two companies. In addition to the non-tax elements driving internal decision-making, there are

[314] *See supra* n. 301.

[315] In fact, fraudulent conveyance laws may not require insolvency at the time of the distribution to trigger liability to shareholders and creditors – it may be sufficient to establish insolvency shortly after the Spin-off. *See, e.g.*, *Tronox Inc., et. al. v. Kerr-McGee Corp., et al., (in re Tronox Inc.)*, 503 B.R. 239 (Bankr. S.D.N.Y. 2013) (successful fraudulent conveyance claim asserted following Controlled's post-Spin-off insolvency).

external, third-party guardrails inherent in any separation transaction. For example, as part of the transaction, each company will be evaluated by credit rating agencies based on all relevant aspects of its financial profile, including fixed leverage and contingent liabilities. The determinations of the credit rating agencies will have significant implications for the companies' cost of capital and valuation in the markets, reinforcing the importance of satisfying the agencies of the viability and sustainability of the business plan.

Any material concern about solvency, viability as a going concern, continued operation of the relevant businesses, or ability to satisfy liabilities (including contingent liabilities) would be inconsistent with structuring a transaction that remains within the parameters of any one of these non-tax guardrails. In this sense, not only is the tax law an ill-fitted mechanism to police what is inherently a financial valuation exercise, and not only does the existing framework of section 355 and related Code provisions not purport to do so, but it is unnecessary to rely on the tax law to avoid a result that is already adequately protected by other legal and economic concepts.

5. The Solvency Concern and Future Substantive Guidance

For the reasons described above, we do not believe that substantive guidance under section 355, section 361, or related provisions should address the Solvency Concern. We believe it would be inappropriate to import an unfounded solvency element to a statutory framework that does not purport to assess solvency. This is especially the case in light of the fact that the relevant nonrecognition provisions already contain safeguards that, consistent with the law and its legislative history, restrict tax-free treatment to non-abusive transactions supported by compelling business purposes and intended to separate two active businesses. This argument is bolstered by the economic reality that capital structuring elements of a Spin-off transaction are motivated by non-tax considerations and there are numerous non-tax related guardrails that eliminate any material likelihood that a Spin-off transaction could be structured in a manner contrary to the Solvency Concern.

6. The Solvency Concern and Revenue Procedure 2024-24

Despite the tenuous connection between the Solvency Concern and the relevant provisions of the Code and Treasury Regulations, Revenue Procedure 2024-24 requires, for all Spin-off transactions, two representations related to solvency and economic viability.[316]

i. Solvency Representation

Taxpayers are required to establish that, immediately after the Control Distribution Date, the fair market value of the assets of each company will exceed the Amount of such company's

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[316] It is unclear why these representations are required for *all* Section 355 Transactions, rather than only Divisive Reorganizations. As discussed above and consistent with Notice 2024-38 (and the 2025 Green Book), the Solvency Concern should not be relevant where the separation transaction does not involve a new allocation of liabilities and assets.

liabilities,[317] including contingent liabilities ("**Representation 8**").[318] The "Amount" generally reflects the adjusted issue price of Debt, but, in the case of convertible debt reasonably certain to be exercised, reflects the fair market value of the instrument[319] and, for all other liabilities, the amount an assignor would be willing to pay for an arm's-length assumption. Importantly, this Amount is measured as of immediately after the Control Distribution Date, notwithstanding the fact that the representation will be made well in advance.

Case Study 11: Unexpected Change in Value of Assets or Liabilities

> 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 business line to a domestic Controlled in a Divisive Reorganization in exchange for Section 361 Consideration, 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 2024, and the Divisive Reorganization and Distribution occur in September of 2024. In January of 2024, the fair market value of Distributing's assets and the Amount of its liabilities equal \$300X and \$100X, respectively, and the fair market value of Controlled's assets and the Amount of its liabilities equal \$100X and \$50X, respectively. In September of 2024, after the Distributing board has declared the dividend of Controlled stock to its shareholders, but before the effective time of the distribution, a subsidiary of Controlled, which has already been contributed to Controlled, becomes subject to a contingent liability, which liability arises from the operation of the Controlled business, with an expected value of \$55X.

Case Study 11 is inconsistent with Representation 8 because, as of the Control Distribution Date, the Amount of Controlled's liabilities (\$105X) exceeds the fair market value of its assets (\$100X). However, at the time Distributing planned, structured, and approved the separation transaction, it had no expectation of Controlled's potential insolvency. Moreover, the allocation of the springing contingent liability to Controlled is appropriate in light of the business to which

[317] For this purpose, liabilities also include liabilities described in Revenue Ruling 80-323, *i.e.*, a partner's share of partnership liabilities). While Revenue Procedure 2024-24 indicates that the liabilities of a partner in a partnership are measured under an aggregate theory, it does not indicate how the assets of such partner are measured. It would be inconsistent to take into account a partner's proportionate share of partnership liabilities, on the one hand, but ignore such partner's proportionate share of partnership assets, on the other hand. Under such an approach, the partner's "assets" would presumably include the value of the partnership interest, which would already have been reduced in respect of partnership liabilities, resulting in potential double counting of the liabilities. Clarification on the calculation of partnership-level liabilities and assets for purposes of Representation 8 would be welcome.

[318] Rev. Proc. 2024-24, section 3.03(5)(a)(i).

[319] If convertible debt is reasonably certain to be exercised, *i.e.*, converted to equity, this raises a question as to whether the instrument should be taken into account as a liability for purposes of a solvency analysis at all. In that case (and assuming a solvent entity), the debt is reasonably certain to reflect a residual claim on the assets of the corporation to be paid after all liabilities have been satisfied and taking into account the value of that residual claim to the equity as a liability is inconsistent with the expected outcome. In the case of an insolvent entity, it is doubtful that convertible debt would be reasonably certain to be exercised (and, if it were, the instrument would have no value).

the liability relates (and, in fact, it automatically attached to Controlled's subsidiary without any affirmative action by Distributing). The transaction is not abusive and the springing solvency concern is not an intentional feature of the structure. Yet, the separation transaction appears to be ineligible for a ruling as a result of the incurrence of an unexpected contingent liability (or, if a ruling had already been issued based on Representation 8, its validity would be jeopardized due to later facts rendering Representation 8 inaccurate). The Solvency Concern does not justify this result.

In addition to Representation 8, taxpayers must provide information and analysis to support the ability to make Representation 8, which may include projections and other financial information to establish the accuracy and reasonableness of the representation.

ii. Economic Viability Representation

Taxpayers are also required to represent that, immediately after the Control Distribution Date, Controlled (i) will be adequately capitalized, (ii) is expected to have the means to satisfy all liabilities incurred as part of the Divisive Reorganization (including assumed liabilities), and (iii) is expected to continue as an economically viable entity, taking into account all liabilities incurred as part of the Divisive Reorganization (including assumed liabilities and, in the case of a pre-existing Controlled, pre-existing liabilities) as they come due ("**Representation 9**").[320] For this purpose, Controlled is not treated as satisfying a liability as a result of a refinancing. Just as in Representation 8, taxpayers must provide information and analysis to support the ability to make Representation 9, which may include projections and other financial information to establish the accuracy and reasonableness of the representation.

