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SECTION 355 SPIN-OFF + SECTION 368 REORGANIZATION ≠ SECTION 355(e). IT'S SIMPLE MATH: THE ANTI-MORRIS TRUST BILL SIMPLY DOES NOT ADD UP

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I. INTRODUCTION

Since the Tax Reform Act repealed *General Utilities and Operating Co. v. Helvering*[1] in 1986, one of the only ways a corporation can avoid the corporate tax on distributing appreciated property is through spin-off type transactions under section 355 of the tax code.[2] This section was designed to permit tax-free separation of one or more active businesses formally operated by a corporation or a corporation and its subsidiary.[3] The rationale behind the tax-free provision was to promote economic growth and encourage companies in extremely competitive markets to improve productivity without a business's concern of recognizing taxable gain on the transaction.[4]

When a section 355 transaction is structured properly, the Internal Revenue Service will respect its form. However, many critics, including the Service and tax policymakers, believe that corporate taxpayers are structuring taxable transactions under the guise of a tax-free reorganization to manipulate one of the last remaining tax advantages.[5] For instance, a target

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1. 296 U.S. 200 (1935). The Supreme Court held that corporations could distribute appreciated property to their shareholders tax-free. *See id.* at 206. *General Utilities'* repeal, coupled with the addition of § 311(b) to the Internal Revenue Code, imposed a corporate level tax on the distribution of appreciated property to shareholders, regardless of whether the distribution is taxed to the shareholders as a dividend, redemption or liquidation. *See* I.R.C. § 311(b) (1994).

2. All section references are to the Internal Revenue Code.

3. *See* Prop. Treas. Reg. § 1.355-1(a), 19 Fed. Reg. 8270 (Dec. 11, 1954).

4. *See* H.R. REP NO. 1337 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4025.

5. *See, e.g.*, Allan Sloan, *The Loophole King: How Disney Will Duck Taxes on Big Paper Profits*, NEWSWEEK, Mar. 31, 1997, at 55 [hereinafter Sloan, *Loophole King*] (speculating that Disney was attempting to profit from auctioning off some of its newspapers without paying taxes on the transaction by creating a subsidiary to hold publications it wished to keep and selling others in a tax free stock for stock trade); Allan Sloan, *A Sexy New Loophole*, NEWSWEEK, Feb. 3, 1997, at 37 [hereinafter Sloan, *New Loophole*] (explaining that GM's conveyance of its defense business to Raytheon Co. is not a sale that the gain from which may be taxed); Lee A. Sheppard, *Rethinking Assumption of Liabilities in Spin-Offs*, 97 TAX NOTES TODAY 30-6 (Feb. 13, 1997) [hereinafter Sheppard, *Rethinking Assumption*] (noting how $80 billion worth of businesses were sold by means of spin-offs in 1996); Lee A. Sheppard, *Aliens Kidnap IRS Lawyers—Inexplicable Viacom Ruling*, 96 TAX NOTES TODAY 129-6 (July 2, 1996) [hereinafter Sheppard, *Aliens Kidnap*] (puzzling over the IRS's ruling that the distribution of Viacom's

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corporation can structure its businesses to meet an acquirer's conditions by structuring a section 355 spin-off to dispose of unwanted business segments in a tax-free stock-for-stock exchange. While this reorganization is a recognized business purpose, it is potentially unacceptable when *cash* from a loan is additionally transferred to the target's historic shareholders, and the acquiring corporation assumes the debt.[6] Essentially, tax policymakers perceive that the target corporation wielded the spin-off provisions in a transaction resembling a "sale," but used the tax-free provisions to get the money tax-free. This result disturbed policymakers, and they endeavored accordingly to modify the Code to prevent tax avoidance on a subsidiary's distribution. Congress responded by adding section 355(e) in the Taxpayer Relief Act of 1997,[7] which effectively overruled *Commissioner v. Mary Archer W. Morris Trust*.[8] Furthermore, in the Revenue Reconciliation Act of 1990,[9] Congress added section 355(d) to bust-up disguised sales which is what the 1997 Act was constructed to impede. Although section 355(e) was created to stop *Morris Trust*-type transactions (the so-called "spin-merge"), in certain circumstances corporations can still use a section 355 spin-off to distribute stock tax-free.[10]

Policymakers continue to be concerned that corporations have shifted their focus to section 355 spin-offs as an escape route.[11] Because of the ongoing dilemma with section 355, the Service and Congress will probably enact further legislative policies to limit tax-free corporate divisions and to modify the section 355 spin-offs as it exists today.

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cable subsidiary fell under section 355).

6. *See infra* Part III.D.

7. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997) (codified as amended in scattered sections of I.R.C.) [hereinafter 1997 Act].

8. 367 F.2d 794 (4th Cir. 1966). *Morris Trust* will be discussed in depth in Part IV, *infra*; *see also* BORRIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATION AND SHAREHOLDERS ¶ 11.11[3][a], 11-78 (7th ed. Supp. 2000) ("Little did Mary Archer Morris realize that her estate's modest tax planning efforts ultimately would stimulate the type of hostility levels formerly reserved for Mrs. Gregory's machinations."). Compare poor Mary Archer Morris to Mrs. Gregory, who formed a subsidiary solely to avoid ordinary income. *See* Gregory v. Helvering, 293 U.S. 465, 467–68 (1935). Yet Mary Archer Morris, like Mrs. Gregory, will have the dubious distinction of spurring Congress and the Service to promulgate an extremely unpopular tax law.

9. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388–400 (1990) (codified as amended in scattered sections of I.R.C.) [hereinafter 1990 Act].

10. *See infra* Part IV.C.

11. *See* Mark J. Silverman & Lisa M. Zarlenga, *The Proposed Section 355(e) Regulations: Broadening the Traditional Notions of What Constitutes a Plan*, 52 TAX EXECUTIVE 1 (2000), *available at* 2000 WL 17804216 (noting that Congress considered a few highly publicized section 355 transactions as more closely resembling a sale in substance).

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Despite the Service's attempts to strike down section 355 violators, astute tax practitioners and sophisticated corporate taxpayers are successfully taking assets out of corporate solution, and are creatively forming tax-free business transactions at a much quicker pace than the IRS can monitor. For instance, the much-publicized Viacom, GM, and Disney Revenue Rulings were questionably permitted as tax-free spin-offs and purchases.[12] Section 355(e) is the response to these leveraged buy-out transactions. Under section 355(e), the shareholder is protected from any taxable gain, but the corporation still recognizes corporate-level taxes if the corporation's construct fails to meet the new bill's requirements.[13]

Despite the potential abuse by corporate taxpayers, this newly added section is too restrictive. Less restrictive measures could have been structured rather than the overreaching, all-inclusive provisions contained in section 355(e). Now, nonabusive transactions are in jeopardy because they fall within section 355(e)'s scope, and numerous interpretive questions regarding the new statute are under consideration by the Treasury and the Service.[14]

This paper is arranged as follows: first is a discussion of section 355 distributions, giving a historical perspective and the policy behind section 355. Next, is a brief delineation of the statutory and nonstatutory requirements of section 355. The paper will then discuss the *Morris Trust* transaction, and the highly publicized *Morris Trust*-type transactions that inspired section 355(e). Subsequently, there will be a discussion of legislative enactments that attempt to bust-up section 355 disguised sales, including problems with the current bill, proposed modifications to improve the bill, and alternative structures to section 355(d) and (e). Finally, this paper will briefly discuss the future of section 355.

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12. *See infra* Part IV.B. for an in-depth analysis.

13. *See* I.R.C. § 355(e) (Supp. IV 1998). *See infra* Part IV.D. for a detailed explanation of this new law.

14. *See for example* I.R.S., *Announcement: Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection with an Acquisition; Hearing*, (Feb. 28, 2000), *available at* 2000 WL 226419 (announcing the rescheduling of the date and time of a hearing on proposed public hearing relating to proposed regulations (REG-116733-98, 1999-36 I.R.B. 392) under section 355(e) of the Code); I.R.S., *Announcement: Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection with an Acquisition; Withdrawal of Proposed Rule Making*, (Jan. 22, 2001) *available at* 2001 WL 45236 (withdrawing proposed regulations (REG-116733-98, 1999-36 I.R.B. 392) under section 355(e) of the Code).

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II. HISTORY AND POLICY UNDERLYING SECTION 355 SPIN-OFFS

When spin-offs were originally introduced under the Revenue Act of 1924,[15] the purpose was to permit tax-free separation of one or more active businesses formally operated by a corporation or a corporation and its subsidiary.[16] If a merger of two businesses was permissible, then a corporation's division was also permitted, provided that the businesses had been functioning for a significant period of time and the shareholders had a continuing stock interest.[17] However, the poorly constructed statute provided taxpayers with a providential opportunity to bail out dividend income.[18] A corporation could transfer its excess funds or liquid assets to a newly organized corporation, distribute the stock of the new corporation to its shareholders, and finally liquidate the new corporation so the shareholders could obtain the assets. This construction was beneficial because, upon liquidation of the second corporation, the shareholders were taxed at capital gains rate rather than ordinary income. The Service's main concern was not a corporation's avoidance of corporate tax treatment, but a shareholder's utilization of the spin-off provisions to convert dividends—and ordinary income—into capital gains treatment.[19]

A series of anti-abuse rules were promulgated in the 1930s; namely, the Revenue Act of 1934 and the Supreme Court's seminal ruling in *Gregory v. Helvering*.[20] In *Gregory*, the Supreme Court enacted the business purpose requirement.[21]

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15. The Revenue Act of 1924 permitted tax-free spin-offs: (1) if there is a transfer by a corporation of part or all of its property to a second corporation, and (2) the first corporation or its stockholders (or both) are in control of the second corporation immediately after the transfer, then no gain will be recognized by the shareholders of the first corporation if stock of the second corporation was distributed to them as part of the reorganization plan. Revenue Act of 1924, Pub. L. No. 68-176, § 203(c), 43 Stat. 253, 256–57 (1924).

16. Ways and Means Committee of the House, *Statement of the Changes Made in the Revenue Act of 1921 by the Treasury Draft and the Reasons Therefore*, N.Y. TIMES, Jan. 5, 1924, at 8–9, *reprinted in* INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS 12 (Bernard D. Reams, Jr. ed., 1979).

17. Revenue Act of 1924, Pub. L. No. 68-176, § 203(c), 43 Stat. 253, 256–57 (1924).

18. Taxpayers paid 46% taxes for dividends at the highest tax rate, while capital gains were taxed only at 12.5%. Revenue Act of 1924, Pub. L. No. 68-176, §§ 210, 211, and 214, 43 Stat. 253, 264–71 (1924) (codified at I.R.C. §§ 210, 211, and 214 (1924)).

19. *See infra* notes 22, 52 (discussing the overall policy of section 355 was to prevent corporations from bailing out earnings and profits at capital gains rates).

20. 293 U.S. 465 (1935).

21. *See id.* The Supreme Court ruled that "a transfer of assets by one corporation to another . . . *in pursuance of a plan or reorganization . . . of corporate business*" implies that there must be a business purpose. *Id.* at 469 (emphasis added). The business purpose rule has been applied very liberally. Today, it is easy to come up with a business

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Thus, even if the spin-off statute were fully complied with, the taxable transaction would be treated as ordinary income to the extent of the corporation's earnings and profits despite the newly structured corporation meeting the fundamental business purpose requirement.[22] Congress eliminated the spin-off provision altogether because it was concerned that businesses were being spun off for tax-avoidance purposes.[23]

After numerous failed proposals thereafter to restore spin-offs, in 1951 Congress finally amended the 1939 Code to provide for tax-free spin-offs.[24] Congress reenacted the spin-offs, positing that it was "economically unsound to impede spin-offs which break up businesses into a greater number of enterprises, when undertaken for legitimate business purposes."[25] Further changes were made three years later, finally molding section 355 into how it exists today. When tax-free spin-offs were reinstated in 1954, its statutory limitations resembled those placed on corporations since *Gregory*.[26] Once section 355 was reinstated, there were no *significant* legislative changes for thirty years until *General Utilities Operating Co. v. Helvering*[27] was repealed by the Tax Reform Act of 1986.[28]Although the Tax Reform Act of 1986 did not alter section 355, this section played an augmented role in the corporate tax world.

Before the *General Utilities* repeal, corporations could distribute appreciated property to the shareholders in a tax-free

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purpose, but the requirements are more stringent for a § 355 spin-off, which the nonstatutory requirements will show. *See infra* Part III.C.

22. House Committee on Ways and Means said that by employing spin-offs, "corporations have found it possible to pay what would otherwise be taxable dividends, without any taxes upon their shareholders" and that "this means of avoidance should be ended." H.R. REP. NO. 73-704 (1934), *reprinted in* 1939-1 C.B. 554, 564 .

23. *See* REVENUE REVISION, 1934, EXHIBIT D, MEMORANDUM ON EXCHANGES AND REORGANIZATIONS (1933), *reprinted in* INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS VOLUME II 60 (Bernard D. Reams, Jr. ed., 1979). Despite the repeal of spin-offs, split-offs and split-ups still exist.

24. *See* Revenue Act of 1951, Pub. L. No. 82-183, § 317, 65 Stat. 452, 493 (1951).

25. S. REP. No. 82-781 (1951), *reprinted in* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1939-1953 1556 (1954).

26. 293 U.S. 465 (1935); *see* Internal Revenue Code of 1954, Pub. L. No. 83-591, § 355(b), 68A Stat. 3, 114 (1954); Donald F. Bronsnon, *Spin-Offs Before And After The Tax Reform Act*, 38 BUFF. L. REV. 157, 162 (1990).

27. 296 U.S. 200 (1936).

28. Tax Reform Act of 1986, Pub. L. No. 99-514 §§ 631-33, 100 Stat. 2085 (codified in I.R.C. §§ 311, 336, and 337); R. David Wheat, *Consolidated Returns in the Nineties—An Overview*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2000 483, 492 (PLI Tax Law and Estate Planning Course Handbook Series No. J0-002R, 2000), *available at* WL 486 PLI/TAX 483.

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transaction. After the *General Utilities*, corporations and potential shareholders recognized taxable income for the distribution of appreciated property.[29] While prior to *General Utilities'* repeal, spin-offs were used to convert ordinary income into capital gains, afterwards, tax-free spin-offs could be utilized as an escape hatch to distribute appreciated property or unwanted assets out of corporate solution tax-free. Consequently, in 1997, Congress reacted with controversial and questionable legislation—section 355(e)—that not only restricted a corporate taxpayer's ability to abuse the tax-free spin-off provision, but also stymied nonabusive transactions.

III. MECHANICS OF A SECTION 355 SPIN-OFF[30]

> EXAMPLE 1: Distributing corporation (D) operates two businesses: an insurance and a banking business. A & B are the only shareholders of D. D transfers all the insurance division assets to a newly formed subsidiary (C) (See Step 1 in the "§355" graph below). Then D distributes the C stock pro rata to its two equal individual shareholders, A & B (Step 2). Immediately after the distribution, the same two shareholders own the two business operations in the same proportions as before; only now the businesses are contained in two separate entities rather than as divisions of one corporate entity.

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29. *See* I.R.C. § 311(b) (Supp. IV 1998).

30. There are three types of § 355 transactions, spin-off, split-off and split-up. In a split-off, some the shareholders of the distributing corporation trade in their shares for subsidiary stock. Some keep stock of distributing and some exchange the distributing stock for the controlled. In a split-up, the distributing corporation owns two subsidiaries and in liquidation distributes the stock of two subsidiaries to the shareholders in exchange for the shareholders' stock in the distributing corporation. Shareholders owning stock of the corporation now receive stock of subsidiary 1 and subsidiary 2. *See generally* Mark J. Silverman & Kevin M. Keyes, *Corporate Divisions Under Section 355*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1998 285, 298–99 (PLI Tax Law and Estate Planning Course Handbook Series No. J0-000C, 1998), *available at* WL 428 PLI/TAX 285 (1998) (defining the three types of transactions). This paper will discuss mainly spin-offs, and occasionally discuss split-offs. For instance, Viacom, discussed *infra* Part IV.B., is an example of a split-off transaction.

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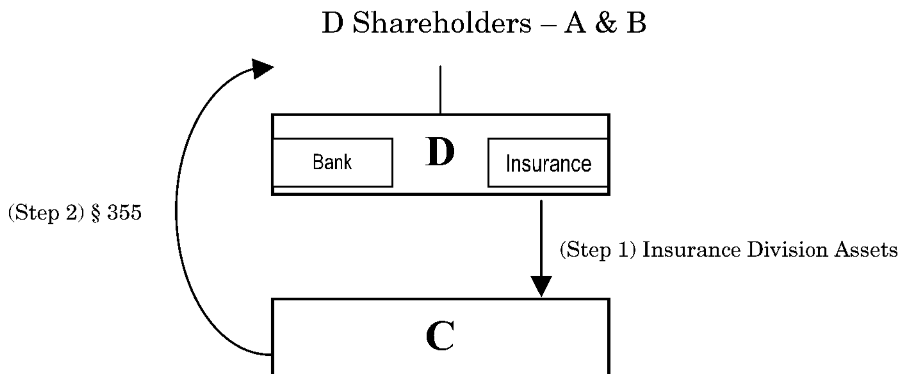
Section 355

D Shareholders – A & B



In a section 355 drop-down spin-off,[31] a continuing corporation distributes assets to a newly formed subsidiary. The corporation then spins off the subsidiary, and the subsidiary stock is distributed to the shareholder without triggering income or gain to the corporation or its shareholders. Alternatively, in a section 355 "non-drop," the continuing corporation may have an existing subsidiary, and subsequently the subsidiary stock is distributed to the shareholders. The shareholders had stock from one corporation, but after the spin off they end up with stock from two corporations—the continuing corporation and its subsidiary.

A. *Relationship of Section 355 and Section 368(a)(1)(D)*

Many stock distributions in a controlled corporation are characterized as a Type D reorganization under section 368(a)(1)(D)[32] and section 355. If a distributing corporation transfers assets to a newly formed controlled subsidiary, or to an old and cold subsidiary, and this asset transfer meets the requirements of section 368(a)(1)(D), the transfer will be considered a tax-free reorganization pursuant to section 361(a).[33] Section 368(a)(1)(D) describes a corporate division, but dictates that such a business action will only be considered a

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31. SHEPHARD'S/MCGRAW-HILL TAX DICTIONARY FOR BUSINESS 114 (1994) (defining a drop down as "the transfer of the assets or *stock* of a target company into one or more subsidiaries following a *corporate reorganization*") (emphasis added) *citing* I.R.C. § 368(a)(2)(C); *see also* Solitron Devices, Inc. v. Commissioner, 80 T.C. 1 (1983) (explaining the mechanics of a drop).

32. A Type D reorganization is a transfer of a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders, is in control of the corporation to which the assets are transferred. *See* I.R.C. § 368(a)(1)(D) (1994).

33. *See* I.R.C. § 361(a); *see also* I.R.C. § 368(a)(1)(D).

