NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON PROPOSED REGULATIONS DEALING WITH "PREDECESSORS" AND "SUCCESSORS" IN SECTION 355(e)

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New York State Bar Association
Tax Section

Report on Proposed Regulations Dealing with "Predecessors" and "Successors" in Section 355(e)

This report, prepared by the Corporations Committee of the New York State Bar Association Tax Section[1] comments on Proposed Regulations that provide guidance regarding predecessors and successors under Section 355(e)[2] (the "Proposed Regulations"), and responds to the related request for comments relating to the application of Section 355(e) to partnership transactions.

I. Introduction

Section 355(e) applies to corporate distributions of the stock of a controlled subsidiary ("Controlled") otherwise intended to be tax-free under Section 355. Section 355(e) generally requires the distributing corporation ("Distributing") (but not the shareholders) to recognize gain with respect to the distribution if the distribution is part of a plan (or series of related transactions) involving the acquisition of 50% or more of the stock (by vote or value) of either Distributing or Controlled.[3] Section 355(e)(4)(D) states that "any reference to a

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[1] The principal drafter of this report was Kathleen Ferrell with assistance from her colleagueYakov Mirocznik. Larry Garrett, Karen Gilbreath, David Hariton, Deborah Paul, Jodi Schwartz and David Sicular also contributed to this report.

[2] 69 F.R. 67,873 (Nov. 22, 2004). Section references are to the Internal Revenue Code of 1986 unless otherwise noted.

[3] One might observe that the statutory "penalty" for planning a transaction that runs afoul of § 355(e), i.e., treating stock of the controlled corporation as not constituting "qualified (…continued)

controlled corporation or a distributing corporation shall include a reference to any *predecessor* or *successor* of such corporation."[4] The terms "successor" and "predecessor" are not defined, and so are not statutorily limited to carryover basis transactions or transactions involving substantially all the assets of a particular entity. The statute also does not prescribe a scope for the application of the predecessors and successors concept, for example, limiting its application to circumstances that might otherwise permit avoidance of Section 355(e).

Generally, the Proposed Regulations are intended to limit the potential application of these statutory rules.[5] A "predecessor" is, in effect, defined as a notional entity which generally exists only where Distributing acquires assets with a carry over basis and subsequently divides those assets between Distributing and Controlled, or those assets include stock of Controlled. The definition of "successor" is limited by the Proposed Regulations to situations in which Distributing or Controlled transfers assets in a transaction governed by Section 381. The Proposed Regulations require separate tracking of changes (or deemed changes) in the ownership of predecessors, successors, Distributing and

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property" for purposes of § 355(c)(2) or § 361(c)(2), may have nothing to do with the gain inherent in the assets of the corporation whose stock has been the subject of the offending acquisition.

[4] § 355(e)(4)(D) (emphasis added). Additionally, § 355(e) uses the term "successor" corporation two other times (§ 355(e)(3)(A)(iii) and § 355(e)(3)(B)). This provision does not appear to address any particular fact pattern considered by the drafters but is more in the nature of "boilerplate" that has been included in a number of modern Code provisions. *See*, *e.g.*, §§ 384(c)(7), 382(l)(8) and 4985(e)(2)(A). Similar provisions appear in several regulations. *See*, *e.g.*, §§ 1.367(e)-1(c)(3)(vi); 1.1275-6(g); 1.1502-1(f)(4). *See also* Zarlenga & Spencer, *Who Proceeds and Who Succeeds: New Anti-Morris Trust Proposed Regulations*, 107 Tax Notes 351 (Apr. 18, 2005) (analyzing various definitions and treatments of predecessors and successors throughout the Code and Treasury Regulations).

[5] *See* 69 F.R. 67,873 at 67,874 (Nov. 22, 2004) (hereinafter, "Preamble").

Controlled, and provide rules for determining the amount of gain that must be recognized where there has been an actual or deemed acquisition of a 50% or greater interest in the stock of a predecessor or successor that occurs pursuant to a "plan." The Proposed Regulations do not, however, elaborate upon the application of the "plan" rules in this context.

The Proposed Regulations address an important guidance need. Among other things, the undefined references to "predecessor" and "successor" obscure the potential reach of Section 355(e). As noted above, the Code does not state whether these terms might include noncorporate entities, whether the transferor or transferee of only a portion of an entity's assets might be included, nor whether transferors and transferees in taxable transactions might be "predecessors" or "successors." Broad literal application of the statutory language could lead to absurd results, including for example, in the case of "predecessors," triggering hundreds of millions of dollars of corporate level gain on a spin off because, as part of a plan including the spin off, Distributing acquired, for a small amount of its stock, the assets of an insubstantial Target (the supposed predecessor) by way of merger into Distributing. Pursuant to Section 355(e)(3)(B), the shareholders of Distributing corporation would be deemed to acquire 100% of the stock of Target. Thus, there literally could be an acquisition of 100% of the stock of a "predecessor" of Distributing as part of a plan that includes the distribution,

arguably yielding the result that the spin off would be taxed at the corporate level.[6]

II. Summary of Comments

The Proposed Regulations are a thoughtful approach to the technical issues created by the statutory language to the effect that references to a corporation must be read as also including a reference to any "predecessor" or "successor" of such corporation. As a general policy matter, we believe it is the correct approach to limit the scope of the "predecessor" and "successor" concept, but we note that the failure of the Proposed Regulations to address the application of the "plan" rules, especially in the predecessor context, leaves the scope of these rules uncertain.