The key distinction between Representations 8 and 9 appears to be that Representation 9, in part, seeks to ascertain a subjective measure of Controlled's future economic viability, by looking to the taxpayer's "expectations" as to Controlled's ability to satisfy its relevant liabilities and to remain economically viable. Compare this to Representation 8's objective solvency inquiry and the first prong of Representation 9, which requires a flat, forward-looking representation as to the adequacy of Controlled's capitalization, in each case, immediately after the Control Distribution Date. Other than the objective versus subjective inquiry, the concept of economic viability is difficult to distinguish from solvency, as it is unclear what a viability analysis would be based on if not a comparison of assets and liabilities. In fact, Representation 9 suggests that adequate capitalization is a necessary prerequisite to having an expected ability to satisfy all liabilities and to be economically viable, blurring the lines between these overlapping concepts. If objective solvency immediately after the Control Distribution Date were sufficient to establish an expectation of continued economic viability, then presumably Representation 8 would be sufficient. Therefore, Representation 9 is likely focused on the latter, *i.e.*, the taxpayer's subjective expectation of solvency post-Spin-off. This comports with the focus of the Solvency Concern: just as there may be an insolvent Controlled with every expectation of becoming profitable and meeting its obligations (a non-abusive scenario), there may be a solvent Controlled that is expected and designed to fail (a potentially abusive scenario).

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[320] Rev. Proc. 2024-24, section 3.03(5)(a)(ii).

iii. Recommendations

a. Solvency Representation: Recommendation

As discussed above, the objective state of solvency on the Control Distribution Date has no obvious connection to the legitimacy of the Divisive Reorganization and is not reflective of whether an allocation of liabilities suggests that the transaction is not intended to effect a genuine separation of two active businesses for compelling business purposes—*i.e.*, the Solvency Concern is not about objective solvency, rather *intent*. This intent is adequately taken into account in section 355 and section 357 concepts that Revenue Procedure 2024-24 addresses through non-solvency related representations and other information. Therefore, arguably, Revenue Procedure 2024-24 should eliminate Representation 8 and any other requirement to make a flat solvency representation or factual showing related thereto.

However, we recognize that, in light of the Solvency Concern and consistent with recent ruling practice, the Service may simply not be willing to rule on the application of section 355 in scenarios involving solvency issues.[321] We believe that a commitment to obtain a solvency opinion from an independent valuation expert in connection with the Divisive Reorganization should provide significant comfort that the Solvency Concern will not be implicated by the transaction, and we recommend that Revenue Procedure 2024-24 permit a commitment to obtain such a solvency opinion in lieu of Representation 8 (and any other submission of detailed financial analysis and projections relevant to Representation 8). In the event that the taxpayer cannot commit to obtain a solvency opinion, we would recommend that the focus of the required representation be on ascertaining whether the structure or design of the Divisive Reorganization evinces an intent or expectation that one or both of the companies would be insolvent. To avoid the issue identified in Case Study 11, Representation 8 could be modified to state that, as of the earliest to occur of the date of approval of the Divisive Reorganization by the Distributing board of directors (*i.e.*, the date on which the specific allocation of liabilities and other capital structuring decisions became fixed) or the date of declaration of the first distribution of Controlled Stock, the fair market value of the assets of Distributing and Controlled were expected to exceed the Amount of their respective Liabilities, with both asset and liabilities measured as of the Control Distribution Date.

b. Economic Viability Representation: Recommendations

If our recommendations with respect to Representation 8 are adopted, we do not believe there is a separate and distinct need for Representation 9. The commitment to obtain a third-party solvency opinion should eliminate any need for the taxpayer to make a separate representation or factual showing as to future economic viability, and, for taxpayers who cannot so commit, our recommended modifications to Representation 8 would sufficiently establish expected viability.

[321] *See* Rev. Proc. 2017-52 (Representation 21: "Immediately after the transaction, the fair market value of the assets of each of Distributing and Controlled will exceed the amount of its Liabilities."). While this solvency representation has consistently been required since 2017, note that Revenue Procedure 96-30 did not contain a solvency representation.

If our recommendations with respect to Representation 8 are not adopted, we would equally recommend that a commitment to obtain a solvency opinion of an independent valuation expert be sufficient to establish future economic viability in lieu of making any specific representation or factual showing. However, for taxpayers who cannot so commit, we recommend that Representation 9 be limited to the subjective inquiry as to expected solvency (*i.e.*, future economic viability) that is not addressed by Representation 8. It is unclear how "adequate capitalization" on a particular date is intended to be measured if not by reference to the values of Controlled's assets and liabilities on such date (which is already addressed by Representation 8). In fact, Representation 9 itself suggests that if there is expected future economic viability, there is necessarily adequate capitalization, such that it should only be necessary to establish the former.[322]

In addition, we recommend that guidance clarify how "economic viability" is measured, as there is no clear calculation required by Representation 9 and it is unclear what showing is required, other than an expectation of having the means to satisfy all relevant liabilities, which is a separate concept required by the representation.

c. Solvency Information and Analysis: Recommendations

The Service should eliminate any requirement to provide detailed financial analysis and projections to support Representations 8 and 9, beyond, perhaps, financial statements and projections that have already been prepared. It is unclear what role this supporting information would serve, as (i) the taxpayer ultimately bears the risk of any of its representations being or becoming untrue and (ii) the Service is unlikely to be well-suited to analyze the propriety of the valuation analysis. Further, it is probable that any solvency-related analysis would need to be prepared specially for the ruling process (duplicating later workstreams, *e.g.*, preparing the solvency opinion), implicating costs and unnecessarily burdening the companies for no material benefit. Although a solvency opinion is likely to become available, it is typically not prepared until close in time to the closing of the Spin-off, well after a ruling request is likely to have been submitted and very possibly after a ruling has been issued. However, a commitment to obtain a solvency opinion, as recommended as an alternative to any solvency-related representations, should provide significant comfort that the Solvency Concern will not be implicated by the transaction.

H. Effect of Transaction Related to Divisive Reorganization on Controlled Securities

1. Controlled Debt Modification Concern Expressed in Notice 2024-38

Notice 2024-38 indicates that Treasury and the Service "are considering the impact of Controlled's modification (including refinancing) of any of its securities or other Debt on the qualification of those securities or other Debt as Section 361 Consideration."[323] In particular, this is being considered in the context of post-Spin-off acquisitions of Controlled that result in a

[322] *Id.* ("Controlled will be adequately capitalized *and, therefore,* is expected to" have the means to satisfy its liabilities and continue as an economically viable entity).