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"reorganization" if "in pursuit of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356."[34] Furthermore, if the distribution of the subsidiary stock qualifies under section 355, "then no gain or loss shall be recognized to . . . [the shareholder distributees] on the receipt of such stock."[35]

Before the 1997 Act, the tax law governing post-stock-distribution acquisitions had developed "illogical distinctions."[36] For instance, the rules differed

(1) depending on whether it was the stock of Distributing or Controlled that was being disposed of, or issued, and

(2) in the case of Controlled, depending on whether
  (a) Controlled was newly formed in connection with the transaction, or assets transferred to the company in connection with the transaction (i.e., a section 368(a)(1)(D) or section 351 transaction), or
  (b) Controlled was old and cold and received no new assets in the transaction.[37]

If the distributing corporation was the actual target of the acquisition, to achieve a tax-free reorganization, the parties simply had to ensure that the stock distribution and subsequent acquisition occurred in proper sequence.[38] If the controlled

34. I.R.C. § 368(a)(1)(D).

35. I.R.C. § 355(a) (1994). The primary section 355(a) requirements include: (1) the distributing corporation must control the subsidiary immediately before the distribution; (2) the transaction must not be simply a device for the distribution of earnings and profits of the distributing corporation; (3) both the distributing and controlled corporations must meet the active trade or business requirements; and (4) the distributing corporation must distribute at least enough of its subsidiary stock to constitute control. *See id.* Judicially-created requirements include the existence of a legitimate business purpose for the transaction and the continuity of shareholder interest in the modified corporate forms after the distribution. STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION 533–43 (4th ed. 1997).

36. *See* Richard L. Reinhold, *Sec 335(e): How We Got Here and Where We Are*, 82 TAX NOTES 1485, 1495–96 (Mar. 8, 1999).

37. *Id.*

38. *See* Commissioner v. Mary Archer W. Morris Trust, 367 F.2d 794, 795 (4th. Cir.

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corporation was the entity acquired after the stock distribution, a "vote of the then shareholders of the spun-off corporation to enter into a statutory merger with an unrelated corporation" would have been sufficient for the Service to find that the transaction "did not violate the continuity-of-interest requirement," and thus was tax-free, because the vote allowed the shareholders to exercise "real and meaningful" ownership of the stock prior to the merger.[39]

However, the Service also had declared in Revenue Ruling 70-225 that "[a] series of prearranged steps by which a controlled corporation transfer[ed] assets for stock of a new subsidiary and distribute[d] such stock to its sole shareholder who exchange[d] it for some of the stock of an unrelated corporation [was] *not a tax-free transfer or reorganization*."[40] The Service applied the step transaction doctrine to the transaction at issue, stating that

> the transfer by [the distributing corporation] of part of its assets to [a newly formed subsidiary] in exchange for all the stock of [the subsidiary] followed by a distribution of the [subsidiary] stock to [the shareholder] and by the transfer of the [subsidiary] stock to [the acquiring corporation] by the [the shareholder] in exchange for [the acquiring corporation] stock is a series of integrated steps which likewise may not be considered independently of each other.[41]

Integrating the steps of the transaction resulted in neither the distributing corporation nor its shareholder controlling the subsidiary after the transaction; instead, the unrelated acquirer controlled the subsidiary.[42] Because the continuity of interest requirement was not met, the transaction was not considered a reorganization under section 368(a)(1)(D) or a transfer under section 351.[43] Accordingly, the transaction was not tax-free to either the corporation under section 361(a) or to the shareholder

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1966); *see also* Rev. Rul. 68-603, 1968-2 C.B. 148 (declaring that "[t]he Internal Revenue Service will follow the decision . . . in the case of Commissioner v. Mary Archer W. Morris Trust").

39. Rev. Rul. 75-406, 1975-2 C.B. 125, *obsoleted by* Rev. Rul. 98-27, 1998-1 C.B. 1159.

40. Rev. Rul. 70-225, 1970-1 C.B. 80, *obsoleted by* Rev. Rul. 98-44, 1998-2 C.B. 315 (emphasis added).

41. *Id.*

42. *See id.*

43. *See id.*

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under section 355.[44] "The 1997 act drafters sensibly . . . made a serious effort to purge this [distinction] from the tax law."[45]

Statutory amendments applicable to section 368(a)(1)(D) and section 351, coupled with Revenue Ruling 98-27, eliminated the step transaction doctrine "to determine whether the distributed corporation was a controlled corporation immediately before the distribution under section 355(a) solely because of any post-distribution acquisition or restructuring of the distributed corporation, whether prearranged or not."[46] Thus, after Revenue Ruling 98-27, a distribution preceding stock dispositions and issuances can occur without concern that the Service would reverse the steps, thereby causing a second-step acquisition of the controlled corporation to be treated as having occurred first.[47]

B. *Overview of Section 355 Statutory Requirements*

A distribution of stock or securities in a controlled corporation will be eligible for section 355 nonrecognition provided it meets certain statutory and nonstatutory requirements.

1. Control. Distributing corporation (D) must "control" Controlled corporation (C) immediately prior to the distribution.[48] That is, D must own C stock constituting at least 80% of the total combined voting power of all outstanding C stock, and at least 80% of each class of outstanding nonvoting S stock.[49] D must *not* have acquired "control" of C within the preceding five years in a transaction in which gain or loss was recognized.[50] Additionally, D must distribute either all of its C stock, or enough stock to constitute control.[51] If D does not distribute all its C stock, but distributes enough to constitute control, then D has the burden of

44. *See id.*

45. *See* Reinhold, *supra* note 36, at 1496.

46. Rev. Rul. 98-27, 1998-22 I.R.B. 4.

47. *See* Reinhold, *supra* note 36, at 1495.

48. *See* I.R.C. § 355(a)(1)(A) (1994).

49. *See* I.R.C. § 368(c) (1994); *see also* Rev. Rul. 59-259, 1959-2 C.B. 115.

50. *See* I.R.C. § 355(a)(3)(B) (1994).

51. I.R.C. § 355(a)(1)(D) (1994). The overall policy of section 355 is to prevent corporations from bailing out earnings and profits at capital gains rates. *See* STEPHEN A. LIND, ET AL., FUNDAMENTALS OF CORPORATE TAXATION 513 (4th ed. 1997).

> The early income tax provisions . . . permitted a corporation to transfer all or part of its assets to a newly formed subsidiary and then to make a tax-free distribution of the stock of that subsidiary to its shareholders as part of a plan of reorganization. The tax avoidance potential of this blanket exemption from the dividend rules was enormous . . . .

Id.

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showing that retention of stock was not principally for tax avoidance purposes.[52]

2. Active Trade or Business. Both D and C must be "engaged immediately after the distribution in the active conduct of a trade or business."[53] A corporation is engaged in an active business if the trade or business was conducted throughout the preceding five-year period,[54] and D did not acquire the trade or business, or control over the corporation conducting the trade or business, in a taxable transaction within the preceding five-year period.[55]

3. Device. The distribution must not be used principally as a device to distribute earnings and profits of D or C.[56] Since the *General Utilities* repeal, section 355 has been used as a device to facilitate distribution of property in a dividend and redemption transaction from the corporate solution to the shareholders. Dividends and redemptions will potentially result in double taxation: the shareholders could recognize taxable gain and the corporation will recognize any gain or loss built into the distributed assets. Consequently, this statutory requirement has been the Service's focal point.[57]

C. *Overview of Section 355 Nonstatutory Requirements*

Even if the statutory requirements are met, D must still meet the judicially developed doctrines, namely the business purpose and continuity of interest requirements.[58]

1. Corporate Business Purpose. D must have a corporate business purpose for the distribution. The regulations define it as a "substantial non-federal tax purpose germane to the business" of D or C.[59] An additional burden placed on the

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52. *See* I.R.C. § 355(a)(1)(D).

53. I.R.C. § 355(b)(1)(A) (1994).

54. *See* I.R.C. § 355(b)(2)(B) (1994).

55. *See* I.R.C. § 355(b)(2)(C), (D) (1994). Congress intended to limit nonrecognition to those corporations that had a division comprising of a "mere change in form," and to prevent corporations from distributing assets to shareholders that should be taxable as dividends. S. REP. NO. 87-1881 (1962), *reprinted in* 1962 U.S.C.C.A.N. 3304, 3453.

56. *See* I.R.C. § 355(a)(1)(B) (1994). Also, Treas. Reg. § 1.355-2(d)(2) lists factors that are used as a device, such as: pro rata distribution, subsequent sale or exchange of stock, nature and use of assets of D and C immediately after the transaction. *See* Treas. Reg. § 1.355-2(d)(2) (2000). Non-device factors include: corporate business purpose, D being publicly traded and widely held, and distribution to domestic corporate shareholders. *See* Treas. Reg. § 1.355-2(d)(4).

57. Silverman & Keyes, *supra* note 30, at 293–94.

58. *Id.* at 293.

59. *See* Treas. Reg. § 1.355-2(b)(2) (2000); *see also* Treas. Reg. § 1.355-2(b)(5) (showing examples of transactions that would constitute an appropriate business purpose).

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corporate taxpayer is that a separation will not meet this requirement if there is an alternative nontaxable transaction, which is neither impractical nor unduly expensive, that would achieve the same result.[60] The higher burden is placed more on corporations attempting to undergo a section 355 spin-off transaction than any other tax-free reorganization, because taxpayers are giving up a layer of tax, while under section 368, taxpayers are just deferring income recognition.[61]

This amorphous definition places a more challenging obstacle for the corporate taxpayer to overcome, while providing little guidance. Accordingly, after a myriad of inquiries and requests for assistance, the Service finally responded with Revenue Procedure 96-30. Revenue Procedure 96-30 is an expanded list of accepted corporate business purposes, which may be relied upon to satisfy the requirements of section 355.[62]

2. Continuity of Interest. It used to be that the continuity of interest requirement was satisfied if, after the division, continuing or former shareholders of D owned at least 50% stock interest in both D and C.[63] In the 1997 budget proposal, the Treasury extended the continuity of interest time frame. Now, an acquisition of 50% or greater that occurs within a four-year distribution period (two years before the distribution) is presumed to have occurred pursuant to a plan unless a shareholder can establish that the acquisition occurring during the four-year period was unrelated to the distribution.[64]

> EXAMPLE 2: In Year 1, D distributes C stock to its shareholders. D's basis is $25,000 in C and

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60. *See* Treas. Reg. § 1.355-2(b)(3).

61. Steven A. Bank, *Federalizing the Tax-Free Merger: Toward an End to the Anachronistic Reliance on State Corporation Laws*, 77 N.C. L. REV. 1307, 1308 (1999) (discussing the fact that under section 368 taxpayers are eligible for non-recognition treatment).

62. *See* Rev. Proc. 96-30, 1996-19 I.R.B. 8. Rev. Proc. 96-30 appendix A provides nonexclusive guidelines in establishing a business purpose, including:

> (1) to facilitate an issuance of stock to a key employee;
> (2) to facilitate a stock offering by D or C;
> (3) to facilitate a borrowing by D or C;
> (4) to obtain significant cost savings;
> (5) to enhance "fit and focus";
> (6) to eliminate a competitive disadvantage;
> (7) to facilitate an acquisition of D;
> (8) to facilitate an acquisition by D or C; and
> (9) to effect significant risk reduction.

63. *See* Treas. Reg. § 1.368-1(d)(2) (1989) (expressing the immediacy in the continuity of interest requirement time frame).

64. *See* I.R.C. § 355(e)(2)(B) (Supp. IV 1998).

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C's value is $75,000. In Year 2, an unrelated corporation, P, purchases 51% of C stock. Because P has purchased greater than 50% interest in C within the four-year window beginning two years before the distribution, it is presumed that the acquisition and distribution are pursuant to a plan, unless D can establish that the acquisition and distribution were unrelated. D must recognize $50,000 gain, the amount of gain recognized if all the C assets were sold at FMV.[65] In addition, if continuity of interest is not satisfied, there will be a shareholder-level tax.[66]

D. *Shareholder-Level Tax Treatment*

If all of the requirements for a tax-free division are met, the shareholders will not report any gain or loss upon receipt of C stock distributed from the distributing parent corporation D.[67] Section 355 requires the shareholders to receive stock from D in order to receive nonrecognition treatment.[68] In addition, if debt securities are distributed in exchange for D's securities in the same principal amount, nonrecognition treatment is still available.[69] If the historic shareholders receive "boot" in a spin-off, then the boot will generally be treated as a section 301 distribution, and thus a taxable dividend to the extent of D's

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65. *See* I.R.C. § 355(e) (Supp. IV 1998). Section 355(e) mandates that any distribution of stock pursuant to a presumed plan of acquisition of a distributing corporation or its subsidiary not be treated as "qualified property" for purposes of section 355(c)(2), which imposes tax on the distributing corporation as if the stock had been sold at fair market value. *See* I.R.C. §355(e); I.R.C. § 355(c)(2) (1994).

66. *See* James M. Lynch, *Tax Free Spin Offs Under Section 355*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1999 611, 668 (PLI Tax Law and Estate Planning Course Handbook Series No. J0-001E, 1999), *available at* WL 453 PLI/TAX 611 ("Section 1.355-2(c) of the regulations takes the position that in order to have a valid tax free spin off, the shareholders must maintain continuity of interest in both the Distributing and the Controlled corporation." However, to meet this test, "it is not required that the shareholders individually retain ownership in each of the corporations." Thus, "a split-off transaction, whereby some shareholders retain stock (and, as a result of the split-off, increase their ownership) in the Distributing corporation, while other shareholders give up their stock in Distributing corporation and receive stock in a Controlled corporation, meets the continuity of interest test.")

67. *See* I.R.C. § 355(a)(1) (1994); Treas. Reg. §1.355-2 (as amended in 2000).

68. *See* I.R.C. § 355(a)(1) (1994); Treas. Reg. §1.355-2 (as amended in 2000).

69. *See* I.R.C. § 355(a)(3)(A) (1994). *See also* Herbert N. Beller, *Tax-Free Corporate Separations: The Tug of War Continues*, 45 INST. ON FED. TAX'N § 201.2 at 2–6 (1993) [hereinafter Beller, *Corporate Separations*].

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current or accumulated earnings and profits.[70] Even if boot was used to effectuate the spin-off, it will not generally disqualify a section 355 distribution.[71]

Because a section 355 spin-off, coupled with a divisive reorganization, is a tax-free drop and distribution, the shareholder's gain will be deferred, and the aggregate basis is allocated pro rata over the retained and newly distributed stocks and securities in proportion to their respective fair market value.[72] If boot is distributed, the historic shareholders must reduce their basis in the stock received by the boot's value, increased by the amount recognized upon receipt of the boot, and finally allocate the revised basis between the D stock and C stock in proportion to their value.[73]

> EXAMPLE 3: Shareholder Z owns 100% of D's stock, with a basis of $60. D consists of two distinct businesses—Insurance and Banking. Insurance's assets have an aggregate basis of $50 and FMV $100; Banking's assets have an aggregate basis of $50 and FMV $150. In a qualifying section 355 transaction, D decides to separate the two businesses by transferring the insurance assets into a newly formed subsidiary, C, in exchange for all of C's stock. D then makes a pro rata distribution to its sole shareholder, Z.
>
> In this basic spin-off, the initial "drop" of D's assets into newly formed C will be tax-free to D

---

70. *See* I.R.C. § 356(b) (1994). "Boot" includes money or property received in addition to qualifying stock or securities of the controlled corporation. *See* BLACK'S LAW DICTIONARY 127 (6th ed. 1991). In addition, if D acquired any C stock within five years prior to the distribution of C stock in a transaction where gain or loss was recognized, then that acquired C stock will be treated as boot to D's shareholders who receive it. *See* I.R.C. § 355(a)(3)(B) (1994). Under the Taxpayer Relief Act of 1997, "nonqualified preferred stock" is not considered stock or securities for purposes of section 355. *See* 1997 Act § 1014(c).

71. *See infra* Part III.D., Ex. 3.

72. *See* I.R.C. § 358 (a), (b) (1994); Treas. Reg. § 1.358-2 (as amended in 1995); *see also* BITTKER & EUSTICE, *supra* note 8, at ¶ 11-11[1][b], 11-68–11-69.

73. *See* I.R.C. § 358(a)(1) (1994); *see also* MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS ¶ 1002.1.2, at 10-18 (Oct. 1998) (explaining that a shareholder must allocate the "predistribution tax basis in T stock over the T and S stock according to the relative FV of each," and in addition S stock must, "(a) decrease the basis in his T stock by the boot's FV, (b) decrease the basis in his T stock by the amount of gain . . . [on the boot], and (c) allocate his revised basis in the T stock between the T stock and the S stock in proportion to the relative FVs of the T and S stock").

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under section 351.[74] D's basis in C stock therefore remains the same as before the exchange—$60; furthermore, the value is the same as the asset basis—$100.

Because this is a qualifying spin-off, shareholder Z will not recognize gain or loss. But if this failed to meet the section 355 requirements, the distribution would be taxable to Z as a dividend pursuant to section 301.[75]

Shareholder Z received a pro rata distribution of newly formed C stock; so Z's aggregate basis remains the same as before the distribution—$60. Z's basis of $60 will be allocated between the D and C shares based on the relative FMV immediately following the distribution. Therefore, 40% ($100 FMV of C stock/$250 total value of D and C stock) will be allocated to the C stock and 60% will be allocated to the D stock. So, Z's basis in the C stock is $24 and in the D stock is $36.

EXAMPLE 4: Assume the same facts above, except that Z also receives $20 cash. Because shareholder Z received boot in addition to qualifying stock, Z's aggregate basis of $60 is reduced by $20 (the amount of boot received), increased by $20 (the amount of gain recognized),[76] and allocated between the D and C shares. The transaction is treated as though D distributed $20 cash to Z in exchange for D stock with FMV of $20. Therefore, Z's basis allocation will remain the same as the prior example, only in this scenario, Z must report $20 taxable income for the receipt of boot.[77]

74. *See* I.R.C. § 351(a) (1994) (stating as a general rule that no gain or loss is recognized when exchanging stock in company C for stock in company D if the transferor is in control of company C and D).

75. *See* I.R.C. § 355(a)(1); I.R.C. § 301(a), (c) (1994) (stating that, except as otherwise provided in the code, a distribution of property made by a corporation, which is a dividend, shall be included in gross income).

76. *See* I.R.C. § 358(a)(1).

77. *See* I.R.C. § 354(a) (Supp. IV 1998).

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E. *Corporate-level Tax Treatment*

When D distributes C stock or securities to its shareholders in a qualifying section 355 spin-off, the corporation will not recognize gain or loss upon the distribution.[78] Even though D may be distributing appreciated property that would be taxable pursuant to section 311(b), if the distribution qualifies as a spin-off, D will not be taxed upon the distribution of C stock to the historic shareholders.[79] However, corporate-level recognition may occur (1) if there is a substantial change in stock ownership (50% or more) during the five-year pre-distribution period;[80] (2) if boot is distributed to a shareholder;[81] or (3) if a distribution is made to a foreign person.[82]

> EXAMPLE 5: Assume the same facts as in Example 3 except that D's basis in Insurance was $5,000 with FMV of $100,000. Ordinarily, D's distribution of appreciated stock would be a taxable event under section 311. However, because the spin-off meets the statutory and nonstatutory requirements, D will not be taxed on the $95,000 gain (Insurance's FMV of $100,000 less adjusted basis of $5,000) for the distribution of C's appreciated property to shareholder Z.

Example 5 illustrates one of the few remaining exceptions to the repeal of *General Utilities and Operating Co. v. Helvering*.[83] Thus, since 1986 spin-offs increased in importance as a means of moving unwanted appreciated assets from a corporation to the shareholders' hands tax-free.[84] In Example 5, D has circumvented the *General Utilities* repeal and has distributed assets with a potential of a tax-free $95,000 gain, provided that the mechanism complies with section 355. Because of the potential tax savings in such a structured scheme, critics and Congress presumed that corporations today are structuring

78. *See* I.R.C. § 355(c) (1994).

79. *See id.*

80. *See* I.R.C. § 355(d) (1994).

81. *See* I.R.C. § 356(b) (1994).

82. *See* I.R.C. § 367(e)(1) (1994); *see also* Beller, *Corporate Separations*, *supra* note 69, § 201.3, at 2–8.

83. 296 U.S. 200 (1935).

84. *See* Richard L. Sitton, *Repeal of the General Utilities Doctrine and the Willing Buyer/Willing Seller: Who are Those Guys Anyway? Eisenberg v. Commissioner of Internal Revenue, 155 F.3d 50 (2d Cir. 1998)*, 41 S. TEX. L. REV. 271, 285–86 (1999).

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transactions and subsequent distribution to circumvent recognition of appreciated assets.[85] Congress addressed this potential loophole by requiring gain recognition upon certain distributions of stock in a controlled corporation.[86] However, this recently enacted bill was too restrictive. It seems Congress has shifted the corporate taxpayer's burden with this new bill.The bill's provisions presume that most corporate taxpayers are guilty of intentionally structuring transactions to manipulate section 355. As will be discussed in greater detail, *infra*,[87] this bill presumes, under many circumstances, that a corporation is structuring a spin-off and merger to take cash out of the corporation. However, many transactions are arranged with a shift in ownership with no distribution of cash; only stock is used to effectuate these transactions. Yet, these transactions are still caught by the new provision.

IV. RECENT MODIFICATIONS: ANTI-*MORRIS TRUST* SECTION 355(e)

This paper has been arranged to provide a broad, yet basic understanding of section 355 spin-offs before delving into the new legislation. The bulk of this paper will focus on *Morris Trust* transactions. The 1997 Act did make some minor modifications to section 355 spin-offs,[88] but Congress' focus and primary alterations were on the *Morris Trust*-type transactions, such as a section 355 distribution and an asset acquisition either under section 368(a)(1)(A) (merger), (C) (assets for voting stock), or (B) (stock for stock).[89] If the transaction falls into the abyss of section 355(e), D will be assessed a harsh penalty tax.[90]

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85. *See* Ernst & Young, L.L.P., *Analysis of the Administration's Partnership Proposals with Addendum*, *in* TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2000 769, 822–23 (PLI Tax Law and Estate Planning Course Handbook Series No. J0-002W, 2000), *available at* WL 464 PLI/TAX 769; Hershel Wein & Naftali Z. Dembitzer, *The Private REIT: Selected Tax Issues*, *in* TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2000 253, 292–93 (PLI Tax Law and Estate Planning Course Handbook Series No. J0-002W, 2000), *available at* WL 469 PLI/TAX 253.

86. *See* AMELIA D. LEGUTKI ET AL, THE LAW OF FEDERAL TAXATION § 41:03.50 (Aug. 2000) (noting that congress enacted section 337(d)(1) which empowers the Treasury to promulgate regulations preventing the circumvention of the *General Utilities* repeal).

87. *See infra* notes 190–94 and accompanying text.

88. *See* I.R.C. § 355 (Supp. IV 1998).

89. RESEARCH INSTITUTE OF AMERICA, INC., RIA'S COMPLETE ANALYSIS OF THE TAXPAYER RELIEF ACT OF 1997 § 1500, at 357–58 (1997) [hereinafter "RIA"] (describing a *Morris Trust* transaction as the combination of "a tax free division with an acquisition of either the distributing corporation or the controlled corporation in a reorganization").

90. *See id.* at 358 (providing that a distributing corporation will realize a taxable gain under section 355(e)(1)).

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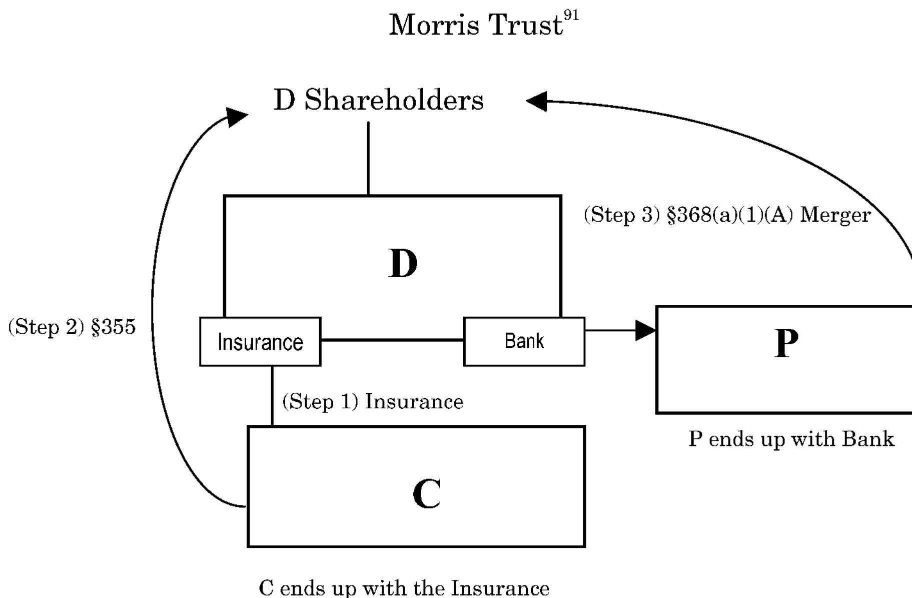
A. *The Beginning: Morris Trust*

Morris Trust[91]



C ends up with the Insurance

In *Commissioner v. Mary Archer Morris Trust*,[92] Purchaser (P), a national bank, was interested in obtaining Distributing-Target's (D) business. D's business encompassed two diverse businesses: a bank with an insurance department.[93] Because national banking law prohibited P from operating an insurance business, D separated the insurance and banking businesses to effectuate the merger.[94] D organized a newly formed subsidiary (C), and transferred its insurance business to C in exchange for 100% of C's stock (see Step 1 in the "Morris Trust" graph above).[95] The C stock was then distributed to D's shareholders (see Step 2).[96] D's banking business merged into P's business, and D's shareholders subsequently received 54% of P's stock (with the remaining 46% distributed to P's shareholders).[97] Thus, the transaction comprised of a section 355 spin-off followed by a section 368(a)(1)(A) tax-free merger (see Step 3). The Service alleged that D's distribution of the C stock to D's shareholders

91. At this point, it would be appropriate to introduce the inspiration for this unpopular bill, Mrs. Mary Archer Morris, otherwise known as the woman who opened Pandora's box.

92. 367 F.2d 794 (4th Cir. 1966).

93. *See id.*

94. *See id.* at 795–96.

95. *See id.* at 796.

96. *See id.*

97. *See id.* at 799.

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was a taxable dividend.[98] The Fourth Circuit ruled for the taxpayer, holding that D's shareholders' receipt of 54% of P's common stock met the requisite continuity of interest.[99] Furthermore, the merger met the active business requirement.[100]

The courts and the Service respected the transaction,[101] and this business structure has been duplicated for over thirty years.[102] Any transaction structured as a tax-free spin-off followed by an acquisition of D or C has been referred to as a "*Morris Trust* transaction."[103] Thereafter, a *Morris Trust* transaction was structured by removing assets into a newly formed or old and cold subsidiary to accommodate the acquiring corporation's needs.[104] The Service respected the form because tailoring D's assets to facilitate P's acquisition of D is listed as an acceptable business purpose in Revenue Procedure 96-30.[105]

While the IRS affirmed the *Morris Trust* decision with Revenue Ruling 75-406,[106] in 1996 the Service modified its decision and suggested that it intended to limit the scope of tax-free *Morris Trust* transactions where C was the target corporation.[107] In Revenue Ruling 96-30, the Service indicated that if any negotiations or dealings prior to a spin-off relate to the subsequent acquisition of the spun-off corporation, the transaction would be restructured as though the merger preceded the distribution of the controlled corporation's stock.[108] That is,

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98. *See id.* at 795.

99. *See id.* at 799.

100. *See id.*

101. *See, e.g.*, Rev. Rul. 68-603, 1968-2 C.B. 148 (stating that the IRS will follow the Fourth Circuit's decision in *Morris Trust*); Rev. Rul. 75-406, 19752 C.B. 125 (describing the general form of a *Morris Trust* transaction); Rev. Proc. 96-30, 1996-1 C.B. (explaining how *Morris Trust's* separation of businesses to tailor acquiring needs is an allowable business purpose).

102. GINSBURG & LEVIN, *supra* note 73, at ¶ 1010, 10-78 (discussing how a *Morris Trust* transaction has been used for more than 30 years).

103. *See* Scott E. Stewart, *New Rules for Spin-Offs: An Analysis of Section 355(e),* 51 TAX LAW. 649, 651 (1998) (defining a *Morris Trust* transaction as any spin-off followed by a non-taxable acquisition of the distributing corporation).

104. *See id.* (stating the *Morris Trust* transaction as a common means by which to remove corporate assets prior to a merger).

105. *See generally,* Rev. Proc. 96-30, 1996-1 C.B. 696, 709–12 (explaining the requirements and limitations of such tailoring of assets).

106. *See* Rev. Rul. 75-406, 1975-2 C.B. 125 (describing how a *Morris Trust* transaction is intended to work, affirming the structure, and citing the case as support).

107. *See* Rev. Rul. 96-30, 1996-1 CB 36 (suggesting that the target corporation must be related to D or the subsidiary).

108. *See id.* (noting that the holding in Commissioner v. Court Holding Co., 324 U.S. 331 (1945) provides for the taxation of the sale of shareholder distributions to the corporation if the purchase negotiations and terms of acquisition had been agreed upon before the distributions were made).

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distribution of the surviving corporation's stock would not comport with the section 355 requirement that at least 80% of the spun-off corporation's stock be distributed in the transaction.[109] However, corporate taxpayers could circumvent the Service's ruling in Revenue Ruling 96-30 if D dropped the unwanted business assets into a newly formed subsidiary (C), spun off subsidiary C to D's historic shareholders, and merged D into the acquiring corporation.[110]

In the *Morris Trust* transaction, D's shareholders were not taxed on the receipt of either C stock or P stock. In addition, D was not taxed on the transfer of Insurance's (or any other business) assets to C, nor was D taxed on the distribution of C stock to D's shareholders.[111] While the former transaction still is not a recognizable event, under the latter arrangement however, the 1997 Act changed the nonrecognition treatment in the *Morris Trust* transaction.[112] Just as it gutted the *General Utilities* doctrine in 1986, Congress enacted sweeping legislative rules to extinguish the *Morris Trust* transaction.[113] It appears that the Service and even legislators succumbed to the extensive criticism over the potential abuses of the *Morris Trust* transaction, and other tax-free spin-off devices.[114] However, while those opposing the *Morris Trust* transaction criticized the perceived abuses, their bitter attacks paled in comparison to tax practitioners' and corporate taxpayers' vitriol, which climaxed when Congress passed the egregious § 355(e) anti-abuse legislation, designed to bust-up what the press dubbed as "monetizing" *Morris Trust* type transactions.[115] Congress included section 355(e) in the 1997 Act to address corporate-level recognition in a *Morris Trust*

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109. *See* Willys H. Schneider & Sydney E. Unger, *TRA '97 Curtails Tax-Free Spinoffs and Use of Preferred Stock in Tax-Free Acquisitions*, 87 J. TAX'N 334, 335 (1997) (describing when distribution of the surviving corporation's stock does not meet the requirements of section 355).

110. *See id.*

111. *See* GINSBURG & LEVIN, *supra* note 73, ¶ 1010, 10-78.

112. *See id.* at 10-78–10-79.

113. *See id.* (describing the legislative effect of section 355 against *Morris Trust* transactions).

114. *See, e.g.*, Mark J. Silverman et al., *'Spin-offs': The New Anti-Morris Trust and Intragroup Spin Provisions*, 98 TAX NOTES 329, 334 (1998) (noting that "[t]he legislative history of the act points to several 'abuses' at which section 355(e) and (f) were aimed"); *see also* Edwards S. Adams & Arijit Mukherji, *Spin-Offs, Fiduciary Duty, and the Law,* 68 FORDHAM L. REV. 15, 22 (1999) (summarizing the abuses that section 355(e) was intended to correct).

115. *See* Robert Willens, *Using Spin-Offs to Divest Tax-Free: the Demise of Morris Trust*, 75 TAX NOTES 1541, 1542 (1997) [hereinafter Willens, *Using Spin-Offs*] (noting that the IRS's steps to restrict the use of spin-offs in conjunction with divestitures "turned into a stampede as press reports describing 'monetizing' *Morris Trust* transactions goaded Congress into action").

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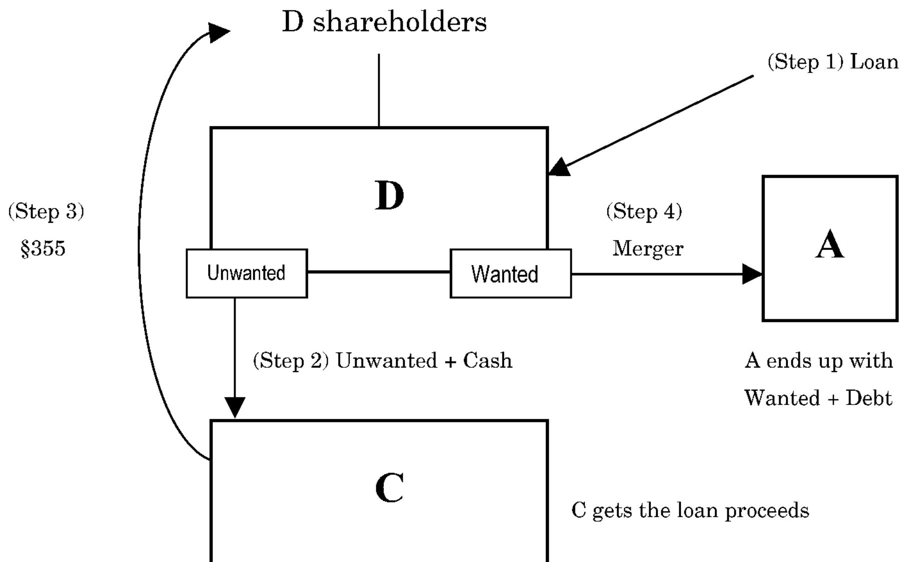
transaction.[116] This provision is now known as the "anti-*Morris Trust*" rule.[117]

"Monetizing" Morris Trust—Morris Trust with Liability Shifting



The Legislators believed the enactment of section 355(d) made in the 1990 Act was inadequate, and more specifically, failed to prevent "abuses" that section 355(e) and section 355(f) endeavored to restrain.[118] According to the legislative history, section 355's intent was to permit tax-free division of a variety of businesses among *existing* shareholders.[119] However, when *new* shareholders acquire a business or businesses coupled with a spin-off, the transaction appears to be a disguised sale rather

116. *See* Silverman et al., *supra* note 114, at 332 (noting that section 355(e), as proposed by the bill, was part of a plan for recognizing corporate-level gain). The 1997 Act also enacted § 355(f), which restricts tax deferral on spin-offs within an affiliated group of transactions where control of one of the entities involved passes out of the group as part of a plan or series of related transactions. *See id.* at 331. This article, however, is limited to discussing § 355(e).

117. Symposium, *The Future of Tax Law in the Face of Globalization: Practical and Policy Considerations: Taxation of Corporate Reorganizations*, 13 ST. JOHN'S J.L. COMM. 35, 36 (1998).

118. *See* GINSBURG & LEVIN, *supra* note 73, at ¶ 1010.1.2.4.1, 10-102 (explaining the abuses of section 355(b)(2)(1) in 1987 and 355(d) in 1990, and how sections 355(e) and (f) tried to correct them).

119. *See id.* (proposing that section 355 "was intended to permit a tax-free division of existing business arrangements among *existing* shareholders").

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than a division of businesses, which is what the legislation intended when spin-offs were restored almost fifty years ago.[120]

Additionally, Congress's concern was the *Morris Trust* arrangement that involves a corporation borrowing money and detaching the loan by distributing the proceeds to its shareholders.[121] The distributing corporation is then absolved from any liability, and the acquiring corporation assumes the debt of the distributing corporation, while the shareholders of the distributing corporation retain the loan proceeds.[122] Another example is the recapitalization epitomized in the Viacom/TCI transaction. Accordingly, Congress enacted some distressingly complex rules in § 355(e) to address the perceived abuses.

B. *The Bastard Children*

1. Viacom

Although the recent legislative enactment intimates that *Morris Trust's* demise was attributable to *Morris Trust*, a better assessment would be to impute the controversial bill to the Service's questionable decisions in Mrs. Mary Archer Morris' bastard children—the infamous Viacom, GM, and Disney transactions.[123] Blame should be imputed to these precocious children. Even one of Viacom's principal shareholders, Sumner Redstone, boasted of Viacom's favorable tax relief from the IRS on a $2 billion transaction that closely resembled a sale.[124]

Viacom owned an old and cold subsidiary, Viacom International (VI), which was engaged in a variety of five-year-old businesses, including a major cable TV business and several

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120. *See supra* note 24 and accompanying text (noting that the 1939 Code amendment in 1951 was intended to provide for tax-free spin-offs).

121. *See id.* (describing a disguised sales transaction where the corporation to be acquired borrows money and distributes the proceeds of the debt to shareholders).

122. *See id.*

123. *See* Robert A. Rizzi & Stephen P. Fattman, *Selected Issues in Spin-Offs, Split-Offs, and Split-Ups*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1998 877, 986 (PLI Tax Law and Estate Planning Course Handbook Series No. J0-000C, 1998), *available at* WL 428 PLI/TAX 877 ("The [Viacom] transaction was controversial, in part because the acquisition of the spun-off cable subsidiary was prearranged, and the transaction is responsible for a good deal of the attention paid to changing section 355 since the ruling was issued.").

124. *See* Sheppard, *Aliens Kidnap*, at 129-6 (observing that the New York Times "reported that Redstone was spotted at the June 17 Outward Bound benefit carrying around his company's press release about its IRS ruling on the sale of its cable operations to Tele-Communications, Inc. (TCI)" and quoted Redstone as saying that 'Viacom just got favorable tax relief from the IRS on a $2 billion cable sale transaction'").

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non-cable businesses.[125] Additionally, VI "owned 100[%] . . . of the outstanding stock of Viacom International Service" (VIS), a newly formed subsidiary established solely to execute the transaction with the acquiring corporation, Tele-Communications, Inc. (TCI).[126]

FCC regulations were placing heavy restrictions, such as pricing, on Viacom because it concurrently owned a cable and a non-cable business.[127] If Viacom separated the cable and non-cable business, it could eliminate the restrictions, and save significant costs.[128] Additionally, TCI was interested in investing in VI's cable business provided that VI disassociated itself from Viacom.[129] Consequently, Viacom's most feasible solution to comply with the regulatory procedures, to save costs, and to remain attractive to TCI, was to structure a spin-off,[130] which the Service had established as a legitimate business purpose under Revenue Procedure 96-30.[131] Accordingly, Viacom's solution was to organize a transaction as follows: VI borrowed $1.7 billion and dropped the proceeds and the non-cable business into VIS in exchange for VIS stock.[132] VIS assumed substantially all of VI's liabilities, except for VI's retained cable business and the $1.7 billion debt.[133] Thus, VI remained liable for that debt.[134] VI then distributed all the VIS stock to its parent, Viacom, in a spin-off ("First Distribution").[135] Then, pursuant to a pre-arranged plan, Viacom exchanged with Viacom shareholders' shares of VI stock for shares of Viacom stock in a section 355 split-off.[136] So after the split-off some of Viacom's shareholders possessed Viacom stock, while others had VI stock.[137]

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125. *See* Rizzi & Fattman, *supra* note 123, at 987 (discussing the factual background of the Viacom transactions in Priv. Ltr. Rul. 96-37-043 (June 17, 1996)).