[323] Notice 2024-38, section 2.02(7).

modification of Controlled's securities, *e.g.*, a Divisive Reorganization involving the issuance of Controlled securities that Distributing utilizes to retire Distributing Debt, followed by a merger, after the Control Distribution Date, of Controlled into an acquiring corporation.[324] Notice 2024-38 sets forth the view that "general principles of [f]ederal income tax law (including substance over form and other relevant theories) could apply to recast such a situation . . . to preclude qualification under [Section] 361(c)(3)" (the "**Controlled Debt Modification Concern**").[325] Notice 2024-38 asserts that Revenue Ruling 98-27, which confirms that, where a purported section 355 distribution is followed by a pre-arranged change in ownership of Controlled stock that was distributed in the Spin-off, the step transaction doctrine will not be applied to conclude that Distributing did not own Controlled stock representing section 368(c) control immediately prior to the distribution, is not relevant to the Controlled Debt Modification Concern.[326] This is because, as Notice 2024-38 explains, Revenue Ruling 98-27's relevance is limited to the determination of whether Controlled is a "controlled corporation" for purposes of section 355(a).[327]

By referencing "qualification under [Section] 361(c)(3),"[328] Notice 2024-38 suggests that the Controlled Debt Modification Concern is focused on the appropriate tax consequences to Distributing under 361(c) upon a transfer of Controlled securities or other Debt, *i.e.*, whether such securities or debt should be respected (i) as Qualified Property within the meaning of section 361(c)(2) (Controlled debt received by Distributing in the Divisive Reorganization) (ii) that is transferred to Distributing creditors in connection with the Divisive Reorganization. The Controlled Debt Modification Concern does not appear to be related to the status of Controlled Debt as securities, which status is irrelevant to the application of section 361(c)).[329] Even if a subsequent modification of Controlled debt were taken into account in determining the proper character of such debt (*e.g.*, as an obligation of Controlled), it seems implausible that such modification could have any bearing on the question of whether such debt was, in fact, transferred

[324] *Id.*

[325] *Id.*

[326] *Id.*; Rev. Rul. 98-27.

[327] Notice 2024-38, section 2.02(7).

[328] *Id.* Since *any* consideration received by Distributing in the Divisive Reorganization in exchange for property transferred to Controlled qualifies as "Section 361 Consideration," the reference to section 361(c)(3) is necessary to understand the statement in the Notice that Treasury and the Service are considering the impact of a modification of Controlled debt on the qualification of such debt "as Section 361 Consideration." *See* section 361(a), (b); Rev. Proc. 2024-24, section 2.42 (defining the term Section 361 Consideration expansively to include "Controlled stock, Controlled securities, Controlled non-security Debt, money, and Other Property"). Despite the broad introductory statement regarding the Controlled Debt Modification Concern, the Notice does not appear to be relevant to the question of whether Controlled debt qualifies as Section 361 Consideration—*i.e.*, the Notice does not appear to be relevant to the question of whether Controlled debt received by Distributing is properly treated as having been *received* by Distributing in the Divisive Reorganization in exchange for property transferred to Controlled. Rather, the Notice's focus seems to be on the question of whether the Controlled debt transferred to Distributing's creditors is properly treated as Qualified Property *transferred* in accordance with section 361(c)(3).

[329] Qualified Property includes any "obligation" of a party to the reorganization that is received by Distributing in the Divisive Reorganization, not solely securities. Status as a security is relevant, however, to determining the tax consequences of Distributing's receipt of Controlled debt under section 361(a) and (b).

to Distributing creditors. A modification of a debt instrument is irrelevant to the question of who holds the instrument. Therefore, the only relevant question seems to be whether, in certain circumstances, purported Controlled debt will be treated for purposes of section 361(c) not as Qualified Property, but rather as other property, the distribution of which is governed by section 361(c)(2).

2. Recommendations Regarding Substantive Guidance and the Controlled Debt Modification Concern

With that understanding, the relevant inquiry of the Controlled Debt Modification Concern is whether the modification results in the Controlled debt received by Distributing in the Divisive Reorganization failing to be treated as such at the time it is transferred to Distributing's creditors. If the answer is "no," then the Controlled Debt Modification Concern should not be implicated Further, if the modification occurs at a time when Distributing no longer holds Controlled debt, *i.e.*, after Distributing has transferred the Controlled debt to its creditors, then, absent fact patterns in which step transaction or other similar principles of tax law are properly applied, the overall transaction (*i.e.*, the Divisive Reorganization and the subsequent transaction in which the Controlled debt is modified) should not be recast such that the modification of Controlled debt is treated as occurring prior to Distributing's distribution of such debt.

As discussed below, we recommend that, to the extent substantive guidance is promulgated regarding the Controlled Debt Modification Concern, such guidance should clarify that Controlled debt received by Distributing in the Divisive Reorganization should not lose its status as Qualified Property as the result of either (i) a modification of such Controlled debt that is not a "significant modification" under Treasury Regulations Section 1.1001-3 (the "**1001 Regulations**" and, such a modification, a "**Disregarded Modification**")[330] or (ii) a modification that is a "significant modification" under the 1001 Regulations as a result of which the holder of Controlled debt is deemed to receive a "new" debt instrument in a transaction that qualifies for nonrecognition of gain or loss to such holder (a "**Nonrecognition Modification**").

There are three categories of potential modifications of Controlled debt subsequent to a Divisive Reorganization: (i) Disregarded Modifications, (ii) Nonrecognition Modifications, and (iii) modifications that are "significant modifications" under the 1001 Regulations as a result of which the holders of Controlled debt are deemed to receive "new" debt instruments in a transaction that is a taxable exchange to such holders (a "**Taxable Modifications**"). As described below, modifications that are not Taxable Modifications should not raise the Controlled Debt Modification Concern. In our experience, Taxable Modification are not a usual or frequent feature of Divisive Reorganizations – *i.e.*, it is not common that Taxable Modifications are undertaken as a part of an overall transaction together with an otherwise tax-free separation.

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[330] *See* Treas. Reg. § 1.1001-3. In general, the 1001 Regulations establish whether a modification of a debt instrument is a "significant modification" that results in a deemed exchange of an old debt instrument for a new debt instrument and is thus a realization event for tax purposes or whether a modification does not meet this threshold and is instead not a realization event (effectively, disregarded for tax purposes).

i. Disregarded Modifications

Disregarded Modifications are generally ignored for Federal income tax purposes and should be equally ignored for purposes of determining whether a modification of Controlled debt implicates the Controlled Debt Modification Concern. Disregarded Modifications could include transactions that result in a new obligor. For the reasons described below, any substantive guidance regarding the Controlled Debt Modification Concern should clarify that Disregarded Modifications are not only disregarded for purposes of the 1001 Regulations but further for purposes of section 361(c).

Case Study 12: Reverse Morris Trust ("RMT") Transaction Involving a Parent-to-Parent Merger of Controlled

> 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 business line to a domestic Controlled in a Divisive Reorganization in exchange for Section 361 Consideration (consisting of Controlled stock and securities), followed by the tax-free distribution of the stock of Controlled in a Spin-off. Immediately following the Spin-off, (i) Distributing transfers the Controlled securities to its creditors in connection with the Divisive Reorganization and in retirement of its historic indebtedness[331] and (ii) Controlled merges with and into Acquiror in a transaction in which (a) Controlled shareholders receive solely Acquiror stock (and, after the merger, Controlled (former Distributing) shareholders own over 50% of Acquiror) and (b) Controlled securities become Acquiror securities. The merger qualifies under section 368(a)(1)(A) and does not result in a change in payment expectations with respect to the Controlled securities. Other than the change in obligor that occurs by virtue of the merger, there are no other alterations to the terms of the Controlled securities.