126. *See id.* at 987–88.

127. *See id.* at 988.

128. *See id.*

129. *See* Priv. Ltr. Rul. 96-37-043 (June 17, 1996) ("[C]orporation Y [TCI] . . . has agreed to make a significant equity investment in Business A [VI's cable business]. However, Y will not invest in Business A while it is affiliated with Parent [Viacom]").

130. *See* Rizzi & Fattman, *supra* note 123, at 988.

131. *See* Rev. Proc. 96-30, 1996-1 C.B. 696 (listing in Appendix A, section 2.04, cost savings as an acceptable business purpose); *see also* Rizzi & Fattman, *supra* note 123, at 988, 1067 n.122 (citing Priv. Ltr. Rul. 95-17-040 (Jan. 31, 1995) (to avoid regulatory restrictions) and Priv. Ltr. Rul. 94-17-045 (Feb. 2, 1994) (in compliance with FTC order)).

132. *See* Rizzi & Fattman, *supra* note 123, at 989 (discussing the factual background of the Viacom transactions in Priv. Ltr. Rul. 96-37-043 (June 17, 1996)).

133. *See id.* at 989–90.

134. *See id.*

135. *See id.* at 990–91.

136. *See id.* at 990–93.

137. *See id.* at 991–92.

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Viacom then recapitalized VI to provide for a second class of common stock; and immediately thereafter, as an integral part of the plan, Viacom's shareholders exchanged their VI first class of common voting stock for a new class of stock, which was converted to preferred non-voting stock upon TCI's investment.[138]

TCI invested $350 million in VI in exchange for VI's second class of common voting stock and VIS's first class of common stock, which had been automatically converted to preferred non-voting stock.[139] The Service ruled that this "Second Distribution" was a tax-free distribution under section 355.[140]

When the dust settled, TCI acquired voting control of VI from Viacom's shareholders, but not as a result of an acquisition as discussed in Rev. Rul. 96-30, but rather by investing in VI as a subsidiary of Viacom.[141] The cash Viacom borrowed was now in VIS and TCI assumed the obligation to repay the debt.[142] Viacom's shareholders had the option of keeping their TCI common stock or cashing out.[143] The Service ruled in its Private Letter Ruling that the transfer of VI's assets into the newly formed VIS in exchange for VIS's stock, coupled with VIS's assumption of the debt and VI's distribution of VIS stock to Viacom, qualified as a section 368(a)(1)(D) reorganization.[144] The tax status of the Second Distribution, specifically the shareholders' option to tender the VI voting common stock for convertible non-voting preferred stock, depended entirely on the order in which the steps in the transaction occurred.[145] The issue was whether Viacom had control of VI immediately before the transaction with TCI and then distributed that control to its shareholders. If TCI invested in exchange for VI's common stock *before* the Second Distribution, then Viacom would not have held 80% control of VI when the stock was distributed to its shareholders.[146] Thus, the controversy surrounding Viacom was whether the steps involved to consummate the transaction should be reversed.[147] Specifically, the "control immediately

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138. *See id.* at 990–93.

139. *See id.* at 992–93.

140. *See* Priv. Ltr. Rul. 96-37-043 (June 17, 1996) (stating that the "[p]arent will recognize no gain or loss upon the distribution of Old Sub stock to the Tendering Shareholders [pursuant to] [section] 355(c)(1) and (d)"); *see also* Rizzi & Fattman, *supra* note 123, at 994-95.

141. *See* Rizzi & Fattman, *supra* note 123, at 994–1003.

142. *See id.* at 993.

143. *See id.* at 990–93.

144. *See id.* at 994–95.

145. *See id.* at 995.

146. *See id.*

147. *See id* at 995–96.

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before" and the "distribution of control" tests would have failed had the steps in the transaction been reversed.[148] However, the Service decided that the step-transaction doctrine should not be utilized solely to reverse the steps in a transaction in order to convert a tax-free transaction, as carried out by the parties, into a taxable one.[149]

Accordingly, based on the Service's precedence, Revenue Ruling 73-246,[150] the Service found that the distribution requirements were satisfied because Viacom, *prior* to the distribution, had the requisite control of VI and Viacom distributed all the stock to its shareholders.[151] In Revenue Ruling 73-246, the Service ruled that the "distribution of control" component is not violated if the D corporation shareholder (here Viacom) subsequently transfers property to the spun-off corporation C (here VI) in exchange for more stock.[152] Further precedential support is Revenue Ruling 76-527, which established that D could spin-off C to enable C's stock acquisition of another corporation in a "Reverse Morris Trust."[153]

Despite prior rulings issued by the Service, and case law that the steps should not be reordered, many commentators and critics questioned the Service's decision in Viacom.[154] For instance, the Service's controversial ruling in Viacom was contradictory to Revenue Ruling 96-30, issued just a month

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148. *See id.*

149. *See* GINSBURG & LEVIN, *supra* note 73, at 10-101; *see also* Rizzi & Fattman, *supra* note 123, at 995–96 and accompanying footnote 128.

150. Rev. Rul. 73-246, 1973-1 C.B. 181 *available at* 1973 WL 33585.

151. *See id.* at *2-*3.

152. *See* Rev. Rul. 73-246, 1973-1 C.B. 181; *see also* Willens, *Using Spin-offs*, *supra* note 115, a1543 (reporting that Rev. Rul. 73-246 provides that subsequent transfers of property to the spun-off corporation in exchange for it's stock do not affect the distribution control requirement). In the Revenue Ruling, however, the D shareholder owned 100% of D and C after the transaction. *See id.*

153. *See* Herbert N. Beller, *Revenue Procedure 96-30: A New Business Purpose Roadmap for Section 355 Transactions*, 50 TAX LAW. 1, 27 (1996) [hereinafter Beller, *A New Business Purpose*] ("Appendix A [of Rev. Proc. 96-30] separately identifies Reverse Morris Trust formats as providing an acceptable business purpose, subject to the identical elements of proof required when the distributing corporation is the target company." Appendix A further notes that "in certain respects reverse transactions provide greater flexibility. For one thing, the subsequent reorganization can safely take the form of a "C" reorganization, a forward triangular merger under [section] 368(a)(2)(D), or a reverse triangular merger under [section] 368(a)(2)(E)." Additionally, "a substantial amount of cash or other boot can be paid to the acquired corporation's shareholders without triggering device concerns." (citations omitted)); *see also* Rev. Rul. 76-527, 1976-2 C.B. 103.

154. *See, e.g.*, Sheppard, *Aliens Kidnap*, *supra* note 5 ("The IRS ruled that the exchange—the second distribution—was covered by [section] 355 without mentioning either Rev. Rul. 75-406 . . . or its successor, Rev. Rul. 96-30 . . . . The Viacom transaction could not have passed muster under Rev. Rul. 96-30 . . . ."); *see also*, Rizzi & Fattman, *supra* note 123, at 997–1002.

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earlier. Revenue Ruling 96-30, which adds an important qualification to its prior Revenue Ruling 75-406,[155] held that a spun-off subsidiary followed by a third party's acquisition of the subsidiary would not violate the control test provided there was not any related dealings by the acquiring corporation prior to the spin-off.[156] Such an agreement existed in the Viacom deal; nevertheless, the Service failed to act accordingly. Furthermore, the Viacom transaction closely resembled a sale in that the acquiring corporation assumed the debt originally incurred by the target corporation, and the shareholders received the proceeds from the debt.[157]

The decision led to a wave of criticism, and in turn, prompted the Service to reassess its position on section 355 transactions. Consequently, only one month later, the Service issued Revenue Procedure 96-39, which rendered Revenue Ruling 96-30 obsolete, thereby terminating the Revenue Ruling's ephemeral life.[158]

The Service announced in Revenue Procedure 96-39 that it would conduct extensive study in the section 355 area, and pending the completion of the study, would not issue advance rulings where "there have been negotiations, agreements, or arrangements with respect to transactions or events which, if treated as consummated before the distribution, would result in

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155. *See* Rev. Rul. 75-406, 1975-2 C.B. 125 (stating that the continuity of interest requirement of sections 1.355-2(c) and 1.368-1(b) of the regulations is not violated when "[a] parent corporation [spins off] its wholly owned subsidiary[] to comply with a governmental agency order, [if it is] followed by the vote of the then shareholders of the spun-off corporation to enter into a statutory merger with an unrelated corporation," and asserting that such a spin-off is "not a device to distribute earnings and profits"); *see also* Rev. Rul. 96-30, 1996-1 C.B. 36 (holding that a parent's distribution of a wholly owned subsidiary's stock followed by an exchange of that stock by the parent's shareholders pursuant to a merger agreement will not violate the control test so long as there were no prior negotiations regarding the merger.)

156. *See* James M. Peaslee, *The Viacom Ruling—Two Ships Passing in the Night,* 72 TAX NOTES 1435, 1435 (Sept. 9, 1996). Additionally, Viacom can be analogized to Revenue Ruling 75-406 in that the public shareholders voted their support of the subsidiary's acquisition.

157. *See* Sheppard, *Aliens Kidnap*, *supra* note 5.

158. *See* Rev. Proc. 96-39, 1996-2 C.B. 300; *see also* Louis S. Freeman et al., *Section 355: Tax-Free Spin-offs, Split-offs, Split-ups—Uses and Requirements*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1999 719, 737–38 (PLI Tax Law and Estate Planning Course Handbook Series No. J0-001E, 1999), *available at* WL 453 PLI/TAX 719 (noting that in Rev. Proc. 96-39, which followed Rev. Rul. 96-30, the IRS "expressed its intention" to further explore "the issue of whether the requirements of Section 355 are satisfied 'in cases in which there have been negotiations, agreements or arrangements with respect to transactions or events which, if consummated before the distribution, would result in the distribution of stock or securities of a corporation which is not controlled by the distributing corp,'" and accordingly "the IRS would not issue rulings on such transactions until its further study was completed").

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the distribution of stock or securities of a corporation which is not controlled by the distributing corporation."[159] While this ruling was designed to clamp down on cunning and inventive corporate taxpayers, Revenue Procedure 96-39 did not prevent all Viacom-like objectives.

Two additional highly publicized transactions finally sealed the fate of *Morris Trust* transactions. Those two spin-off transactions—General Motors' sale of Hughes Electronics to Raytheon and Walt Disney's sale of its newspaper properties to Knight-Ridder—had all the sinister physical characteristics of Viacom and of a "disguised sale," reminiscent of Congress' reason for enacting section 355(d) in 1990.

2. Disney

Disney borrowed $1 billion, and dropped all the non-newspaper assets and all liabilities except the $1 billion debt into a newly formed subsidiary, C.[160] Disney spun the C stock to Disney's shareholders in a tax-free section 355 spin-off.[161] Then Knight-Ridder, the purchasing corporation ("Purchaser"), exchanged $600 million of Purchaser's stock for Disney stock and became liable for the $1 billion debt.[162] Upon completion of the transaction, Disney's shareholders possessed $600 million in Purchaser's stock, Disney contained $1 billion of cash and all of Disney's non-newspaper assets, while Purchaser owned the newspaper assets and owed on the $1 billion debt.[163] Just like Viacom and GM, *infra,* this transaction resembled a leveraged buyout in that the form of consideration used constituted debt assumption.[164] However, just like its predecessors, no taxes were paid on the transaction.[165]

159. *See* Rev. Proc. 96-39 at 301; *see also* Freeman et al, *supra* note 158, at 737–38; Gilbert D. Bloom & Richard W. Bailine, *KPMG Peat Marwick Urges Easing of No-Rule Policy on Viacom-type Transactions*, 97 TAX NOTES TODAY 6-24 (1997), *available at* LEXIS 96-32974 (criticizing the Service's no-ruling position, stating that it "is unwarranted and puts a chill on bona fide business transactions that heretofore have been routinely (and appropriately) approved by Treasury/IRS—[t]his is most vexing when proper satisfaction of the business purpose requirement for a [section] 355 transaction is the trigger for application of Rev. Proc. 96-39").

160. *See* Lynch, *supra* note 66, at 668.

161. *See id.*

162. *See* Sloan, *Loophole King, supra* note 5, at 55.

163. *See id.*

164. *See* Lynch, *supra* note 66, at 668.

165. *See* Sloan, *Loophole King, supra* note 5, at 55.

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3. General Motors

GM's structural plan to dispose of its subsidiary, Hughes Electronics (HE), closely resembles the Viacom transaction.[166] In GM, HE created a newly formed subsidiary, Hughes Aircraft (HA), and dropped the non-defense assets and historic liabilities into HA while HE maintained the defense assets.[167] The HA stock was spun-off to GM and pursuant to a prearranged plan, HA was immediately spun-off to GM's shareholders in a tax-free section 355 spin-off.[168] HA borrowed $4 billion, paid a dividend to GM, and incurred liability on the loan.[169] Subsequently, Raytheon (RN) merged into HA (RN-HA) for Class B stock, which constituted 70% of the value and slightly less than 20% of the vote.[170] After the merger, GM's public shareholders received RN-HA stock, constituting of 30% of the value and 80% of the vote.[171] When the transaction concluded, GM's public shareholders possessed stock in two different entities, GM with its HE subsidiary and the merged entity comprising of RN-HA.[172]

While the transaction appeared to be a replica of Viacom, there was a deviation in the GM transaction: in the RN-HA merger, the RN shareholders received stock that constituted slightly less than 20% of the entity's voting power.[173] The section 368(c) control requirement focuses on stock ownership constituting at least 80% of the voting power.[174] Accordingly, the GM shareholders still retained control of HA, thereby circumventing Revenue Procedure 96-39's no-ruling policy.[175]

Revenue Procedure 96-39 and Revenue Ruling 96-30 were resounding rulings that impeded tax-free corporate transactions;

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166. *See* Willens, *Using Spin-offs*, *supra* note 115, at 1543.

167. *See* Lee A. Sheppard, *GM Hopes Sale of Hughes to Raytheon Passes Section 355 Spin-Off Muster*, 97 TAX NOTES TODAY 12-2 (Jan. 17, 1997) [hereinafter Sheppard, *GM Hopes*].

168. *See* Willens, *Using Spin-offs*, *supra* note 115, at 1543.

169. *See* Sheppard, *GM Hopes*, *supra* note 167, at 3.

170. *See* Willens, *Using Spin-offs*, *supra* note 115, at 1543; Sheppard, *GM Hopes*, *supra* note 167, at 3.

171. *See* Sheppard, *GM Hopes*, *supra* note 167, at 3.

172. *See* Sloan, *New Loophole*, *supra* note 5, at 37.

173. *See* Willens, *Using Spin-offs*, *supra* note 115, at 1543.

174. *See* I.R.C. § 368(c) (1994) (defining control to mean "ownership of stock possessing at least 80[%] of the total combined voting power of all classes of stock entitled to vote and at least 80[%] of the total number of shares of all other classes of stock of the corporation").

175. *See* Rev. Proc. 96-39, 1996-2 C.B. 300 (stating that the no-ruling policy only applies if there have been negotiations, agreements, or arrangements which "would result in the distribution of stock or securities of a corporation which is *not* controlled by the distributing corporation") (emphasis added); *see also* Willens, *Using Spin-offs*, *supra* note 115, at 1544.

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but the GM transaction provided a glimmer of hope for the inventive corporate taxpayer. Although a corporation could not structure a deal resembling that of GM, a corporation could, alternatively, arrange a *Morris Trust*-type transaction because the Service still lacked the authority to quell a *Morris Trust* transaction in which the distributing parent lost control in a spin-off followed by a divestiture.[176] Congressional intervention, therefore, was the only viable solution to proscribe tax-free sales in a *Morris Trust*-type transaction. Pressure was mounting by critics, commentators, and especially the Service to take action. It reached its climax when the final three much publicized transactions—Viacom, GM and especially Disney—were completed under the guise of a tax-free spin-off.[177] Once Lucifer eluded Big Brother on at least three different occasions, tax practitioners and corporate taxpayers knew the end of the spin-off world was near.[178] Legislators were going to stymie any violator's proclivity to construct a nefarious *Morris Trust*-type transaction.[179] In doing so, however, they not only stifled the abusive transactions but also took down the innocent, tax-abiding, nonabusive transactions as well. Congress repealed *Morris Trust* transactions with a new sweeping provision—section 355(e), the atomic bomb.

C. *Archer-Roth Proposed Legislation*

House Ways and Means Committee Chairman Bill Archer and Senate Finance Committee Chairman William V. Roth, Jr. ("Archer-Roth") jointly introduced a bill that would repeal the *Morris Trust* doctrine.[180] The Archer-Roth proposal provided that in an otherwise tax-free spin-off involving either the acquisition of a distributing or a distributed corporation, the other corporation recognizes gain. If the distributing corporation is acquired, then the distributed corporation recognizes gain as if it had sold the stock of the distributed corporation for fair market

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176. *See* Willens, *Using Spin-offs*, *supra* note 115, at 1544.

177. *See* Robert Stowe England, *New Deals*, CFO, MAG. FOR SENIOR FIN. EXECUTIVES, (May 1, 1997) 1997 WL 8300136, at 3 (noting that Ken Kies, Chief of Staff for Congress' Joint Committee on Taxation, was "speaking out publicly about *Morris Trust* abuses").

178. *See id.* at 3 (reporting managing director and tax accountant at Lehman Brothers Inc., Robert Willens' surprise that the IRS had even approved the Viacom deal and Ken Kies' worry about the Viacom ruling).

179. *See id.* at 1–4 (explaining the Clinton Administration's stance on *Morris Trust* "abuses").

180. *See* H.R. 1365, 105th Cong., 1st Sess. (1997); S. 162, 105th Cong., 1st Sess. (1997); Introductory Statement, Description, and Text of Bills (H.R. 1365, S. 612) to Close Tax Loophole Involving Morris Trust Transactions (April 17, 1997).

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value at the time of the distribution.[181] The proposed legislation to tax under section 355(e) would affect only the corporations involved in the spin-off, not the distributing corporation's shareholders. The most appalling feature of the proposed legislation was that the unacquired controlled subsidiary could be taxed on built-in gains attributable to the controlling corporation's assets, with no step-up in basis for the recognized gain.[182] The proposed legislation would have dire consequences if the parent corporation is acquired, and the smaller subsidiary is taxed on the parent's appreciated assets. This scenario could force the subsidiary into insolvency if it is unable to pay taxes on the appreciated property.[183]

> EXAMPLE 6: Assume that D spins-off C stock to its shareholders and subsequently, D is acquired by P. Under the proposed legislation, C would be taxed on D's appreciated property, measured by the fair market value on the date of the distribution. Even though C pays taxes, it will not get a step-up in basis. Assuming this is a valid section 355 distribution, then D's shareholders will not be taxed on the gain.[184]

> EXAMPLE 7: Assume that D spins-off C stock to its shareholders and subsequently, C is acquired by P. Under the proposed legislation, D would be taxed on appreciated C stock. Again, D would not get a step-up in basis for gain recognition. D's shareholders will not be taxed on the gain if this qualifies as a valid section 355 distribution.[185]

Example 6 demonstrates the austerity of the proposed legislation. A small subsidiary will be taxed on the appreciated assets twice, and eventually the shareholders will also recognize gain, thereby subjecting the same corporation to triple tax. But, the Archer-Roth legislation was mercifully modified, eliminating

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181. *See* H.R. 1365 § 1(a)(E)(1)(B) (1997); S. 612 § 1(a)(E)(1)(B) (1997).