As a result of the RMT Transaction in Case Study 12, the Controlled securities Distributing transferred to its creditors become securities with respect to which Acquiror is the obligor. Moreover, this occurs pursuant to a pre-arranged plan of which the Divisive Reorganization was a part. However, because Acquiror becomes the new obligor with respect to the Controlled securities pursuant to a transaction to which section 381(a) applies (and there is no change in payment expectations or significant alteration of the securities), the change in obligor is a Disregarded Modification.[332] For tax purposes, the Acquiror securities are treated as the same instruments as the Controlled securities. Consistent with the approach under the 1001 Regulations,

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[331] An alternative fact pattern ("**Case Study 12A**") would involve a transfer by Distributing of the Controlled securities to its creditors in connection with the Divisive Reorganization and in retirement of its historic indebtedness within one year of the Spin-off (*i.e.*, Distributing continues to hold Controlled securities after the occurrence of the merger, but intends to, and does, transfer all Controlled securities to its creditors pursuant to the Divisive Reorganization, albeit on a fully or partially delayed basis). As discussed further below, so long as the transfer of Controlled securities received in the Divisive Reorganization occurs in connection with the Divisive Reorganization, the timing of such transfer relative to the merger transaction should not be meaningful.

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

the transaction in Case Study 12 should not implicate the Controlled Debt Modification Concern, and the Controlled securities should be respected as Section 361 Consideration, more specifically, Qualified Property that is transferred in compliance with section 361(c)(3).[333]

ii. Nonrecognition Modifications

Nonrecognition Modifications are "significant modifications" within the meaning of the 1001 Regulations and, therefore, result in the original debt instrument being treated as exchanged for a new debt instrument with the modified terms, but, under the rules governing tax-free reorganizations (*e.g.*, section 354), the debt holder is entitled to nonrecognition treatment on its deemed receipt of the new debt instrument ("**Nonrecognition Property**"). The holder takes a substituted basis in such Nonrecognition Property under section 358(a)(1), reflecting that "the property received [in a nonrecognition exchange] shall be treated as taking the place of the property exchanged . . . ."[334] As discussed below, any substantive guidance regarding the Controlled Debt Modification Concern should confirm that Nonrecognition Property received in a Nonrecognition Modification in exchange for Controlled debt that is Qualified Property received in the Divisive Reorganization continues to be treated as such Qualified Property after the Nonrecognition Modification and is eligible to be transferred to Distributing's creditors pursuant to section 361(c)(3).

Nonrecognition Modifications may arise both in the context of, and in the absence of, a post-Spin-off merger transaction.

Case Study 13: Reverse Morris Trust ("RMT") Transaction Involving a Reverse Subsidiary Merger of Controlled

Same as Case Study 12, except, immediately following the Spin-off, (i) Distributing transfers the Controlled securities to its creditors in connection with the Divisive Reorganization and in retirement of its historic indebtedness[335] and (ii)

[333] The same conclusion applies with respect to Case Study 12A. *See, e.g.*, PLR 201032017 (Feb. 5, 2010) (ruling (54) concluding that a Spin-Off followed by a merger of Controlled with and into acquiror would not cause a significant modification of Controlled securities; ruling (53) concluding that Distributing would generally not recognize gain or loss on the transfer of Controlled securities to its creditors or shareholders as part of the Divisive Reorganization, even where those Controlled securities were transferred after the proposed transaction); PLR 200447031 (Nov. 19, 2003) (ruling (47) concluding that a post-Spin-off merger of each Controlled with and into acquiror would be transactions within the meaning of Treas. Reg. § 1.1001-3(e)(4)(i)(B); rulings (6) and (18) concluding that neither Distributing would recognize gain or loss on the distribution of the securities of the relevant Controlled to Distributing's creditors).

[334] H. Rep. No. 350, 67th Cong., 1st Sess., at 176 (1921); *see also* S. Rep. No. 398, 68th Cong., 1st Sess., at 278 (1924) (noting that in nonrecognition exchanges, which are "merely changes in form and not in substance . . . property received should be considered as taking the place of the property exchanged"); H. Rep. No. 68-179, at 16 (1924) (same).

[335] An alternative fact pattern ("**Case Study 13A**") would involve a transfer by Distributing of the Controlled securities (or the Acquiror securities for which such Controlled securities are exchanged in the merger) to its creditors in connection with the Divisive Reorganization and in retirement of its historic indebtedness within one year of the Spin-off (*i.e.*, Distributing continues to hold Controlled securities at the time of the merger, exchanges such Controlled

a subsidiary of acquiror merges with and into Controlled, with Controlled surviving as a wholly-owned subsidiary of Acquiror. In the merger, Controlled securities are exchanged for Acquiror securities (*i.e.*, Nonrecognition Property) with identical terms. The merger qualifies under section 368(a)(2)(E).

The sole distinctions between Case Studies 12 and 13 are (i) the structure of the merger as an A reorganization or a reverse subsidiary merger (and the fact that the modified securities are indebtedness of a parent entity, whereas the original securities were indebtedness of a corporate subsidiary entity), (ii) the automatic modification of Controlled securities or an elective exchange of Controlled securities for Acquiror securities pursuant to the merger reorganization, and (iii) the resulting differential treatment of such debt modification/exchange under the 1001 Regulations. In both cases, pursuant to a pre-arranged plan, the Controlled securities Distributing received as Section 361 Consideration and transferred to its creditors become securities with respect to which Acquiror is the obligor. However, unlike Case Study 12, in Case Study 13, Acquiror becomes the new obligor with respect to the Controlled securities pursuant to a transaction to which section 381(a) does not apply, and therefore the change in obligor is a "significant modification."[336] However, while the exchange of Controlled securities for Acquiror securities is a realization event (under the 1001 Regulations), it is afforded nonrecognition treatment by virtue of section 354.[337] Though Acquiror is a party to the reorganization with respect to the merger (and its securities are Nonrecognition Property in the merger), it is not a party to the Divisive Reorganization. Is this, then, a transaction that implicates the Controlled Debt Modification Concern and are the Acquiror securities that are Nonrecognition Property other than Qualified Property for purposes of section 361(c)(3)?

The answer should be no, both because (i) an exchange of Controlled securities for Nonrecognition Property that occurs subsequent to the transfer of Controlled securities to Distributing's creditors should not be treated as having occurred prior to such transfer for purposes of determining whether the transfer qualified under section 361(c)(3) and (ii) even such an exchange that occurs prior to the transfer of Controlled securities to Distributing's creditors should not result in the Nonrecognition Property being other than Qualified Property that was received in the Divisive Reorganization for purposes of 361(c)(3).

a. Application of Step Transaction Principles to Nonrecognition Modifications

In fact patterns such as Case Study 13, in order to conclude that the transfer of Controlled securities was not in accordance with section 361(c)(3), step transaction or other similar principles of tax law would need to be applied to recast the subsequent tax-free exchange of Controlled

securities for Acquiror securities in a transaction in which no gain or loss is recognized under section 354, and intends to, and does, transfer all Controlled securities (or substitute Acquiror securities) to its creditors pursuant to the Divisive Reorganization, albeit on a fully or partially delayed basis). As described in n. 331, so long as the transfer of Controlled securities received in the Divisive Reorganization occurs in connection with the Divisive Reorganization, the timing of such transfer relative to the merger should not be meaningful.

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

[337] *See also* Treas. Reg. § 1.368-2(j)(4).

securities for Nonrecognition Property as having occurred prior to the transfer of the Controlled securities to Distributing's creditors. Otherwise, there is no basis on which to conclude that the Controlled securities constituted not Qualified Property, rather other property, the distribution of which triggers the recognition of gain or loss under section 361(c)(2).

We do not believe that Nonrecognition Modifications should implicate step transaction principles or otherwise be subject to a recast such that the Section 361 Consideration received by Distributing and distributed to its creditors is treated not as Qualified Property distributed under section 361(c)(3). As discussed above, the step transaction doctrine generally should not be employed where the overall result is consistent with the policies underlying section 361.[338] There is no basis on which to conclude that Nonrecognition Modifications are inconsistent with the policies underlying section 361. Nonrecognition Modifications can only occur in the context of transactions that are independently afforded nonrecognition treatment under section 361 or other corresponding or similar provisions of the Code that apply to corporate reorganizations and other mere changes in corporate form. Moreover, with respect to Nonrecognition Modifications that occur as part of RMT Transactions, such as Case Study 13, it would be inconsistent with both the policy of permitting such transactions and the clear legislative intent not to "impose additional restrictions on post-distribution restructurings of [Controlled] if such restrictions would not apply to [Distributing]"[339] to recast tax-free exchanges that occur pursuant to an RMT Transaction. This is especially the case where such exchanges are motivated by legitimate corporate business purposes, *e.g.*, ensuring an appropriate capital structure for the combined company post-merger.

Moreover, any such application of the step transaction doctrine would be inconsistent with the application of the 1001 Regulations to a Nonrecognition Modification. As discussed earlier, the 1001 Regulations treat a significant modification as resulting in a deemed exchange of the original, unmodified debt instrument for a new, modified debt instrument. The 1001 Regulations require respecting the separate and distinct existence of the old and new debt instruments. On the other hand, the step transaction doctrine would *ignore* the Controlled debt that existed immediately prior to the Nonrecognition Modification—the original, unmodified debt instrument—and recast the transaction as if that debt never existed (or, at least, had not existed at the time of Distributing's transfer of Controlled debt to its creditors pursuant to the Divisive Reorganization). In that sense, application of the step transaction doctrine to a significant modification under the 1001 Regulations is internally inconsistent. For these reasons, Nonrecognition Modifications should not be subject to step transaction principles simply because they occur in connection with a Divisive Reorganization.

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[338] *See, e.g.*, Rev. Rul. 2017-9 ("The determination of whether steps of a transaction should be integrated requires review of the scope and intent underlying each of the implicated provisions of the Code. The tax 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.").

[339] H. Rep. 105-220, 1st Sess. (1997).

b. Nonrecognition Property Treated As Qualified Property

Even if the step transaction were applied to recast a Nonrecognition Modification as having occurred prior to the transfer of Controlled securities in the Divisive Reorganization, and even where such transfer occurs subsequent to a Nonrecognition Modification, Nonrecognition Property (Acquiror securities) received in exchange for Controlled securities (Qualified Property received by Distributing pursuant to the Divisive Reorganization) should remain eligible for transfer to Distributing's creditors pursuant to section 361(c)(3). In transactions that involve Divisive Reorganizations afforded nonrecognition treatment under section 355 and 368 (and related provisions) followed by a second transaction that qualifies for nonrecognition treatment (under section 354, section 361, or otherwise), section 361(c)(3) should not be applied in a manner that converts what is otherwise a series of transactions that qualifies for nonrecognition treatment – a mere change in corporate form – into a taxable transaction by treating Nonrecognition Property received in exchange for Qualified Property as other than such Qualified Property. In other words, the same "step into the shoes" treatment that applies to Nonrecognition Property under other nonrecognition provisions of the Code should apply for purposes of the section 361(c)(3) analysis. The fact that the 1001 Regulations treat certain modifications of debt instruments as deemed exchanges, where those deemed exchanges are afforded nonrecognition treatment, should not disturb this result. This is consistent with long-standing tax policy of "exempting from tax the gain from exchanges made in connection with a reorganization, in order that ordinary business transactions will not be prevented on account of the provisions of the tax law."[340] Therefore, in the context of the Controlled Debt Modification Concern, Controlled obligations that are exchanged for Nonrecognition Property in a transaction that results in a Nonrecognition Modification should remain Qualified Property eligible for transfer under 361(c)(3) in their modified form.

In Case Studies 13 and 13A, both the Divisive Reorganization and the subsequent merger fall squarely within the nonrecognition provisions of the Code, which nonrecognition provisions treat the Acquiror securities as Nonrecognition Property that takes the place of the Controlled securities exchanged therefor. Section 361(c)(1) and (3) reflect a policy of permitting nonrecognition treatment to Distributing on the transfer by Distributing to its shareholders or creditors of property that was received on a tax-free basis by Distributing. For the reasons described above, the imposition of tax under section 361(c)(3) on the transfer of Controlled securities (or the Nonrecognition Property that takes the place of the Controlled securities in the post-Spin-off merger) to Distributing's creditors would be inconsistent with the nonrecognition provisions of the Code (and the purpose thereof).

On the other hand, subjecting Distributing to tax under 361(c)(2) where a post-Spin-off transaction results in a Nonrecognition Modification (Case Studies 13 and 13A) would result in disparate treatment of such transactions and those involving Disregarded Modifications (Case Studies 12 and 12A) despite there being no clear justification for so doing. The structural differences between Case Studies 13 and 12 do not bear any relation to the Controlled Debt

[340] S. Rep. No. 398, 68th Cong., 1st Sess., at 276 (further noting that, "[i]f it is necessary for this reason to exempt from tax the gain realized by the stockholders, it is even more necessary to exempt from tax the gain realized by the corporation").

Modification Concern. Just as the Acquiror securities in Case Study 12 reflect a continuing creditor interest in the Controlled business (owned by the surviving corporation), the Acquiror securities in Case Study 13 reflect a continuing creditor interest in the Controlled business (owned by a wholly owned subsidiary of the acquiror corporation). Treating economically equivalent transactions differently elevates form over substance and would either compel taxpayers to choose their form according to their desired outcome or penalize taxpayers who are unable to structure into section 381(a) transactions for non-tax reasons.

As noted above, Nonrecognition Modifications may also arise outside the context of post-Spin-off merger transactions, *e.g.*, as a result of a standalone financing of Controlled debt.

Case Study 14: Divisive Reorganization Followed by a Refinancing of Controlled Securities Via Recapitalization

> 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 business line to a domestic Controlled in a Divisive Reorganization in exchange for Section 361 Consideration (consisting of Controlled stock and securities), followed by the tax-free distribution of the stock of Controlled in a Spin-off. The Controlled securities issued to Distributing in the Divisive Reorganization have a maturity of seven years. Shortly following and as part of an overall plan with the Spin-off, (i) Distributing transfers the Controlled securities to its creditors in retirement of its historic indebtedness,[341] and (ii) the term of the Controlled securities is extended to eleven years.