182. *See* BITTKER & EUSTICE, *supra* note 8, at ¶ 11.11[3][a], 11-77.

183. *See id.* at ¶ 11.11[3][c], 11-79 & n.270.14 (forecasting effects of the proposed Archer-Roth legislation).

184. *See id.*

185. *See id.*

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a taxable event to the other corporation.[186] Instead a single taxability rule was imposed, so that only the distributing parent corporation is taxed, regardless of which corporation was subsequently acquired. Even though, the amount of taxable gain on the appreciated stock remained the same, and the distributing parent corporation still did not get a step-up in basis after the taxable event. In effect, the "triple tax" was unaltered in the final legislation.

D. *Final Legislation Section 355(e)*

What the Archer-Roth Bill proposed from its inception, and what remained unmodified in the final bill is as follows: (1) if pursuant to a *plan* or series of *related* transactions, (2) in which one or more persons *acquire*, (3) a *50% or more stock* of a (4) *controlled or distributing corporation*, (5) then D will recognize gain as though it sold C to the distributing corporation's shareholders for its fair market value on the date of distribution.[187] The bill was an enigma to many tax practitioners, particularly the bill's lack of clarity on many essential elements. What was the legislator's interpretation of such words as "plan," "related transactions," and "acquire?" Fortunately, after many inquiries, some of the necessary clarifications were made.

1. Plan. Section 355(e) applies, and the corporate-level tax is triggered, if the distribution is part of a plan or series of related transactions to which D's historic shareholders lack the requisite control of D after the distribution.[188] That is, the distribution must be part of a plan in which one or more persons acquire a 50% or greater stock interest of vote or value in D or C corporation.[189] Whether two transactions are part of the same "plan (or series of related transactions)" under section 355(e)(2)(A) is a subjective test, depending ultimately on the intentions and expectations of the relevant parties. A plan is presumed if one or more persons acquire a 50% or greater interest within a four-year window beginning two years before the spin-off unless D can establish that the spin-off and acquisition are not part of a plan or series of related

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186. *See* I.R.C. § 355(e)(1) (Supp. IV 1998). Even though the controlled corporation's gain recognition under § 355(e) was deleted under the final legislation, distributing corporation and shareholders are still subject to the triple tax.

187. *Compare* H.R. 2014, 105th Cong. § 1012(e)(1)-(2)(A) (1997) (enacted) *with* H.R. 1365 § 1(a)(E)(1), (2) (1997).

188. *See* I.R.C. § 355(e)(2)(A) (Supp. IV 1998). Note that the shareholders can meet the control requirement by retaining only 50% of the distributed stock; however, the distributing corporation must distribute at least 80% of the controlled corporation's stock. *Id*; *see* I.R.C. § 368(c) (1994).

189. *See* I.R.C. § 355(e)(2)(A).

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transactions.[190] Although the presumption applies if the distribution and acquisition are achieved within a four-year period, acquisitions beyond the four-year period may still be part of a plan under section 355(e).[191] Additionally, the Treasury has authority to suspend the four-year period.[192]

What constitutes a prohibited plan remains unsettled. The legislative history intentionally omitted the circumstances and explanation of a prohibited plan.[193] This lack of guidance can be disturbing. For instance, consider a situation where D distributes C stock to avoid a hostile takeover of D or C. If the distribution is futile, and ultimately, D or C is acquired, it could be argued that D's distribution was related to the hostile takeover. In fact, D may have a difficult time rebutting the presumption that the transactions were related.[194] How the Service proceeds in determining what constitutes a plan remains to be seen, but clearly the legislation's silence in this area can have repercussions under this new bill.

2. Related Transactions. Neither the Code nor its Regulations provide any guidance on this issue. Furthermore, it remains to be seen how the Service will interpret this phrase.

3. Acquire. Pursuant to section 355(e), one or more persons must "acquire" stock representing a 50% or greater interest in D or C.[195] What constitutes an acquisition is determined under the rules employed in section 355(d) "except that acquisitions would not be restricted to 'purchase' transactions."[196] Section 355(d) excludes from "purchase" any carryover basis transactions and any transactions under sections 351, 354, 355, or 356.[197] Because the legislative history explicitly states that the term "acquire" is not restricted to purchase transactions, it seems clear that any carryover basis transaction, including a section 351, 354, 355, or 356 transaction, is included in the term acquire.[198]

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190. *See id.* at § 355(e)(2)(B) (Supp. IV 1998).

191. *See* RIA, *supra* note 89, at § 1501, 360.

192. *See* I.R.C. § 355(e)(5)(c) (Supp. IV 1998) (stating that "[t]he Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection").

193. *See* Silverman et. al, *supra* note 114, at 336 (citing Sheryl Stratton, *New Corporate Laws Beg for Interpretive Regs,* 97 TAX NOTES TODAY 196-2 (Oct. 9, 1997), "A senior staff member of the Joint Committee on Taxation stated during a recent meeting . . . that the legislative history intentionally omitted an explanation of what constitutes a plan.").

194. *See* GINSBURG & LEVIN, *supra* note 73, at ¶ 1010.1.2.4.2, 10-104.

195. I.R.C. § 355(e) (Supp. IV 1998).

196. H.R. CONF. REP. NO. 105-220, at 528 (1997).

197. *See* I.R.C. § 355(d)(5)(A)(ii), (C)(i)-(ii) 1994.

198. *See* GINSBURG & LEVIN, *supra* note 73, at ¶ 1010.1.2.4.2, 10-104.

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If the arranged transaction falls under section 355(e), then D will recognize gain. The amount of corporate-level recognition is based on C stock's fair market value on the date of distribution. D corporation, not D's historic shareholders, will recognize gain for the distribution. Furthermore, no step-up to the basis in the stock or assets will be permitted to reflect D's gain on the stock distribution.[199] It seems that this series of anti-abuse rules has lost touch with reality. Even a denial of step-up in basis is unsettling, given that the distributing corporation will get a taxable hit once after the spin-off and a second time if the controlled or the distributing corporation disposes of its assets. A better solution would be for the distributing corporation (rather than the controlled stock) to distribute the appreciated assets as a dividend and take a hit under section 311(b). In such a case, the assets receive a step-up in basis. Furthermore, "even a taxable cash transaction does not incur the recognition levels imposed by this bill."[200]

> EXAMPLE 8: Assume a *Morris Trust* transaction (i.e., C stock is distributed to shareholder Z, and P subsequently merges into D). D's basis in Insurance was $5000 and FMV is $100,000. D spins off C's stock to its historic shareholder, Z, who now owns less than 50% interest after P merges into D. This transaction is a valid spin-off because it meets the section 355 requirements. However, because D's shareholders lost control after the distribution, D, but not Z, will be taxed on the value of the appreciated asset, for example, $95,000. However, D's basis in the assets remains at $5,000 and C receives no increase in the basis of its assets.

> EXAMPLE 9: Assume D's basis in Insurance is $5,000 and FMV is $100,000. Because D will recognize double taxation under this new bill, the

199. *See* H.R. CONF. REP. NO. 105-220, at 531–32 (1997). However, if D were an S Corporation, gain recognized would be reflected in D's basis. That is, D's basis will be adjusted upward upon gain recognition. *See* I.R.C. § 1367 (1994 and Supp. IV 1998), *construed in* H.R. CONF. REP. NO. 105-220, at 532 n.13.

200. BITTKER & EUSTICE, *supra* note 8, at ¶ 11.11[3][a], 11-77. *See id.* at n.319 ("Inadvertent triggers by the unwary or poorly advised are the most likely revenue sources of this proposal. Distributions on and after April 17, 1997 are subject to the new law.").

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> more practical solution would be for D to distribute the unwanted assets as a dividend and recognize taxable gain under section 311(b), or leave the property to the acquiring corporation to dispose of the unwanted properties.[201] In such case, the Insurance assets have a $100,000 basis.

Note that section 355(e) will not apply if D's historic shareholders maintain a greater than 50% interest in the successor corporation, or if D's shareholders owned both D and P.[202]

> EXAMPLE 10: Assume a *Morris Trust*-type transaction and that D is the larger corporation, or that D and P are commonly controlled. No corporate-level tax is incurred on either the distribution of the C stock or on P's acquisition of D.[203] This is a rare exception to the new legislation. D will not incur tax if it is the larger corporation in the transaction.

> EXAMPLE 11: If D and P were both owned by the same shareholder (or shareholders), then section 355(e) would not apply. This is the common control exception.[204]

E. *Section 355(d)*

Congress enacted section 355(d) as part of the 1990 Act to prevent a corporation from converting a purported sale of a controlling corporation's interest into a tax-free sale under section 355.[205] Congress imposed limitations on section 355 by

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201. *See* BITTKER & EUSTICE, *supra* note 8, at ¶ 11.11[3][a], 11-77–11-78 ("The well advised will simply distribute the unwanted assets as a dividend (and take the § 311(b) taxable hit) or leave it to the acquiring corporation to dispose of the unwanted properties.").

202. *See* I.R.C. § 355(e)(3)(A) (Supp. IV 1998) (describing acquisitions that will not be subject to § 355(e) tax treatment).

203. *See* BITTKER & EUSTICE, *supra* note 8, at ¶ 11.11[2][c], 11-76.

204. *See* I.R.C. § 355(e)(3)(A), *construed in* BITTKER & EUSTICE, *supra* note 8, at ¶ 11.11[3][c], 11-81, Ex. 5 (describing the "common control exception" of § 355(e)).

205. *See* H.R. REP. NO. 881-101, at 341–42 (1990) (declaring that "[t]he committee is concerned that some corporate taxpayers may attempt, under present-law rules governing divisive transactions, to dispose of subsidiaries in transactions that resemble sales, or to obtain a fair market value stepped-up basis for any future dispositions, without incurring corporate-level tax").

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enacting "the 80% control" test and the "five-year active trade or business" requirement.[206] However, many of the statutory requirements were easy to meet, and accordingly, D could remove appreciated assets without a corporate-level tax, while D's shareholders held the assets with step-up in basis. Like section 355(e), section 355(d) was a result of Congress' concern that corporate taxpayers were using section 355 to circumvent a corporate-level tax.[207] Thus, Congress resolved to restrict a taxpayer's ability to manipulate the tax-free spin-off provisions, but instead, it enacted an overbroad provision that encompasses nonabusive transactions as well.[208] Congress attempted to rectify this problem by granting the Treasury authority to cure deficiencies in section 355(d).[209] That is, the Treasury could issue regulations to mitigate the restrictive nature of section 355(d) that imposes gain recognition on nonabusive corporate taxpayers.[210] However, as two distinguished tax scholars have stated, "curing the overbreadth of Code [section] 355(d) through the granting of regulatory authority has some of the appearance of placing the fox in charge of the henhouse."[211]

In general, section 355(d) triggers corporate-level gain if D's distribution of C stock constitutes a "disqualified distribution."[212] D's distribution of stock is a disqualified distribution if, immediately after the distribution, any person holds "disqualified stock" in either D or C, and the stock constitutes a 50% or greater interest.[213] A person holds disqualified stock if it was acquired by "purchase," after October 9, 1990, and within five years prior to

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206. *See* I.R.C. §§ 355(b)(2)(B), (e)(3)(B) (1994); § 368(c) (Supp. IV 1998).

207. *See* H.R. REP. NO. 881-101, at 341 (1990) (noting that "[t]he provisions for tax-free divisive transactions under section 355 were a limited exception to the repeal of the *General Utilities* doctrine, intended to permit historic shareholders to continue to carry on their historic corporate businesses in separate corporations" and further stating that "the benefit of tax-free treatment should not apply where the divisive transaction, combined with a stock purchase resulting in a change of ownership, in effect results in the disposition of a significant part of the historic shareholders' interests in one or more of the divided corporations").

208. *See* GINSBURG & LEVIN, *supra* note 73, at ¶ 1009.2, 10-55 (arguing that section 355 "appears overbroad and . . . [encompasses] nonabusive transactions that logically were not the congressional target at all").

209. *See* I.R.C. § 355(d)(9) (1994) (declaring that the Secretary (Treasury) "shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including—(A) regulations to prevent the avoidance of the purposes of this subsection through the use of related persons, intermediaries, pass-thru entities, options, or other arrangements, and (B) regulations modifying the definition of the term 'purchase'").

210. *See* GINSBURG & LEVIN, *supra* note 73, at ¶ 1009.2, 10-55.

211. *See id.*

212. *See* I.R.C. § 355(d)(2) (1994).

213. *See* I.R.C. § 355(d)(2), (3) (1994).

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the distribution period.[214] Either voting power or stock value is used to determine if a particular person holds stock that constitutes 50% or greater stock interest.[215] Furthermore, the special aggregation and attribution rules apply in determining the amount of disqualified stock held by a particular person.[216]

If D's distribution is characterized as a disqualified distribution, then D's shareholders will be unaffected provided the spin-off qualifies under section 355.[217] The shareholders will receive a tax-free substituted basis, but D will get a step-up in basis because D is recognizing corporate-level gain for the disqualified distribution.[218]

> EXAMPLE 12: Unrelated shareholders Y and Z each own 50% of D stock. Individual X, also unrelated to Y and Z, purchases all of Y's stock on January 1, 1992. Now X and Z are each 50% shareholders of D. On January 1, 1994, D spins-off stock of its subsidiary, C, pro rata to X and Z in a valid section 355 transaction.
>
> The distribution is a disqualified distribution because immediately after distribution, X owns a 50% interest in both D and C stock, acquired by purchase within five years of the January 1, 1994 distribution. Accordingly, D is taxed on the inherent gain in the stock; however, X's tax treatment is not affected by the disqualified distribution.[219]

Certain elements of section 355(d) overlap with section 355(e). For instance, D corporation, but not D's shareholders, will recognize gain on the section 355 distribution of C's stock if, among other things, there involves an acquisition of 50% or more of D's or C's stock (by vote or value).[220] However, both provisions

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214. *See* I.R.C. § 355(d)(3) (1994).

215. *See* I.R.C. § 355(d)(4) (1994).

216. *See* I.R.C. § 355(d)(7), (8) (1994).

217. *See* I.R.C. § 355(a)(1) 1994.

218. *See id.*

219. Note that this paper and these examples only focus on spin-off transactions. If the transaction is comprised of a split-off or split-up, then many more of the distributions could violate the disqualified distributions rule. *See* GINSBURG & LEVIN, *supra* note 73, at ¶ 1009, 10-50–10-54, Ex. 1-12.

220. *See id.*, at ¶ 1009.1, 10-54 (explaining that section 355 requires D, but not D's shareholders, to "recognize gain on a Code [section] 355 distribution of [C's] stock if

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cannot simultaneously apply, therefore, in the event of an overlap, section 355(d) will trump section 355(e).[221]

F. *The 2000 Proposed Regulations § 1.355-7*

When Congress amended section 355 in 1997, tax practitioners were angered by the broad presumption embodied in section 355(e)(2)(B).[222] Practitioners feared the number of harmless transactions that would be affected.[223] In response, the Service in 1999 issued proposed regulations that attempted to take the sting out of section 355(e) with a "safe harbor" provision that loosens the presumption by shortening the two-year window after the distribution to six months ("1999 Proposed Regulations").[224] After receiving numerous comments and concerns about the 1999 Proposed Regulations, the IRS and Department of Treasury withdrew the 1999 Proposed Regulations[225] and issued new proposed regulations in 2000 ("2000 Proposed Regulations").[226]

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pursuant to a plan or arrangement in existence on the date of distribution, 50% or more of the voting power or value of the stock of [D or C] is thereafter acquired by a person, or persons acting in concert").

221. *See* I.R.C. § 355(e)(2)(D) (Supp. IV 1998) (declaring that section 355(e) "shall not apply to any distribution to which [subsection 355(d)] applies").

222. *See* Kenneth J. Kies & Gary B. Wilcox, *PricewaterhouseCoopers Suggests Changes to Anti-Morris Trust Regs*, 2000 TAX NOTES TODAY 34-14 (Feb. 18, 2000) (decrying that section 335(e)(2)(B) "provides that such a plan or arrangement is *presumed* to exist on the date of distribution where the 50%-or-greater acquisition occurs within two years after the date of the spin-off, 'unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions'") (emphasis added) (internal citations omitted).

223. *See id.* (countering that the authors "believe that Congress wanted to cover only those transactions where the taxpayer already had planned (or, alternatively, actually had completed) the acquisition transaction before the spin-off was consummated" and stating that "nothing in the legislative history suggests that Congress intended that plans would be deemed to exist where they did not based on whether a future acquisition could be reasonably anticipated") (internal citations omitted).

224. *See* Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(2), (iii), 64 Fed. Reg. 45155, 46161 (Aug. 24, 1999) [hereinafter 1999 Proposed Regulations].

225. *See* I.R.S. Announcement: *Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection with an Acquisition; Withdrawal of Proposed Rulemaking*, 20001-4 I.R.B. *in* 2001 WL 45236 (Jan. 22, 2001) (withdrawing Prop. Treas. Reg., 1999 Proposed Regulations, § 1.355-7.

226. *See* Prop. Treas. Reg. § 1.355-7, 66 Fed. Reg. 66, 67 (Jan. 2, 2001) (listing commentators assertions (1) that the "approach of the 1999 proposed regulations, providing exclusive rebuttals for establishing that transactions are not part of a plan, was inappropriate because it unfairly limited the evidence taxpayers could produce that may be relevant to whether transactions are part of a plan;" (2) that "section 355(e) does not require the IRS and the Department of the Treasury to adopt a clear and convincing evidence standard for establishing whether transactions are part of a plan;" (3) that "the exclusive rebuttals contained in the 1999 proposed regulations may not be available in cases in which there was an intent to facilitate any acquisition, regardless of its type or size, even if the acquisition being tested was not

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The 2000 Proposed Regulations[227] provide that a distribution and acquisition might be part of a plan or series of related transaction "based on all the facts and circumstances."[228] The 2000 Proposed Regulations list nine nonexclusive factors to determine if an acquisition and distribution are part of a plan, seven nonexclusive factors showing that the distribution and acquisition are not part of a plan, and six safe harbor provisions describing, when applicable, a distribution and acquisition that are not part of a plan.

1. Safe Harbor Provisions. The 2000 Proposed Regulations adopted six safe harbor provisions. The distribution and acquisition are not part of a plan if the two transactions fall within one of the six safe harbor provisions:

(1) Safe Harbor I—acquisition *after* spin-off.[229]
   (a) If the acquisition is more than six months after the spin-off;
   (b) Any agreement, understanding, arrangement of substantial negotiations concerning the acquisition was at least six months after the distribution; and
   (c) The distribution was motivated by a non-acquisition corporate business purpose.[230]

(2) Safe Harbor II—acquisition *after* spin-off.[231]
   (a) If the acquisition is more than six months after the spin-off;

the intended acquisition;" and (4) that "one of the rebuttals in the 1999 proposed regulations was only available" under specific circumstances; that is, the taxpayer must prove that at distribution neither Distributing, Controlled, nor their controlling shareholders "'reasonably would have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in the distributing corporation or the controlled corporation within 2 years after the distribution . . . who would not have acquired such interests if the distribution had not occurred'") (citation omitted).

227. Prop. Treas. Reg. § 1.355-7, 66 Fed. Reg. 66 (Jan. 2, 2001) [hereinafter "2000 Proposed Regulations"].

228. *Id.* § 1.355-7(b)(1), 66 Fed. Reg. at 70; *see also id.* § 1.355-7(d), 66 Fed. Reg. at 71 (listing the facts and circumstances factors).

229. *Id.* § 1.355-7(f)(1), 66 Fed. Reg. at 72.