As a result of the refinancing transaction in Case Study 14, the Controlled securities Distributing received as Section 361 Consideration and transferred to its creditors would likely be treated as having undergone a "significant modification" and, therefore, as having been exchanged for new Controlled securities with an extended maturity date.[342] However, while the deemed exchange of old Controlled securities for new Controlled securities is a realization event (under the 1001 Regulations), it constitutes a recapitalization and is afforded nonrecognition treatment by virtue of section 354. Controlled is both a party to the Divisive Reorganization and a (or, the) party to the reorganization with respect to the recapitalization (and its "new" securities are Nonrecognition Property in the recapitalization).

[341] An alternative fact pattern ("**Case Study 14A**") would involve a transfer by Distributing of the refinanced Controlled securities to its creditors in connection with the Divisive Reorganization and in retirement of its historic indebtedness within one year of the Spin-off (*i.e.*, Distributing continues to hold Controlled securities at the time of the refinancing, but intends to, and does, transfer all Controlled securities to its creditors pursuant to the Divisive Reorganization, albeit on a fully or partially delayed basis). As described in n. 331, so long as the transfer of Controlled securities received in the Divisive Reorganization occurs in connection with the Divisive Reorganization, the timing of such transfer relative to the refinancing transaction should not be meaningful.

[342] *See* Treas. Reg. § 1.1001-3(e)(3). The safe harbor in Treas. Reg. § 1.1001-3(e)(ii) would not be available because the extension exceeded the lesser of five years or fifty percent of the term to maturity.

For the reasons described above, neither Case Study 14 nor Cast Study 14A should be a transaction that implicates the Controlled Debt Modification Concern.

3. Revenue Procedure 2024-24 and the Controlled Debt Modification Concern

Under Revenue Procedure 2024-24, if any transaction related to a Divisive Reorganization may affect the terms of any Controlled securities received by Distributing, then the taxpayer must represent that (i) there no transaction (or series of transactions) that is directly or indirectly related to the Divisive Reorganization that will result in a deemed exchange (pursuant to the 1001 Regulations) of such Controlled securities and (ii) Controlled will continue as the obligor of such Controlled securities after the transaction(s) ("**Representation 29**").

For the reasons discussed above, we believe Representation 29 is unnecessary. At most, the Service should ascertain whether a Taxable Modification will occur pursuant to an overall plan with the Divisive Reorganization. However, even where such a Taxable Modification will occur, in light of the fact that tax will be separately imposed on the subsequent transaction, it is unclear whether such a transaction would or should implicate the Controlled Debt Modification Concern such that the transfer of Controlled debt to Distributing's creditors should be subject to recast. Accordingly, any information required to be submitted with respect to Taxable Modifications should be in the nature of additional information and not a representation (such that the inability to make such representation would automatically jeopardize the ability to receive a ruling). In the form proposed, Case Studies 12, 13, and 14 (and the alternative versions in Case Studies 12A, 13A, and 14A) would be inconsistent with Representation 29, notwithstanding that none of those fact patterns should implicate the Controlled Debt Modification Concern. Moreover, Representation 29 is overbroad in its application because (i) it is not limited to tax-relevant modifications (*e.g.*, implicating changes in obligor that are Disregarded Modifications) (ii) it applies with respect to transactions that are "directly or indirectly related to the Divisive Reorganization," a poor proxy for the proper application of step transaction principles where the transaction occurs after the Controlled debt has been transferred to Distributing's creditors, and (iii) it requires a non-time-bounded commitment that Controlled will continue as the obligor on its securities – a principle that bears no relation to the proper application of section 361(c)(3).

VII. AMOUNT AND TIMING OF INFORMATION REQUIRED TO BE SUBMITTED UNDER REVENUE PROCEDURE 2024-24

Revenue Procedures 96-30, 2017-52 and 2018-53 have required taxpayers to submit information sufficient to allow the Service to issue a ruling that a proposed Spin-off qualifies under sections 368(a)(1)(D) and 355. Revenue Procedure 2024-24 marks a major expansion of the amount of such information, support, and analysis now required to be submitted (which is in addition to information still required to be submitted under Revenue Procedure 2017-52).[343] The following is now required:

[343] We focus on transactions seeking to qualify under sections 368(a)(1)(D) and 355, but standalone distributions intending to qualify under section 355 are subject to many of the same burdensome information requests.

- If Distributing intends to distribute less than all the stock and securities of Controlled on the same day, the taxpayer must submit information on the expected percentage of Controlled stock or securities that will not be distributed, the expected duration of the period between the first and last distribution, and if that period is greater than 90 days, the taxpayer must also submit the expected percentage of Controlled stock or securities that will not be distributed within such 90-day period and the business reasons for the percentage and duration. The taxpayer must also submit facts and analysis to establish that each Distribution is "part of the distribution" or "in pursuance of the plan of reorganization".[344]

- Where there's a Retention of Retained Controlled Stock (or Securities), the taxpayer must submit:

    - the number of shares and percentage of each class of stock in, and the principal amount of each series of securities of, Controlled to be held by Distributing after the Control Distribution Date;

    - a description of options or similar instruments to acquire Controlled stock or securities that Distributing will hold after the Control Distribution Date;

    - an explanation for why the Retention is necessary, including descriptions of businesses reasons (or causes that are not business reasons);

    - the expected duration of the Retention and specifics around timing for dispositions; and

    - information describing any Federal income tax benefit or advantage resulting from or relating to the Retention and the disposition of Retained Controlled Stock (or Securities).[345]

- Where there is a Retention, the taxpayer must also establish to the satisfaction of the Associate Chief Counsel (Corporate) that the Retention is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.[346]

- Where there is a Retention and two or more factors described in section 3.03(3)(e)(ii) are present, the taxpayer must establish to the satisfaction of the Associate Chief Counsel (Corporate) that (i) a business exigency exists that outweighs such factors and directly causes the need for the Retention; and (ii) in light of such business exigency, the Retention

[344] Section 3.03(2)(c).

[345] Section 3.03(3)(d)(i).

[346] Section 3.03(3)(d)(ii)(A).

should not be viewed as in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.[347]

- If Controlled will owe Debt to Distributing after the Control Distribution Date, the taxpayer must submit information describing any Debt to be owed by Controlled or a Controlled Related Person to Distributing or a Distributing Related Person after the Control Distribution Date and analysis establishing that such Debt is not stock or securities.[348]

- The taxpayer must provide information and analysis to support the ability to make Representation 8, regarding the solvency of Distributing and Controlled, which may include projections and other financial information.[349]

- The taxpayer must provide information and analysis to support the ability to make Representation 9, regarding the future economic viability of Controlled (*e.g.*, adequate capitalization, ability to pay Liabilities as they come due), which may include projections and other financial information.[350]

- The taxpayer must submit information and analysis to establish that, under general principles of tax law, the transactions should not be recharacterized or otherwise treated as transaction(s) that do not qualify under relevant provisions of the Code.[351]

- The taxpayer must submit information describing:

    - Distributing Debt that will be satisfied with Section 361 Consideration and other Distributing Liabilities that will be assumed by Controlled (including relevant terms, agreements, and arrangements that evidence such Distributing Debt and Liabilities and the dates on which such Debts and Liabilities were incurred);

    - Section 361 Consideration that will be transferred to Distributing's shareholders or creditors in satisfaction of Distributing Debt; and

[347] Section 3.03(3)(e)(iii)(B). Where two or more factors are not present, the tax taxpayer must still submit analysis to establish that the Retention should not be viewed as in pursuance of a plan having as one of its principal purpose the avoidance of Federal income tax, and there is a business purpose for the Retention or disposition, and the Retention or disposition is consistent with the business purpose for the Distribution. Section 3.03(3)(e)(v).