230. *Id.* § 1.355-7(f)(1)(ii), 66 Fed. Reg. at 72 ("[T]he presence of a business purpose to facilitate an acquisition of Distributing or Controlled is relevant in determining the extent to which the distribution was motivated by a corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to facilitate an acquisition of Distributing or Controlled.").

231. *Id.* § 1.355-7(f)(2), 66 Fed. Reg. at 72; *see* § 1.355-7(m), Ex. 7, 66 Fed. Reg. at 76.

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(b) Any agreement, understanding, arrangement or substantial negotiations concerning the acquisition that occurred at least six months after the distribution; and

(c) The distribution was motivated by a business purpose to facilitate an acquisition that is:
(i) less than 33% of Distributing or Controlled's stock; and
(ii) less than 20% of Acquired's stock (the company whose stock was acquired in the acquisition or acquisitions that motivated the distribution) was either acquired or the subject of any agreement, understanding, arrangement, or substantial negotiations before six months after the distribution.[232]

(3) Safe Harbor III—acquisition *after* spin-off.[233]

(a) If the acquisition is more than two years after distribution; and

(b) There was no agreement, understanding, arrangement or substantial negotiations concerning the acquisition at time of distribution or within six months thereafter.

(4) Safe Harbor IV—acquisition *before* spin-off.[234]

(a) If acquisition was more than two years before the distribution; and

(b) There was not any agreement , understanding, arrangement or substantial negotiations concerning the acquisition at the time of distribution or within six months thereafter.

(5) Safe Harbor V—less than 5-percent shareholder of a publicly traded company.[235]

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232. *See Id.* § 1.355-7, 66 Fed. Reg. 66, 69 ("Safe Harbor II is intended to alleviate the concerns commentators expressed about the unavailability of the rebuttals in the 1999 proposed regulations if the distribution was motivated by an intent to facilitate an acquisition regardless of its type or size."); *but see* Robert Willens, *The Re-proposed "Anti-Morris Trust" Regs. are Vastly Improved, but Some Aspects Remain Vague*, 94 J. TAX. 69, 73 (Feb. 2001) [hereinafter Willens, *Re-proposed*] (asserting that Safe Harbor II "appears to be of limited utility").

233. Prop. Treas. Reg., 2000 Proposed Regulations, § 1.355-7(f)(3), 66 Fed. Reg. at 72.

234. *Id.* § 1.355-7(f)(4), 66 Fed. Reg. at 72.

235. *Id.* § 1.355-7(f)(5), 66 Fed. Reg. at 72–73.

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(a) If the Acquired's stock (Distributing or Controlled) is listed on an "established market";[236]

(b) the stock is transferred between Distributing or Controlled's shareholders who are not "5-percent shareholders."[237]

(6) Safe Harbor VI—Acquisition by Employee or Director.[238]

(a) If an employee or director acquires stock (including exercising certain compensatory stock options) for performing services.

2. Plan Factors. If the transaction does not fall within a Safe Harbor provision, then the 2000 Proposed Regulations consider all the facts and circumstances to determine if the two transactions are part of a plan.[239] The acquisition and distribution are part of a plan if any of the following occur:

(1) Acquisition *after* spin-off.

(a) If Distributing, Controlled, or its shareholders discussed the acquisition or a similar

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236. Prop. Treas. Reg., 2000 Proposed Regulations, section 1.355-7(k)(4), 66 Fed. Reg. at 74 defines "established market" as:

> (i) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);
> (ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Act of 1934 (15 U.S.C. 78o-3); or
> (iii) Any additional market that the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see section 601.601(d)(2) of this chapter).

237. Prop. Treas. Reg., 2000 Proposed Regulations, section 1.355-7(k)(5), 66 Fed. Reg. at 74 defines "five-percent shareholder" as:

> A person will be considered a 5-percent shareholder of a corporation the stock of which is listed on an established market if the person owns, directly or indirectly, or together with related persons (as described in sections 267(b) and 707(b)) 5 percent or more of any class of stock of the corporation whose stock is transferred. A person is a 5-percent shareholder if the person meets the requirements of the preceding sentence immediately before or after each transfer. All options are treated as exercised for the purpose of determining whether the shareholder is a 5-percent shareholder.

238. *Id.* § 1.355-7(f)(6), 66 Fed. Reg. at 73.

239. *Id.* § 1.355-7(b)(1), 66 Fed. Reg. at 70.

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acquisition with the acquirer or another outside party before its spin-off;[240] or

(b) If there was an agreement, understanding, arrangement or substantial negotiations about a similar acquisition at the time of the distribution or within six months after the spin-off;[241] or

(c) If, in a public offering or auction, Distributing, Controlled, or its shareholders discussed the acquisition with an investment banker or outside adviser before the distribution.[242]

(2) Acquisition before spin-off.

(a) If Distributing, Controlled, or its shareholders discussed the distribution with the acquirer before the acquisition;[243] or

(b) If the transaction breaks down (with a potential acquirer), and discussions occur with a different person (the actual acquirer) before the distribution;[244] or

(c) If, in an acquisition involving a public offering or auction, Distributing, Controlled, or its shareholders discussed a distribution with an investment banker or outside advisor before the acquisition.[245]

(3) Acquisition either *before* or *after* the distribution.

(a) If "distribution was motivated by a business purpose to facilitate acquisition or a similar acquisition of Distributing or Controlled;"[246] or

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240. *Id.* § 1.355-7(d)(2)(i), 66 Fed. Reg. at 71 (involving the Acquirer) & (ii) (involving the potential acquirer). *See, e.g., id.* § 1.355-77(m), 66 Fed. Reg. at 74, 76 (examples 1, 2, and 7).

241. *Id.* § 1.355-7(d)(2)(viii), 66 Fed. Reg. at 71. *See, e.g., id.* § 1.355-7(m), 66 Fed. Reg. at 74–76 (examples 1, 2, 3, 4, 5, and 6).

242. *Id.* § 1.355-7(d)(2)(iii), 66 Fed. Reg. at 71. *See, e.g., id.* § 1.355-7(m), 66 Fed. Reg. at 74 (example 3).

243. *Id.* § 1.355-7(d)(2)(iv), 66 Fed. Reg. at 71 ("The weight to be accorded the discussions depends on the nature, extent and timing of the discussions.").

244. *Id.* § 1.355-7(d)(2)(v), 66 Fed. Reg. at 71 ("The weight to be accorded the discussions depends on the nature, extent and timing of the discussions and the similarity of the acquisition actually occurring to the potential acquisition that was discussed.").

245. *Id.* § 1.355-7(d)(2)(vi), 66 Fed. Reg. at 71 ("The weight to be accorded the discussions depends on the nature, extent and timing of the discussions."). *See, e.g., id.* § 1.355-7(m), 66 Fed. Reg. at 75 (example 4).

246. *Id.* § 1.355-7(d)(2)(vii), 66 Fed. Reg. at 71. *See, e.g., id.* § 1.355-7(m), 66 Fed.

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(b) If the acquisition occurred within six months of the distribution, or there was an agreement, understanding, arrangement, or substantial negotiations within six months of the two transactions;[247] or

(c) If there is debt allocation between the Distributing and Controlled that looks like the transaction is an acquisition of debt.[248]

3. Non-Plan Factors. The facts and circumstances showing the involved parties did not intend the transactions to occur in connection with each other are the following:

(1) Just as the discussions with the acquirer or potential acquirer would constitute a plan, the absence of discussions show that the parties did not intend the transactions to occur in connection with each other;[249] or

(2) If there was an identifiable, unexpected change in market or business conditions after the first event that resulted in the second, unexpected transaction;[250] or

(3) If there is a corporate business but non-acquisition or similar acquisition purpose for conducting the transaction;[251] or

(4) If Distributing can demonstrate in an acquisition either before or after a distribution, "the distribution would have occurred at approximately

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Reg. at 74–76 (examples 1, 2, 3, 4, 5, 6, and 7).

247. *Id.* § 1.355-7(d)(2)(viii), 66 Fed. Reg. at 71. *See, e.g., id.* § 1.355-7(m), 66 Fed. Reg. at 74–76 (examples 1, 2, 3, 4, 5, 6, and 7).

248. *Id.* § 1.355-7(d)(2)(ix), 66 Fed. Reg. at 71.

249. *Id.* § 1.355-7(d)(3)(i), 66 Fed. Reg. at 71 (regarding an acquisition after the distribution); *id.* § 1.355-7(d)(3)(ii),66 Fed. Reg. at 71 (regarding an acquisition involving a public offering or auction occurring after the distribution); *id.* § 1.355-7(d)(3)(iv), 66 Fed. Reg. at 71 (regarding an acquisition before the distribution). *See, e.g., id.* § 1.355-7(m), 66 Fed. Reg. at 75 (examples 4 and 5).

250. *Id.* § 1.355-7(d)(3)(iii), 66 Fed. Reg. at 71 ("In the case of an acquisition *after* a distribution, there was an identifiable, unexpected change in market or business conditions occurring after the distribution that resulted in the acquisition that was otherwise unexpected at the time of the distribution.") (emphasis added); *id.* § 1.355-7(d)(3)(v), 66 Fed. Reg. at 71 ("In the case of an acquisition *before* a distribution, there was an identifiable, unexpected change in market or business conditions occurring after the acquisition that resulted in a distribution that was otherwise unexpected.") (emphasis added).

251. *Id.* § 1.355-7(d)(3)(vi), 66 Fed. Reg. at 71–72. *See, e.g., id.* § 1.355-7(m), 66 Fed. Reg. at 75–76 (examples 4, 5, and 6).

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> the same time and in similar form regardless of the acquisition . . . (including a previously proposed similar acquisition that did not occur)."[252]

The 2000 Proposed Regulations make several references to the existence of "an agreement, understanding, arrangement, or substantial negotiations." It, however, does not define these concepts, but indicates that where the parties entered in a binding contract, or reached an agreement on all terms, then a plan exists. Additionally, if there are enforceable rights to acquire stock, or in a public offering or auction, an agreement, understanding, arrangement, or substantial negotiations can exist even if the acquirer has not been identified.[253]

4. Examples. The 2000 Proposed Regulations include several examples to clarify some of the new provisions.

> EXAMPLE 13:[254] D consists of two distinct businesses—Insurance and Banking. D wants to combine with P, a larger corporation also engaged in the Banking business. But P does not want to acquire the Insurance business. To facilitate the acquisition, D discusses with P and subsequently agrees to separate the two businesses, place the Insurance in C, and distribute the stock pro rata to its C shareholders before the acquisition. D and P enter into a binding contract to merge the two companies. D distributes C and then merges into P one month later. As a result of the acquisition, D shareholders own less than 50% of P's stock.
>
> Safe Harbor does not apply to this spin-merger because the distribution and discussions occurred within six months of the acquisition. Therefore, look at the facts and circumstances to

252. *Id.* § 1.355-7(d)(3)(vii), 66 Fed. Reg. at 72. *See, e.g., id.* § 1.355-7(m), 66 Fed. Reg. at 72 (examples 4, 5 and 6).

253. *Id.* at § 1.355-7(k)(1), 66 Fed. Reg. at 73. In a situation where a plan exists even if the acquirer has not been specifically identified, the 2000 Proposed Regulations indicate, "[t]he existence of such an agreement, understanding, arrangement, or substantial negotiations will be based on discussions with an investment banker or other outside adviser." *Id.*

254. *Id.* § 1.355-7(m), 66 Fed. Reg. at 74 (example 1).

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determine if the spin-off and merger are part of a plan.

Plan—Acquisition *after* spin-off. D and P discussed the acquisition before the distribution;[255] the distribution and acquisition occurred within six months of each other;[256] and D was motivated by a business purpose to facilitate the acquisition.[257]

Non-plan. None of the non-plan factors exist in this case.

Therefore, the distribution and subsequent merger are part of a plan under section 1.355-7(b)(1).

EXAMPLE 14:[258] Same facts except that after D distributes C, P is unable to fulfill one of the conditions and consequently the agreement breaks down. Y, one of P's competitors, acquires D five months after the distribution. As a result of the acquisition, D shareholders own less than 50% of Y's stock.

Safe Harbor does not apply to this spin-merger because the distribution and discussions occurred within six months of the acquisition. Therefore, look at the facts and circumstances to determine if the spin-off and merger are part of a plan.

Plan—Acquisition *after* spin-off. D and P, a potential acquirer, discussed the acquisition before the distribution and a similar acquisition by Y occurred;[259] the distribution and acquisition occurred within six months of each other;[260] and

255. *Id.* § 1.355-7(d)(2)(i), 66 Fed. Reg. at 71.
256. *Id.* § 1.355-7(d)(2)(viii), 66 Fed. Reg. at 71.
257. *Id.* § 1.355-7(d)(2)(vii), 66 Fed. Reg. at 71.
258. *Id.* § 1.355-7(m), 66 Fed. Reg. at 74 (example 2).
259. *Id.* § 1.355-7(d)(2)(ii), 66 Fed. Reg. at 71.
260. *Id.* § 1.355-7(d)(2)(viii), 66 Fed. Reg. at 71.

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D was motivated by a business purpose to facilitate the acquisition.[261]

Non-plan. None of the non-plan factors exist in this case.

Therefore, the acquisition and subsequent distribution are part of a plan under 1.355-7(b)(1).

EXAMPLE 15:[262] D's stock is listed on an established market. D announces that it will make a pro rata distribution of C stock to its D shareholders. At the time of its announcement, the distribution was motivated by a non-acquisition corporate business purpose. After the announcement but before the distribution, T becomes available as an acquisition target. There were no discussions between D and T before the announcement. D acquires T before the distribution. After the acquisition, T's former shareholders own 55% of D's stock. D makes a pro rata distribute of C stock within six months of the T acquisition.

Safe Harbor does not apply to this spin-merger because the distribution and discussions occurred within six months of the acquisition. Therefore, look at the facts and circumstances to determine if the spin-off and merger are part of a plan.

Plan—Acquisition *before* spin-off. The distribution and acquisition occurred within six months of each other;[263] and D may have been motivated by a business purpose to facilitate the acquisition because the acquisition occurred after the public announcement of the planned distribution.[264]

261. *Id.* § 1.355-7(d)(2)(vii), 66 Fed. Reg. at 71.
262. *Id.* § 1.355-7(m), 66 Fed. Reg. at 75–76 (example 6).
263. *Id.* § 1.355-7(d)(2)(viii), 66 Fed. Reg. at 71.
264. *Id.* § 1.355-7(d)(2)(vii), 66 Fed. Reg. at 71.

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> Non-plan. The distribution was motivated by non-acquisition corporate business purpose;[265] and since D publicly announced its intention to distribute C before it became aware of the acquisition opportunity is evidence that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition.[266] T's lack of participation in the decision further establishes that fact.
>
> If D can establish the non-plan facts and circumstances, then distribution and merger are not part of a plan.

Because the 2000 Proposed Regulations were just released in January 2001, the Service is still getting feedback from the public. Certainly, these regulations lessen the taxpayer's burden by removing the "clear and convincing evidence" standard and the amorphous "reasonably anticipated that an event was more likely than not to occur . . . ."[267] But these new regulations still need to provide some guidance and explanation to specifically describe what circumstances would taint the transaction.

For instance, one tax practitioner asked the government panelists to provide clarification of "similar acquisitions."[268] The panelists indicated that where the first acquirer would acquire all of Distributing's stock breaks down after Controlled is spun-off, and an unrelated corporation acquires all of Controlled within three months of its spin-off, the transaction is "probably" not tainted.[269] It was not anticipated at the time of the distribution that the second transaction would involve a different target and a different acquirer.[270] As the facts and circumstances test delineates, the transaction could be tainted as the

265. *Id.* § 1.355-7(d)(3)(vi), 66 Fed. Reg. at 71.

266. *Id.* § 1.355-7(d)(3)(vii), 66 Fed. Reg. at 71.

267. *Id.* § 1.355-7, 66 Fed. Reg. at 67 (stating that the 1999 Proposed Regulations are withdrawn of which the "clear and convincing evidence" requirement and the "reasonably anticipated" criteria were included).

268. News, Commentary, and Analysis, *Officials Pinpoint Problem Areas in Proposed Anti-Morris Trust Regs.*, 2001 TAX NOTES TODAY 42-8 (2001), LEXIS, Tax Analysts Tax Notes File ("Steptoe & Johnson's Mark Silverman asked government panelists whether the final regs will define what the government means by a 'similar' acquisition.").

269. *Id.*

270. *Id.*

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distribution preceded the acquisition by only three months.[271] But "there were no discussions with the same or similar acquirer, there was no business purpose for the acquisition, and Distributing might have done the spin-off anyway."[272]

V. ANALYSIS OF SECTIONS 355(d) AND 355(e)

A. *Practical Problems Raised by Sections 355(d) & 355(e)*

The enactment of the highly controversial Code section 355(e) not only significantly affected *Morris Trust*, and Reverse-*Morris Trust* transactions, but also extended beyond to include a variety of similarly arranged section 355 distribution/spin-off transactions.[273] While tax policymakers passed this bill because they were wary of the abusive transactions, this resounding legislative enactment has left many corporate tax lawyers harrowing over the egregious tax ramifications.[274]

Congress reinstated spin-offs in 1951 because its repeal hindered a business' ability to separate business activities and to maximize economic efficacy.[275] Spin-offs were encouraged to separate active ventures provided the divestiture was for a compelling business purpose. This was the legislative purpose for permitting spin-offs.[276] But the 1997 Act has diverted significantly from its intent, and now has shifted to a

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271. *Id.*; *see also* Prop. Treas. Reg., 2000 Proposed Regulations, § 1.355-7(d)(2)(i) & (ii), 66 Fed. Reg. at 71.

272. News, Commentary, and Analysis, *supra* note 268.

273. *See supra* Part IV.

274. *See* David A. Alderman, *Out in the Cold*, MGMT. REV., Nov. 1, 1997, at 45, *available at* 1997 WL 9568280 (arguing that selling something requires payment of taxes); Emily S. Plishner, *Indirect TV: How GM's Use of Tracking Stock is Complicating a Tax—Free Divesture of its Directv Business*, CFO, Jan. 1, 2001, at 39 (Morris Trust transactions are in "legal limbo"); Tax Penalties and Interest: Hearing on Penalty and Interest Provisions in the Internal Revenue Code Before the Senate Comm. on Finance, 106th Cong. (2000), *available at* 2000 WL 11069131 (statement of Peter L. Faber, Partner, McDermott, Will & Emery stating that the definitions have not caught abusive transactions, or have included non-abusive transactions); *see also* Beller, *A New Business Purpose*, *supra* note 153, at 1 ("[T]he nonstatutory requirements prescribed by the regulations can often prove troublesome . . . [b]ecause the 'double whammy' stakes stakes of flunking section 355 are so daunting, i.e., both shareholders and corporate level taxpayers and their advisers typically are very reluctant are very to proceed with a section 355 transaction unless an advance ruling can be obtained." The nonstatutory requirements are "especially troublesome [for] the critical business purpose requirement.").

275. *See* S. REP. NO. 82-781 at 57–58 (1951), reprinted in J.S. SEIDMAN, 1 SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS 1556 (1954) (expressing the view that impeding spin-offs which break up businesses into a greater number of enterprises was "economically sound").

276. *See id.* (explaining that "[t]his section has been included in the bill because . . . it is economically unsound to impede spin-offs which break up [sic] businesses into a greater number of enterprises, when undertaken for legitimate business purposes").

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presumption that a transaction falling within the ambit of *Morris Trust* or a similarly structured transaction is arranged solely to take appreciated assets out of corporate solution and not for a legitimate business purpose.