[348] Section 3.03(4)(b).

[349] Section 3.03(5)(b).

[350] *Id*.

[351] Section 3.03(6).

   - Transactions that will implement (i) Controlled's assumption of each Distributing Liabilities; and (ii) each transfer of Section 361 Consideration to shareholders or creditors in satisfaction of Distributing Debt.[352]

- The taxpayer must submit information and analysis to establish that (i) any assumption of a Distributing Liability will be subject to section 357, (ii) any transfer of Section 361 Consideration to creditors in satisfaction of Distributing Debt will be in connection with the Divisive Reorganization, and (iii) any distribution of Section 361 Consideration to shareholders will be in pursuance of the plan of reorganization.[353]

- The taxpayer must establish that each specific step of the Proposed Transaction is part of the plan of reorganization,[354] and the taxpayer must submit as an exhibit to the ruling request a copy of the plan of reorganization, including a draft and final copy through a supplemental submission.[355]

- If Distributing Debt will be satisfied with Section 361 Consideration and/or Distributing Liabilities will be assumed by Controlled, the taxpayer must submit information with respect to any co-obligation, guarantee, indemnity, surety, make-well, keep-well, or similar arrangement, including security provided by any person other than Distributing, and analysis to establish that Distributing is the obligor of such Distributing Debt or Distributing Liability.[356]

- If the taxpayer cannot represent that the basis of the assets transferred by Distributing to Controlled exceeds the amount of liabilities assumed and boot received, the taxpayer must submit computations of any gain to be realized and recognized in the transactions.[357]

- If the holder of Distributing Debt that will be satisfied with Section 361 Consideration is a Distributing Related Person, the taxpayer must describe the steps and timing of all transactions that will implement the series of transfers of Section 361 Consideration required by Alternative Representation 15B (including information regarding any potential alternative pathways that culminate in the transfer of Section 361 Consideration to an unrelated creditor).[358]

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[352] Section 3.04(1).

[353] Section 3.04(2).

[354] Section 3.05(1)(b).

[355] Section 3.05(1)(c).

[356] Section 3.05(2)(b).

[357] Section 3.05(3)(b).

[358] Section 3.05(4)(b).

- The taxpayer must submit information and analysis to address any potential application of Treasury Regulations under section 1502 (presumably as relates to the satisfaction of Distributing Debt with Section 361 Consideration).[359]

- Where an Intermediary will acquire historical Distributing Debt to be satisfied with Section 361 Consideration, the taxpayer must submit:

  - The name of each Intermediary and a description of the terms of all agreements, understandings, and arrangements pertaining to the proposed transactions between the Intermediary and Distributing or Controlled or persons related thereto, including the terms of any Distributing Debt, stock or Section 361 Consideration to be acquired by the Intermediary and the terms of all agreements, understandings and arrangements relating to those acquisitions;

  - A description of any co-obligation, guarantee, indemnity, surety, make-well, keep-well, or similar arrangements, including security provided to the Intermediary by Distributing or Controlled or persons related thereto, or any other undertaking that results in the protection of the Intermediary against the risk of loss with regard to the Section 361 Consideration or Distributing Debt;

  - The length of time expected to elapse between the Intermediary's acquisition of a Distributing Debt and the satisfaction of that Debt with Section 361 Consideration; and

  - Information to establish that the exchange of Section 361 Consideration for Distributing Debt is made at arm's length.[360]

- Where an Intermediary will acquire historical Distributing Debt to be satisfied with Section 361 Consideration, the taxpayer must also provide analysis to establish that the terms of all agreements, understandings, and arrangements with an Intermediary and all activities by that Intermediary are consistent with the Intermediation Representations, and that the exchange of Distributing Debt for Section 361 Consideration contemplated by any such agreements, understandings, and arrangements will be in pursuance of the plan of reorganization. The Intermediation Representations will not be treated as furnished by the taxpayer "unless the taxpayer provides analysis that establishes that the Intermediary is a creditor of Distributing and participates as a principal for its own account in the exchange with Distributing, and that the transfer of Section 361 Consideration to the Intermediary should be respected and not recast or recharacterized under any principles of Federal income tax law (including the substance over form doctrine), agency, or any similar theory." If the Intermediary will hold the Distributing Debt for a short period of time, such

[359] Section 3.05(4)(b)(iii).

[360] Section 3.05(5)(c).

analysis must establish that the short time should not cause the form of the transaction to be recast.[361]

- If the amount of a Distributing Contingent Liability to be assumed by Controlled differs from the amount submitted because Distributing continues to engage in the same type of activities that generated the Distributing Contingent Liability, the taxpayer must submit a description of the continuing activity and explain the effect such activity on the Contingent Liability.[362]

- In connection with required adjustments to prevent duplication or omission of Debt or any other distortion as relates to the total amount of Distributing Debt to be satisfied with Section 361 Consideration or assumed by Controlled, and the historical average amount of Distributing Debt, the taxpayer must submit information and analysis to explain such adjustments and establish that they were made to prevent duplication or omission of Debt or any other distortion.[363]

- The taxpayer must submit a description of any qualified property, money, or other property to be transferred by Controlled to Distributing, a description of transactions in which such transfers to shareholders or creditors will occur, and analysis to establish that such transfers occur in pursuance of the plan of reorganization or in connection with the reorganization, as relevant.[364]

- If transfers of qualified property, money, or other property to Distributing shareholders or creditors occurs prior to the First Distribution Date, the taxpayer must submit information describing any transaction involving qualified property, money, or other property that will not be transferred by Distributing to its shareholders or creditors, and analysis of the tax treatment of such transaction.[365]

- The taxpayer must submit information and analysis to establish the substantial business reasons for any delay in satisfying Distributing Debt beyond 90 days after the First Distribution Date, and that the satisfaction more than 90 days thereafter will be in connection with the plan of reorganization.[366]

- With regard to Post-Distribution Payments, the taxpayer must submit information and analysis to establish (i) that, in character, the Post-Distribution Payment constitutes Section 361 Consideration and not a payment for goods or services, (ii) whether the fair market

[361] Section 3.05(5)(d).

[362] Section 3.05(7)(b).

[363] Section 3.05(8)(b)(iii).

[364] Section 3.05(9)(b), (c).

[365] Section 3.05(9)(c).