Although the newly enacted section 355(e) is alluded to as the "anti-*Morris Trust*"[277] and, among other things, the "*Morris Trust*-killer bill,"[278] and the "*Morris Trust repeal*,"[279] it does not actually overrule *Morris Trust* because the actual shareholders of the distributing corporation in *Morris Trust* still maintained a majority interest in the merged entities.[280] Rather, *Morris Trust* is still good law and *Morris Trust*-type transactions are still permissible; only these transactions will be assessed a penalty tax.[281] Indeed, *Morris Trust*-type transactions are consistent with new section 355(e) in that they both require the shareholders to maintain continuity of interest.[282]

Morris Trust transactions have been supported for over thirty years by the Courts and the Service.[283] *Morris Trust* transactions are created to achieve spin-offs followed by acquisitions when assets must be removed for a multitude of business reasons such as regulatory compliance, antitrust regulations, or Federal Communications Commission regulations.[284] In the *Morris Trust* transaction itself, the spin-off and subsequent acquisition were arranged for a valid business purpose because the national banking law prohibited the acquiring bank corporation from attaining an insurance business.[285] But most importantly, no *cash* was exchanged between the entities, and the acquired corporation did not take any appreciated property out of corporate solution. A transaction that mirrors the *Morris Trust* transaction is not motivated for

277. *See supra*, note 117 and accompanying text.

278. *See* BITTKER & EUSTICE, *supra* note 8, at ¶ 11.13[3][a], 11-77.

279. Benton Burroughs, Jr. & Geoffrey C. Dodson, *Will They Stop Free Spinoffs?*; LEGAL TIMES, June 2, 1997, at S32.

280. *See* Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal, JCS-10-97, Joint Comm. on Tax'n, 105th Cong., at 47, n.47 (1997).

281. Chris Hesse, *What the Anti-Morris Trust Provisions Really Do*, 78 TAX NOTES 359, 359 (1998).

282. *See* Steven A. Bank, *Taxing Divisive and Disregarded Mergers*, 34 GA. L. REV. 1523, 1534 (2000) (noting that the treasury regulations require only that the acquirer continue a significant line of business; therefore as long as the transaction is not used to transfer a secondary line of a company's business, all of the formal requirements for nonrecognition will be met).

283. Silverman et al., *supra* note 114, at 329.

284. Stewart, *supra* note 103, at 651.

285. *See* Commissioner v. Mary Archer W. Morris Trust, 367 F.2d 794, 795 (4th. Cir. 1966).

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corporate bailout earnings or to avoid a corporate taxable hit pursuant to the *General Utilities* repeal, but is structured for adequate business consequences, including those enumerated business purposes in Revenue Procedure 96-30.[286] Nevertheless, even if the arrangement is an appropriate business structure where no cash changes hands, the distributing corporation will be hit with a taxable event without getting the benefit of a step-up in basis.[287] In a section 355 transaction, which undergoes more extensive scrutiny than transactions governed by other tax-free provisions in the Code, section 355(d) and section 355(e) provide insurmountable barriers for nonabusive transactions to overcome. The purpose of section 355 was to promote economic efficiency and to encourage business expansions on a global international scale.[288] Surely, this result is not what the legislators intended when they brought back spin-offs in 1951. To the contrary, this bill discourages and impairs those taxpayers this legislation sought to protect.

The new bill was received with bitter response. Practitioners launched into a windy diatribe, attacking the Treasury and sternly opposing the *Morris Trust* legislation as it stands today.[289] Critics have called the *Morris Trust* repeal an example of Congressional overreaction,[290] and have claimed that the Administration's proposal exemplifies a "crude, meat-ax approach" to a device that has assisted businesses to reorganize corporate groups.[291] Nevertheless, the Treasury rationalized that the 1997 Act would not hinder corporate taxpayers from engaging in "normal business pursuits," but rather would "improve tax policy, to some extent simplify the tax system, and ensure that the burden of deficit reduction is borne fairly by all sectors."[292]

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286. *See generally* Rev. Proc. 96-30, 1996-1 C.B. (listing examples of legitimate business purposes such as stock offering, borrowing, cost savings, fit and focus, competition, facilitating an acquisition, and risk reduction).

287. *See* Mark J. Silverman, *Recent Developments in the Step Transaction Doctrine*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2000 791, 842–43 (PLI Tax Law and Estate Planning Course Handbook Series No. J0-002R, 2000), *available at* WL 478 PLI/TAX 791 [hereinafter Silverman, *Recent Developments*].

288. *See* Bank, *supra* note 253, at 1533.

289. *See supra* note 245 and accompanying text (noting that the enactment of section 355(e) has caused tax lawyers to complain of its harsh ramifications).

290. *See* David L. Klusman et al., *Clinton Administration Budget Proposals*, 49 TAX EXECUTIVE 234, 236 (1997) (stating that the Tax Executives Institute "believes that the Administration's proposal is an example of overreaction and overkill").

291. *Id.*

292. *Selected Revenue-Raising Provisions*: *Hearing Before the Senate Comm. on Finance*, 105th Cong. 2 (1997) (statement of Donald C. Lubick, Acting Assistant Secretary

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B. *Suggested Modifications*

Certainly, there are abusive spin-off transactions in which a corporation borrows a significant amount of money or incurs a substantial amount of debt that the acquiring corporation assumes. Similarly, spin-off transactions resembling a sale are prearranged to circumvent the *General Utilities'* repeal. These "disguised sales" justifiably mandate legislative response to preclude corporations from so-called "monetizing" *Morris Trust* transactions. However, taxing all *Morris Trust* transactions that fail the 50% control test is the inappropriate solution. The media scathed the Treasury for failing to police highly publicized *Morris Trust*-type transactions that resulted in a "sale," or was wielded as a "loophole."[293] The Treasury's hastily proposed legislation probably was a compromise to subdue the perturbed media but, unfortunately, the Treasury did not realize the repercussions of its actions.

Because this new bill has a chilling effect on tax-free deals, the legislation should elucidate the complexities by confining the bill to abusive transactions only. Albeit, a proposal that confines the bill to abusive transactions presents questions about what would constitute an abusive transaction. For example, transactions could be probed on a case-by-case basis, and the facts and circumstances might suggest whether each individual transaction would pass section 355 spin-off muster. This is nothing new; the Service is frequently called on to scrutinize the structure by which corporations attempt to obtain tax-free separations under section 355.[294]

Today, the Service regularly issues private letter rulings to corporations regarding section 355 tax issues.[295] Corporations are weary of circumventing the *General Utilities* repeal with a

(Tax Policy), Department of the Treasury).

293. *See, e.g.*, Allan Sloan, *IRS Opens a Loophole for Viacom, But Needs to Close It Quickly*, WASH. POST, July 2, 1996, at C3 (commenting that "someone should slam-dunk this loophole"); *see also* 143 CONG. REC. E702 (daily ed. Apr. 17, 1997) (statement of Rep. Archer) (referring to "several recent news reports" describing corporate acquisition transactions, the tax-free status of which was, despite the original Congressional intention, granted by the Internal Revenue Service).

294. *See* Beller, *A New Business Purpose*, *supra* note 153, at 1 ("For many tax professionals, the workday cannot begin without a quick scan of newly released private letter rulings. Rarely a week goes by in which those rulings do not include at least a few involving spin-offs or other types of corporate separations designed to achieve tax-free treatment under [section] 355.").

295. *See, e.g.*, Priv. Rul. 200038034 (June 26, 2000) (ruling on the federal income tax consequences of proposed transactions concerning section 355). A search of Private Letter Rulings and Technical Memorandums shows that in the six months prior to September 29, 2000, the IRS issued thirty-four documents that had some relevance to section 355.

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section 355 transaction, for a failed section 355 can be frightening—both the corporation and shareholder will recognize taxable gain. The Service is continually probing these *Morris Trust*-type business transactions despite the critics' conviction that these transactions evade the Service. Granted, they were castigated for their blunder in Viacom (actually the Service was not, but Mrs. Morris was), the Service will not have difficulty detecting these so-called "monetizing" *Morris Trust*-type transactions. Today, these leveraged transactions are easy to identify and they will not overcome the overwhelming obstacles. Accordingly, the Service or the Courts should continue monitoring each case, as they have routinely accomplished over the past thirty years.

After the *Morris Trust* repeal, taxes can potentially arise at three levels.[296] First, the distributing corporation will be taxed on the transaction under section 355(e) if it cannot convince the Service that the distribution was not related to a subsequent acquisition of either the distributing corporation or the company it spun-off.[297] Second, because the section 355(e) tax does not give rise to a stepped-up basis in the stock of the spun-off company,[298] the shareholders who received the stock in the distribution will face a tax on the built in gain when they sell or exchange that stock. Third, because the distributing company was not taxed on the appreciation of the assets it dropped down into the spun-off company,[299] the assets will have a carry-over basis[300] and the spun-off company will recognize gain if it sells its assets. Therefore, if a transaction falls under section 355(e), the parties to that transaction could be susceptible to three levels of tax.[301] If the legislative intent was to compel corporations to recognize only two levels of tax, pursuant to the *General Utilities* repeal, then this "triple tax" is fundamentally inconsistent with the *General Utilities* repeal and even the legislator's objectives for enacting section 355(e).[302]

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296. *See* Hesse, *supra* note 281, 359 (explaining the three levels of taxes in a comfort letter Hesse issued to a client).

297. *See supra* Part IV.D. (elaborating on the section 355(e) provisions).

298. *See* I.R.C. § 358(a)(1) (1994). Because gain is recognized by the corporation under section 355(e), but not by the shareholders, there is no shareholder tax to support an increase in the basis of the stock. *Id.*

299. *See* I.R.C. § 361(a) (1994).

300. *See* I.R.C. § 362(b) (1994).

301. *See* Hesse, *supra* note 281, at 359; *see also* Silverman, *Recent Developments*, *supra* note 258, at 841–43.

302. *See* Stewart, *supra* note 103, at 656 (stating that "this triple tax is . . . fundamentally inconsistent with the intent of the General Utilities repeal, which was to ensure two levels of taxation").

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The advent of section 355(d) was designed to bust-up transactions resembling disguised sales.[303] Because it was so poorly constructed, Congress' solution was to give the Service broad regulatory power to correct any flaws in the statute.[304] However, every tax practitioner, including the IRS, was vexed about Congress' intent.[305] Ten years later, Congress once again constructed a poorly drafted and overbroad doctrine, which galvanized because of a few extreme cases.[306] Today, there are two provisions, the 1990 Act and the1997 Act, that were enacted to combat perceived abuses, but instead created more problems than solutions. A narrower provision could interdict abusive transactions, while permitting *Morris Trust*-type transactions to be accomplished as they have for over thirty years.

For instance, Congress should adopt the continuity of interest construct from the section-368-reorganization section. Many tax consultants advise their clients that, in a reorganization involving a stock-for-stock or asset-for-stock exchange, the target's shareholders should receive at least 50% of the acquiring corporation's stock and the controlling corporation's stock. That is, when the distribution and acquisition are complete, someone should ascertain the debt-to-equity ratio that D's shareholders possessed in the *Morris Trust*-type transaction.[307]

This test has been used in the reorganization arena to assess if the distributing corporation's historic shareholders possess the requisite 50% continuity of interest.[308] Additionally, it should also be used to assess the overall objective of the transaction; to evaluate the overall transaction to determine if it is heavily laden

303. *See supra* Part IV.F. (discussing section 355(d)).

304. *See supra* notes 209–11 and accompanying text

305. *See* Lee A. Sheppard & Heidi Glenn, *Viacom Revisited: Why Split-off Guidance is Needed*, 96 TAX NOTES TODAY 239-5 (Dec. 10, 1996) (noting that section 355(d) was poorly drafted, that mention of section 355(d) has been conspicuously absent from other section 355 letter rulings, and that John Geracimos, the IRS Assistant Branch Chief, has stated that the confusion caused by these factors calls for better section 355(d) guidance).

306. *See supra* Part III.B.–D. (discussing the cases that caused Congress to pass section 355(e)).

307. *See* Silverman et al., *supra* note 114, at 364 (noting that a spin-off transaction in which the acquiring corporation inherited a large amount of the acquired corporation's debt, while the cash proceeds of that debt were distributed to the acquired corporation's shareholders prior to the spin-off, appeared to be a disguised sale and should not be accorded tax-free status under section 355(e), which "was intended to permit the tax-free division of existing business arrangements among existing shareholders").

308. *See* Paulsen v. C.I.R., 469 U.S. 131, 136–40 (1985) (holding that the continuity of interest requirement will not be satisfied if the shares issued to the acquired corporation's shareholders are not substantially an equity interest in the acquiring corporation such that "the debt characteristics of [the] shares greatly outweigh the equity characteristics").

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with debt and ascertain the debt-to-equity ratio. Section 355(e) permits a transaction involving over 50% equity.[309] So let this stand as one of the essential criteria to ascertain if a corporation is using the section 355 provisions as a ploy. Note that even if the parties meet the continuity of interest test, they must still comply with the additional judicial doctrines of the continuity of the business enterprise and the heightened business purpose scrutiny.

The New York City Bar Association ("New York Bar") has illustrated the wisdom of explaining the debt-to-equity ratio as a means to determine when to assess the section 355(e) tax. It sent an appeal to members of Congress, beseeching the legislature to reconsider section 355(e) before passing it.[310] The New York Bar gave the following example:

> D is engaged in two separate businesses, the Widget and Gadget business. D has $25 million in debt ($20 million in Widget and $5 million in Gadget). D has $100 million of assets in the Widget business with a cost basis of $20 million; and $25 million of assets in the Gadget business with a cost basis of $5 million. P is a large Widget business interested in merging only with D's Widget business. Therefore, to tailor to P's business objectives, D drops all of the Gadget business into a newly formed (or old and cold) C, and distributes all of the C stock (including the debt) to its shareholders. D subsequently merges with P, and P receives all of Widget's assets and liabilities. D's shareholders receive solely P stock with a value of $80 million.[311]

The transaction was arranged to facilitate P's needs, an appropriate Revenue Procedure 96-30 business objective. Furthermore, the transaction does not contain any indicia of a sale because cash was not used as consideration to compensate the shareholders. Nevertheless, D will realize and recognize taxable gain for the appreciated assets in the Widget business.

309. *See supra* Part IV.D. (discussing section 355(e)).

310. *See* Sydney E. Unger, *New York Attorneys Oppose Morris Trust Legislation,* 76 TAX NOTES 693, 694–95 (Aug. 4, 1997). Sydney Unger wrote to Congressman Archer and Senator Roth to express the New York City Bar Association's opposition to the proposed legislation, stating that "the proposed amendment would render most Morris Trust transactions economically unfeasible." *Id.* at 693.

311. *Id.* at 694–95.

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Accordingly, D's taxable income will be $80 million, and assuming the corporate tax rate is 35%, D is "penalized" $28 million (80 X .35). Under section 355(e), D must pay $28 million in taxes, *even though no cash was employed to facilitate the transaction.*[312] If D is cash-poor and it's valuation is based primarily on other fixed assets, then to accommodate for the $28 million tax bill, D will be forced to partially liquidate to fulfill its tax obligation. Surely, this result could not be what the legislation intended, because it neither promotes economic efficiency nor the expansion of business.[313] To the contrary, section 355(e) discourages transactions that are purely business motivated.

However, if D spun-off C's Gadget business to D's shareholders in a transaction that was independent and prior to P's merger proposal, that is, if the distribution to D's shareholders was not related to the subsequent merger with P, then D's distribution would qualify as a tax-free spin-off, as would the subsequent merger.[314] Thus, rather than promoting uniformity and conformity, section 355(e) would be encouraging "under-the-table, economically inefficient, planning that promotes the general distaste for the taxing system."[315]

The New York Bar Association suggests that the better legislative solution would be to impose section 355(e) only in highly leveraged transactions that have the indicia of sales,[316] such as the Viacom, Disney, and General Motors transactions.[317] Specifically, in a *Morris Trust* transaction, they recommend comparing the debt-to-equity ratio of the acquired corporation with the debt-to-equity ratio of the pre-spin-off group.[318] If the

312. Imagine the absurdity of the proposed legislation. In this example, C would be forced to pay taxes upon D's merger. Accordingly, a corporation whose assets comprise only $25 million is constrained to pay $28 million in taxes!

313. *See* Kenneth McLennan, *Manufacturers Alliance Opposes Spin-off Legislation*, 97 TAX NOTES TODAY 119-65 (June 20, 1997) (arguing that the "Morris Trust approach makes possible corporate restructurings that would not occur in the absence of nonrecognition," which "promotes business efficiencies and thus is good for the economy").

314. *See supra* notes 188–94 and accompanying text (explaining that section 355(e) is only triggered if the distribution and subsequent merger are pursuant to a plan or a series of related transactions). Note that one way around § 355(e) would be to establish that the acquisition and distribution were not related.

315. *See Selected Revenue-Raising Provisions: Hearing Before the Senate Comm. on Finance*, 105th Cong. 31 (1997) (prepared statement of Martin D. Ginsburg at Part II.D.1).

316. *See* Unger, *supra* note 310, at 695 (stating that the New York Bar Association's purpose in proposing such legislation was to differentiate those transactions tainted with the indicia of sales so that "any remedial legislation [w]ould not have the effect of eliminating all Morris Trust transactions").

317. *See supra* Part IV.B.

318. *See* Unger, *supra* note 310, at 695.

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ratio of the acquired corporation exceeds the ratio of the pre-spin-off group, then the historic distributing corporation should be assessed a tax based on the difference.[319] This approach would have the effect of taxing *Morris Trust* transactions in which the merged corporation is more leveraged than the pre-spin-off corporate group "as a result of assuming a disproportionate amount of existing debt or engaging in new borrowings."[320] The distributing corporation should be compelled to pay taxes for the excessive borrowing because it retained the debt proceeds, but transferred to the acquired company the underlying debt, which has all the appearances of a sale.[321]

Another approach would be to adopt the boot[322] rule similar to the provision under section 368(a)(1)(C) practical mergers involving an exchange of substantially all of a target corporation's property solely for a purchasing corporation's voting stock.[323] Despite section 368 (a)(1)(C)'s mandate that a target corporation transfer substantially all of its assets *solely* in exchange for voting stock of the purchasing corporation, the inclusion of boot in the consideration used by the purchasing corporation will not necessarily disqualify the transaction as a Type C reorganization.[324] The boot rule states that a purchasing corporation's consideration may be comprised of up to at least 20% boot without the transaction being disqualified under Section 368(a)(1)(C).[325] For instance, assuming target's assets are

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319. *See id.* As noted in the previous example, D would have a debt-to-value ratio of 0.2 ($25 million debt divided by Widget and Gadget's $125 million asset value). Because D's asset value is $100 million following the spin-off of C, (D) would recognize gain for any debt that exceeds $20 million (20% of $100 million). If D borrowed $50 million from a third-party lender, distributed the proceeds of the loan to its shareholders, and P assumed the $50 million debt (including the $20 million of Widget's debt) just before the merger, D would recognize $50 million of taxable gain ($70 million of debt less $20 million "allowable" debt). *See id.*

320. *See id.* at 695, n.13 (stating that "[i]n order to avoid abuses, it will be necessary to test the debt-to-value ratio of the pre-spin-off corporate group sufficiently in advance of the actual spin-off .... [and] that such ratio could be determined over the 12-month period beginning 24 months before the spin-off").

321. *See id.* at 694.

322. *See supra* note 70 and accompanying text (defining "boot").