[366] Section 3.05(10)(c)(1)(A).

value of Distributing's right to receive the Post-Distribution Payment will be reasonable ascertainable, and whether the payment will be property accounted for when received, and (iii) whether Distributing will account for the right to receive the payment under the installment method.[367]

- If any transaction related to the Divisive Reorganization may affect the terms of any Controlled securities received by Distributing, the taxpayer must describe any change to the terms of the Controlled securities or other qualified property received by Distributing in connection with the related transaction and submit analysis to support the conclusion that (i) the change will not constitute a deemed exchange under Treas. Reg. § 1.1001-3 and (ii) Controlled will remain the obligor of any such securities or other qualified property thereafter.[368]

- If Distributing or Distributing Related Person is a borrower under a revolver or similar arrangement in existence as of the Earliest Applicable Date, the taxpayer must submit information and analysis to establish that any increase either in the available borrowing under the revolver or the actual amount borrowed thereunder (i) did not occur in connection with the Spin-off, (ii) would have occurred without regard to the Spin-off or any related transaction, and (iii) occurred in the ordinary course of business (*i.e.*, any increase is demonstrably independent of the Spin-off or any related transaction).[369]

- If Distributing or a Distributing Related Person is a prospective or actual borrower as a result of an event unrelated to the Section 355 Transaction and not in the ordinary course of business of Distributing and directly arises from changed circumstances that were not anticipated prior to the Control Distribution Date, the taxpayer must submit information and analysis to establish that (i) the event (a) occurred outside the ordinary course of business of Distribution, (b) did not occur in connection with the Spin-off, and (c) directly arose from changed circumstances that were unanticipated prior to the Control Distribution Date (*i.e.*, the event is demonstrably independent of the Spin-off or any related transaction) and (ii) the borrowing would have been incurred without regard to the Spin-off or any related transaction.[370]

- If the taxpayer seeks a ruling that a transaction or series of transactions pursuant to an agreement or arrangement constitutes the assumption by Controlled of a Distributing Liability, the taxpayer must submit:

[367] Section 3.05(10)(c)(ii).

[368] Section 3.05(11)(b).

[369] Section 3.05(12)(c)(i)(B).

[370] Section 3.05(12)(c)(ii)(B).

- o A description of each Distributing Liability to be assumed by Controlled, including the circumstances of its incurrence;[371]

- o A description of each agreement or arrangement at issue, including the rights and obligations of Distributing, Controlled, and any other parties, and, if a payment is made to a trust or escrow agent, information and analysis to establish that neither Distributing nor any Distributing Related Person will have legal or practical dominion or control over any part of the payment;[372] and

- o If Controlled will assume a Distributing Contingent Liability:

  - ▪ A description of each Distributing Contingent Liability to be assumed, including the circumstances of its incurrence, the length of time expected before amounts to be paid will be substantially determined, the relationship of the liability to Controlled's business and assets, and the current and anticipated disclosure of the liability on financial statements of the relevant party; and

  - ▪ A statement as to whether Distributing or Controlled (or another person) will deduct or capitalize payments to satisfy the assumed liability.[373]

- The taxpayer must submit information and analysis to establish that (i) no assumption by Controlled of a Distributing Liability will have as a principal purpose the avoidance of Federal income tax or any other purpose that is not a bona fide business purpose and (ii) no proposed transaction or series of transactions will have as a principal purpose the avoidance of any requirement or limitation in sections 357 or 361.[374]

The added burden on taxpayers is difficult to overstate. The required information and analysis listed above generally functions as support for the representations, demonstrating to the Service that the representations are accurate and the taxpayer can reasonably make the required representations. This signals a departure from approaches embraced in the prior revenue procedures; the new PLR process is more similar to an audit than to the historical approach. And it's unclear what is gained from this shift.[375] Taxpayers submit a ruling request only if they are confident they are able to make the required representations. Diligence is undertaken, support is gathered, and a penalties of perjury statement is signed. In our experience, taxpayers approach a ruling request earnestly and with great preparation.

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[371] Section 3.05(13)(c)(i).

[372] Section 3.05(13)(c)(ii).

[373] Section 3.05(13)(d).

[374] Section 3.05(14)(b).

[375] *See also* discussion with respect to solvency in Part VI.G.

Even if taxpayers intend to provide the required information and analysis, actually meeting the standard to the letter of Revenue Procedure 2024-24 generally will prove impossible. As discussed above with respect to Post-Distribution Payments, timing will present a significant obstacle because taxpayers seek PLRs well in advance of a potential Spin-off. Whether Distributing will endeavor to implement a Debt-for-Debt Exchange or Debt-for-Equity Exchange may be unknown—identification of the Intermediary may not even be an agenda item, let alone knowledge of the agreements and specific terms governing the related arrangements. The taxpayer may not yet know which Distributing Debt (or how much) it may want to satisfy with Section 361 Consideration and, even if identified, unforeseen changes to the expected Spin-off timeline may render the targeted Distributing Debt unavailable for satisfaction. Information with respect to Distributing Liabilities (contingent or otherwise) to be assumed by Controlled generally may be knowable (*e.g.*, liabilities associated with the Controlled business) but not much more and certainly not the amount of such liabilities. These are just a few examples of the timing issues; Revenue Procedure 2024-24 is littered with such problems.

Taxpayers seek PLRs for prospective transactions. The subject transaction cannot be hypothetical in nature—the proposed transaction must be well described, reasonably concrete, and not merely one of several potential options—but taxpayers are permitted to obtain a PLR and then forgo execution of the proposed transaction. Much of the information now required is unknowable for a transaction that is still often at least several months from execution and which such execution may never eventuate. The Service should clarify whether it intends to issue PLRs for only those Spin-offs which are nearly guaranteed to occur. That would mark yet another departure from historical practice and, more importantly, have a negative impact on the execution of commercial transactions. If the aim is to create a robust yet efficient PLR program, we recommend the Service revisit the required information and analytical submissions, be mindful of timing and commercial realities, and tailor the requirements in a manner that would allow taxpayers to satisfy them.

Appendices

New York State Bar Association Tax Section, *Report on Procedural Guidance for Private Letter Rulings on Divisive Reorganizations: Issues Related to Section 361 Exchanges* (Report No. 1491, March 4, 2024).

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), attached as Appendix to Report No. 1491

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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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

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[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				

Color	Legend
	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

[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,

[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

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[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

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[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

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[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

[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,

[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

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[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

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

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

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

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

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

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

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

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

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

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

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

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

B. Intermediated Exchanges

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

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

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

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

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

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

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

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

[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] *Id.*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Case Study 9: Direct Issuance by Distributing to Financial Intermediary

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

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

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

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

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

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

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

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

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

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

C. Other Creditor Transactions Involving Recently Issued Distributing Debt

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

Case Study 10: Distributing Commercial Paper

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

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

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

73 *Id.*

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

D. Related Party Issues

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

E. Reborrowings by Distributing

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

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

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

[86] *Id.*

[87] *Id.*

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

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

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

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

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

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

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

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

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

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

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

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

Case Study 17: Reborrowing by Subsidiary of Distributing

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

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

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

F. Post-Spin-off Refinancing of Controlled Debt

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

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

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

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

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

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

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

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

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

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

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

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

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

G. Boot Required to Be Purged

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

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

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

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

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

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

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

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