323. *See* I.R.C. § 368(a)(1)(C) (1994). A Type C reorganization is commonly known as a "practical merger" because the outcome of a Type C reorganization is very similar to a merger. *See* STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION 460 (4th ed. 1997). The difference in a Type C and Type A, or statutory, merger is that a Type C merger requires a transfer of assets and liabilities under a negotiated agreement without requiring that the target company necessarily sell all of its assets or liquidate, whereas a statutory merger involves the automatic absorption of all of the target company's assets and liabilities by the acquiring company. *Id.*

324. *See* I.R.C. § 368(a)(2) (1994) (designating special boot rules that apply to § 368(a)(1)(C) reorganizations).

325. *See* I.R.C. § 368(a)(2)(B) (1994).

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worth $100, the acquiring corporation must exchange at least $80 (80% of $100) worth of voting stock. If the shareholders receive boot in addition to the voting stock, then the boot's value reduces the stock's value. Instead, assume target's shareholders receive $85 worth of stock, then $6 of boot will disallow this attempted tax-free merger. That is, the target shareholders must receive at least $80 of stock, which they did; boot can decrease the percentage.

Similarly, legislation or the Service can use a boot relaxation rule as a way to clamp down on so-called "monetizing" *Morris Trust* transactions. Since D and C's acquisition is pursuant to a section 368(a) reorganization, employing the boot rule under a *Morris Trust*-type transaction would be to assess the total amount of cash or debt involved in the spin-off and merger. The boot relaxation rule, however, should not mandate a restrictive amount, such as the 20% limit in a C reorganization. There are numerous alternatives to structuring a tax-free, section 368(a) reorganization.[326] In a failed practical merger under section 368(a)(1)(C), an alternative arrangement would be to arrange a section 368(a)(1)(A) statutory merger, which is less restrictive. However, imposing strict provisions in the *Morris Trust* arena will virtually eliminate a longstanding provision that has been used to encourage separation of businesses. The Service should instead make a compromise by imposing a more practical rule that does not restrict boot as consideration, but provides an opportunity to regulate transactions that abuse the spin-merge by shifting debt. For instance, the Service can disallow an attempted section 355 transaction if the boot used by either party comprises of more than 40% of the asset or stock value. On the other hand, there is always the continuity of interest limitation, which entails the use of boot so long as it does not violate the continuity of interest requirement.

Another dilemma with the legislative problem is the 50% control requirement. In *Morris Trust*, the historic shareholders received slightly more than 54% of the newly merged entity, thereby meeting the continuity of interest requirement.[327] Apparently, legislators were persuaded, and decided to incorporate the so-called "control" into the new bill. However, there are some instances in which this control requirement will have detrimental tax consequences to a distributing parent

326. *See supra* note 32, 323 (discussing Type A, C and D reorganizations under section 368).

327. *See* Commissioner v. Mary Archer W. Morris Trust, 367 F.2d 794, 799 (4th Cir. 1966).

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because of the relative size of a company with which it merges, even though these companies had a perfectly legitimate, entirely business-motivated reason to consummate the merger. Posit that a distributing parent has two businesses—it spins-off one of those businesses and then proceeds to merge itself with another company. Whether or not this merger transaction is taxable to the parent company will depend on whether the parent company is larger or smaller than the company with which it merges, because this will determine which company's stockholders retain control.[328] The acquired parent corporation must be larger than the third party acquiring corporation; otherwise, the tax will be assessed.[329] The manipulation of the *Morris Trust* galvanized Congress into fixing a flaw in the Code, but surely the size of the two entities was not the influential factor for repealing *Morris Trust*.[330] Creating a standard that references arbitrary factors such as the relative values of the entities as a means to determine when to tax certain reorganization transactions contradicts the legislature's intent to promote business expansions.

The 1999 Proposed Regulations were intended to be "taxpayer favorable," that is, to soften the blow of section 355(e);[331] but the Service implemented the "clear and convincing evidence" standard, which presented the taxpayer with a difficult burden to overcome.[332] After receiving numerous comments about

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328. *See* Stewart, *supra* note 103, at 657 (noting that the shareholders of an entity going into a merger with a higher value will have a controlling interest in the resulting merged company).

329. *See id.* (pointing out the irony that if the parent company had *independently* decided to spin-off its business before beginning negotiations with another company to merge, the transactions would qualify for a tax-free spin-off followed by a tax-free merger).

330. *See id*; *see also* BITTKER & EUSTICE, *supra* note 8, at ¶ 11.11[2][c], 11-76, n. 314 ("It is difficult to see why the relative size of the target and the acquiror should govern taxability of the parent in the [section] 355 transaction . . . .").

331. *See* Barton Massey, *Anti-Morris Trust Regs Designed to be Taxpayer Favorable*, 24 TAX PRAC. 80 (1999) (quoting the remarks of several government officials that the "general rebuttal," that is, the requirement that taxpayers satisfy certain tests to rebut the statutory presumption under section 355(e) that stock was distributed as part of a plan, was intended to be "taxpayer favorable" and was "a matter of administrative grace").

332. Joseph M. Pari et al., *Sections 355(d), (e) and (f): Disqualified Distributions and the Anti-Morris Trust Rules, in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2000 209, 266 (PLI Tax Law and Estate Planning Course Handbook Series No. J0-002R, 2000), *available at* WL 480 PLI/TAX 209 (noting that "clear and convincing evidence" is not defined in proposed section 355(e), but stating that "[c]lear and convincing evidence has been defined in other contexts, however, as . . . evidence that is 'so clear, direct and weighty and convincing so as to enable [the fact finder] to come to a clear conviction, without hesitancy, of the truth of the precise facts in issue;'" and concluding that "it is clear that the burden on the taxpayer is likely to be an onerous one").

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the 1999 proposed regulations, the Service refurbished the 1999 regulations and re-released a vastly improved 2000 version.

The 2000 Proposed Regulations attempt to provide taxpayers guidance on which transactions would fall within the safe harbor provisions and therefore outside of 355(e). However, there is still some uncertainty over these new regulations. Safe Harbor II,[333] for example, appears to apply in only limited circumstances. As one commentator pointed out, "[i]t is highly unlikely—in fact, inconceivable—that an agreement or substantial negotiations (and remember, in the case of a public offering or auction, the existence of an agreement will be based on discussions with one's investment bankers) will not have been reached, or taken place, before the six-month period has elapsed."[334] Additionally, if the acquisition and distribution occur within two years of each other, then the transaction will not be tainted only if there is a non-acquisition business purpose, such as an acquisition occurring more than six months after the spin-off.[335] The number of transactions falling within the safe harbor is therefore substantially reduced, and as with any of these safe harbor provisions, the taxpayer would be wise to refrain from any sort of discussions with outside parties before the six -month period has lapsed. Essentially, the taxpayer will be protected if the acquisition occurs at least two years before or after the distribution, and avoids any acquisition discussions with the potential acquirer for at least six months within the distribution.[336]

The regulations repeatedly refer to the parties' "discussions" before the distribution or acquisition. Whether the two parties "discussed" any part of the desired transaction determines whether they intended the distribution and acquisition to be part of a plan. What remains unclear are the types of discussions or "substantial negotiations" that would give rise to a tainted transaction. Because it appears that even initial, preliminary discussions with another party would give rise to an acquisition business purpose, the Service needs to provide guidelines for determining the existence of a plan or series of related transactions based on the parties' discussions.

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333. *See supra* Part IV.E.1, Safe Harbor Provision II.

334. *See* Willens, *Re-proposed, supra* note 232, at 73.

335. *See supra* Part IV.E.1, Safe Harbor I; Prop. Treas. Reg., 2000 Proposed Regulations, § 1.355-7(f)(1), 66 Fed. Reg. at 72.

336. *See supra* Part IV.E.1, Safe Harbor III; Prop. Treas. Reg., 2000 Proposed Regulations, § 1.355-7(f)(3), 66 Fed. Reg. at 72; *Id.* § 1.355-7(f)(4), 66 Fed. Reg. at 72.

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C. *Planning Transactions/Alternatives to Spin-offs*

Despite the overbroad, all-encompassing provision of the newly enacted section 355(e), there remains *Morris Trust* transactions that do not fall within the new provision's reach. For instance, where a distributing parent company exchanges property for its subsidiary's stock, or acquires additional stock in a pre-existing controlled corporation and subsequently distributes the subsidiary's stock to the parent company's shareholders, section 355(e) is disregarded.[337] Shortly thereafter, in an unrelated transaction, if P approaches D to engage in a business transaction, and subsequently merges into P in an "A" reorganization under section 368(a)(1)(A), then section 355(e) will not apply.

Secondly, *Morris Trust* transactions can be consummated if less than 50% of D corporation is obtained. For instance, if an acquiring corporation acquires 49% of a distributing corporation's stock it could acquire some control, but not the requisite 50% or greater interest to trigger section 355(e).[338] Also, because section 355(e) presumes a transaction is part of a plan if the acquisition is within a four-year period beginning two years prior to the section 355 distribution, a distributing corporation *may* not be required to recognize gain under section 355(e) if the acquisition falls outside the four-year window.[339] Even if the acquisition falls within the four-year period, a distributing corporation can avoid section 355(e) if it can establish that the distribution and acquisition were not related.[340]

Section 355(e) is disregarded when a distributing corporation's former shareholders acquire "stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock . . . in such . . . corporation."[341]

> EXAMPLE 16: In order to facilitate P's acquisition of [D], [D] distributes [C]'s stock to [D]'s shareholders. Shortly thereafter, [D] mergers

337. *See* I.R.C. § 355(e)(3)(A)(i) (Supp. IV 1998) (citing types of acquisitions for which section 355(e) will not apply).

338. *See* Stewart, *supra* note 103, at 660–61 (suggesting tax planning strategies for corporations wary of section 355(e) implications).

339. *See supra* notes 190–92 (explaining that the *presumption* of the existence of a plan only occurs when an acquisition takes place within a four-year window, but also noting that the Service is not bound by this four-year window and may still make transactions beyond this period subject to section 355(e)).

340. *See supra* note 64 and accompanying text.

341. I.R.C. § 355(e)(3)(A)(iii) (Supp. IV 1998).

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> into P in a Code section 368(a)(1)(A) reorganization, with the shareholders of [D] receiving [60%] of the stock of P.
>
> Because [D]'s assets were acquired by a successor corporation, P, in an "A" reorganization, Code section 355(e)(3)(B) provides that P's shareholders are treated as having acquired [D]'s stock. Because the P stock acquired by [D]'s former shareholders in exchange for their [D] stock is not taken into account for purposes of applying section 355(e), only [40%] of the stock of [D] was acquired within the meaning of Code section 355(e), and hence [D] does not recognize gain.[342]

The potential for the section 355(e) triple tax is avoided if the distributing corporation is an S corporation.[343] An S corporation is treated as a pass-through entity—that is, S corporation gain recognition is passed through to its shareholders and the shareholders recognize that gain on their personal tax returns.[344] The shareholders' stock bases are then increased by the amount of gain recognized.[345] The stepped-up basis in the stock results in the shareholder not recognizing that amount of gain on any subsequent disposition of his S corporation stock.[346] Therefore, an unfavorable stock distribution that leads to a section 355(e) tax will result in only one level of tax for an S corporation. In contrast, the same distribution will result in two levels of tax for a non-pass-through C corporation.[347] The

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342. GINSBURG & LEVIN, *supra* note 73, at ¶ 1010.1.2.4.2, 10-105 ex. 1.

343. *See* H.R. REP. NO. 105-220, at 531–32, n.13 (1997) (stating that "[t]here is . . . no intention to limit the otherwise applicable provisions of section 1367 with respect to the effect on shareholder stock basis of gain recognized by an S corporation under [the section 355(e) gain recognition] provision"); *see also* I.R.C. §1361 (1994) (defining an S corporation as a "small business corporation for which an election under section 1362(a) is in effect").

344. *See* I.R.C. § 1366 (1994). In a pass-through entity, entity income and loss is attributed directly to the shareholders and not the corporation. *See* PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION OF PARTNERSHIPS AND S CORPORATIONS 405–06 (2d ed. 1997).

345. *See* I.R.C. § 1367 (1994 and Supp. IV 1998) (listing factors for which the "basis of each shareholder's stock in an S corporation shall be increased".

346. *See* I.R.C. § 1001(a) (1994) ("The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.").

347. *See supra* notes 296–98 and accompanying text (discussing two of three levels of

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remainder of a section 355(e) transaction, that is, the drop-down of assets, with a carry-over basis, into a distributing corporation's subsidiary, will result in one more level of tax on the appreciation of those assets if and when they are sold.[348] Thus, a section 355(e) transaction by an S corporation results in two potential levels of tax, whereas the same section 355(e) transaction by a C corporation will result in three potential levels.

Section 355(e)'s effects can be avoided if the percentage of stock owned directly or indirectly by the historic shareholders of a distributing corporation or its controlled corporation immediately before the acquisition is not decreased following the acquisition in a *Morris Trust* transaction.[349]

> EXAMPLE 17: Individual [Z] owns all the stock of [D] and P. [D] owns all of [C's] stock. [D] distributes [C's] stock to [Z] in a transaction otherwise qualifying under Code [section] 355. As part of a plan, [D] then mergers into P. Because [Z] owned directly and indirectly 100% of [D]'s stock before [D]'s merger into P, and owns 100% of [D]'s successor P after [D]'s merger into P, [Z]'s acquisition of [D] stock pursuant to [D]'s merger into P is disregarded, and hence [D] does not recognize gain under Code section 355(e).[350]

Finally, where the business to be kept is not yet separated from the business to be merged, alert tax planners can formulate a strategy that will minimize any resulting section 355(e) tax liability. Because the gain recognition will always be with respect to the controlled corporation's stock, the distributing corporation can distribute to its shareholders stock with a basis fairly close to its fair market value, and the distributing corporation may be able to minimize the gain it must recognize.[351]

> EXAMPLE 18: P corporation operates two businesses, business A and business B. Business A consists of assets with a basis of zero and a fair

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taxation under section 355(e)).

348. *See supra* notes 299–301 and accompanying text (discussing the last of three levels of taxation under section 355(e)).

349. *See* I.R.C. § 355(e)(3)(A)(iv) (Supp. IV 1998).

350. GINSBURG & LEVIN, *supra* note 73, at ¶ 1010.1.2.4.2, 10-105, ex. 2.

351. RIA, *supra* note 89, at ¶ 1501, 358.

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> market value of $100,000. Business B consists of assets with a basis and a fair market value of $100,000. Corporation X wishes to acquire only business A in a transaction to which the gain recognition rules apply.
>
> One approach is for P to contribute business A to newly formed subsidiary S in exchange for S stock, distribute the S stock to P's shareholders, and then have X acquire S. In that case, P will take the S stock with a basis of zero (equal to P's basis in the assets constituting business A), and will therefore recognize $100,000 of gain. Alternatively, P could contribute business B to S, distribute the S stock to P's shareholders, and then have X acquire P. In that case, P will take the S stock with a basis of $100,000 (P's basis in the business B assets), so that no gain is recognized despite application of the new rule.[352]

VI. THE FUTURE OF SECTION 355

Section 355 is a longstanding provision. Some have argued that section 355 should be repealed,[353] with many commentators opposing section 355 because it may be manipulated to take appreciated assets out on a tax-free basis.[354] However, because section 355 offers many more benefits than abuses, it has remained in the Code. While the recent amendments to section 355 were sections 355(d) and (e), future publicized cases, like the recent disguised sales, will most likely incite Congress to make further restrictions. Currently, however, there is nothing on the legislature's table.

Section 355(e)'s advent resulted in a wave of criticism.[355] Since its inception, there have been a myriad of articles and

352. *Id.*, at ¶ 1501, 358–59, Illus. (3).

353. *See* Silverman & Keyes, *supra* note 30, at 296 (noting that section 355 may need to be repealed because it is inconsistent with the general policy reasons for repealing *General Utilities*, that is, to prevent assets from being taken out of corporate solution without the imposition of a corporate level tax).

354. *See* Sloan, *New Loophole*, *supra* note 5, at 37 (criticizing the General Motors transaction that allowed the company to unload assets without paying capital-gains taxes); *see also supra* Part IV.B.3. (describing the General Motors transaction in which it took advantage of the section 355 provisions).

355. *See* Michael L. Schler, *Fate of the Proposed Spinoff Regulation Remains Unknown*, N.Y.L.J., Mar. 6, 2000, at 7 (commenting that the regulations proposed under section 355(e) were also vehemently opposed).

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commentaries criticizing the sweeping provisions and apprehending the chilling effects section 355(e) will have on future *Morris Trust*-type transactions.[356] Critics futilely implored the Administration to write section 355(e) out of the Code.[357] Because tax experts are continually criticizing section 355(e)'s amorphous provisions, it should be amended to clarify any ambiguities, and to narrowly tailor its application.

VII. CONCLUSIONS

Proponents of section 355 endorse its longevity because it promotes economic efficiency and encourages expansion in an extremely competitive market. Section 355 should be retained because it promotes economic efficiency and encourages expansion in an extremely competitive market.[358] But equally important, it defers taxes because a "mere change in form" is not the appropriate juncture for tax recognition.[359] Opponents of section 355 disapprove of how inventive tax planners have wielded it to take cash or appreciated assets out of a corporation tax-free.[360] Accordingly, these critics are pushing for section 355's demise.[361] In reality, section 355 is probably here to stay, but as the recent bills indicate, there is a chipping away of its provisions.

The 2000 Proposed Regulations attempt to provide a moderate compromise for the spin-merge transactions, and certainly the revised regulations' modifications provide more guidance than its 1999 counterpart. However, questions still arise regarding what transactions will taint the eventual sale of the Distributing or Distributee corporation. Corporate tax advisors are requesting that the proposed regulations provide

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356. *See, e.g.*, *id.* (noting that section 355(e) "creates many practical problems for taxpayers . . . because of the vagueness of the 'plan' concept, as well as the [statutory] presumption," and concluding that as "result of these uncertainties, there would be a risk of tax liability on [a] Distributing [corporation] any time there was a 50% change in ownership of either [the] Distributing or Controlled [corporation] within two years after [a] spin-off").

357. *See id.* at 7.

358. *See* STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION Ch. 10 (4th ed. 1997) (describing how Congress intended section 355 to provide corporations with a tax-free mechanism to achieve a division divestiture that would be economically wise to undertake except for the prohibitive tax cost that would otherwise be incurred on a sale of that division).

359. *See supra* note 55 (noting that Congress intended to limit nonrecognition to those corporations that had a division comprising of a "mere change in form").

360. *See* Sloan, *New Loophole*, *supra* note 5, at 38 (fearing that if the "Loophole passes its road test, any company could use it to dispose of businesses tax-free").

361. *See* Sloan, *New Loophole*, *supra* note 5, at 37–38 (noting that even though section 355 might be good for a corporation, it is not good for the country, and thus should be abolished).

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guidance about which types of negotiations will be allowed,[362] and until further guidance is provided, are weary that *any* discussions of a possible spin-merge would fall within 355(e).

Section 355 should continue to be a way to divide up a company tax-free, but should not be tolerated to affect a sale of that company's assets. This is what happened in certain *Morris Trust* transactions that prompted Congress to pass the severe section 355(e) provisions.

362. *See, e.g.*, Willens, *Re-proposed*, *supra* note 232, at 80 ("The question of when the requisite reasonable certainty exists, and the role of internal discussions (regarding an acquisition), both need to be substantially clarified if, as the drafters intended, taxpayers and their advisers are going to be able to plan transactions with the appropriate degree of certainty and predictability.").