In the case of predecessors, the Proposed Regulations focus on gain recognition with respect to particular assets the ownership of which has changed as part of a divisive transaction. This approach will require separate tracking of acquisitions of interests in Controlled and the notional predecessor entity within Controlled.[7] In addition, application of the gain recognition rules will create new tracing requirements and the potential for valuation disputes not otherwise present in the fact patterns involved. We believe administrability of these rules could be enhanced by the adoption of de minimis rules. Many of these problems also

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[6] It is not clear that a court properly presented with the issue would find that the statute compels this result. We recommend that the examples in the Proposed Regulations be revised to avoid the implication.

[7] As a technical matter, this separate tracking seems to be required even where there was no change of ownership of the relevant assets as a result of the combining transaction.

could be ameliorated by providing more specific guidance on the application of the "plan" concept in this context.[8]

In addition to the potential for substantive complexity, the Proposed Regulations suffer somewhat from confusing drafting. We recommend that the final regulations be drafted to be more accessible to readers, and where possible dispense with fictions and detailed technical rules in favor of a statement of the principles to be applied.

Finally, as discussed more fully below, the asset-focused view that underlies the Proposed Regulations has important implications for the application of Section 355(e) to partnership transactions as well as other transaction patterns that involve changes in the indirect ownership of assets without any actual acquisition of stock of Controlled or Distributing corporation. We recommend that this approach not be expanded to apply generally any time assets of Distributing or Controlled are transferred with a carryover basis to a corporation or partnership.

III. Discussion of Proposed Regulation

General Approach to Predecessors

The Proposed Regulations properly reject the notion that Section 355(e) should apply any time Distributing or Controlled has acquired the assets of another corporation in a carryover basis transaction that was part of a plan with the distribution. As noted above, it is arguable that the statute literally produces

[8] Unfortunately, the final "plan" regulations provide only limited guidance with respect to acquisitions preceding a spin off generally, and do not address application of the concept in the context of the acquisition of a target that might fit within the "predecessor" definition. *See* Treas. Reg. § 1.355-7.

this result because there would have been a deemed acquisition of 100% of the stock of a predecessor corporation (by reason of the tax-free acquisition of its assets in a reorganization). The policy judgment reflected in the Proposed Regulations is that the predecessor concept should only be relevant where the purpose of Section 355(e) is implicated; that purpose is described as preventing tax-free division of corporate assets coupled with a planned acquisition of a 50% or greater interest in Distributing or Controlled or their predecessors.[9] With this focus in mind, the Proposed Regulations define "predecessor" of Distributing in a way that generally applies Section 355(e) to tax the built-in gain of the portion of Target assets that are distributed with Controlled (and any Controlled stock that was acquired as an asset of Target), where less than all the Target assets are contributed by Distributing to Controlled.

Definition of Predecessor

Specifically, pursuant to the Proposed Regulations, a corporation will be a predecessor of Distributing if it transfers property to Distributing in a transaction to which Section 381 applies (for example, a type "A", "C" or "D" reorganization, or a liquidation pursuant to Section 332) (the "combining transfer"), and either: (1) Distributing transfers some but not all of the acquired assets to Controlled (or

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[9] This approach suggests the use of Section 355(e) to police gaps in the rules for acquisitive reorganizations. If target assets are acquired in a purportedly tax-free transaction that is part of a plan to divide the assets of the target in connection with a distribution under § 355, the plan to so divide the assets would have to be taken into account in determining whether the COBE rules (and "substantially" all requirements if applicable) are satisfied. The Proposed Regulations effectively apply § 355(e) to address circumstances under which Target's assets may be acquired in a carryover basis transaction notwithstanding distribution of some of those assets to the acquiror's shareholders as part of the distribution of Controlled. While it is appropriate for Treasury to interpret § 355(e) in a way that prevents abuse, in the absence of "plan" guidance it is not clear that the Proposed Regulations are so focused.

in certain specific circumstances a predecessor of Controlled), and the basis of such property in the hands of Controlled is determined in whole or in part by reference to the basis of such property in the hands of Distributing; [10] or (2) the acquired assets include stock of Controlled, and Distributing does not transfers all of the acquired assets (other than Controlled stock) to Controlled.[11]

The concern addressed by the Proposed Regulations seems to be that the predecessor (whose stock is deemed to have been acquired by the shareholders of Distributing at the time of the "combining transfer"[12]) is constructively effecting a spin off when its assets are divided between Controlled and Distributing in the "separating transfer."[13] The Proposed Regulations would not identify a "predecessor" if Controlled receives *all* of the assets of a target, or if Distributing does not transfer any of the acquired assets to Controlled, other than in the case where the transferee's assets include stock of Controlled. In that case, even if Distributing transferred no acquired assets to Controlled, the distribution of C stock itself would lead to a tax-free division of the assets of the predecessor.[14]

Recognizing the substantial complexity involved in permitting the rules to contemplate predecessors of predecessors, the Proposed Regulations make it clear that a corporation that transfers property to a predecessor of Distributing is not

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[10] *See* Prop. Treas. Reg. § 1.355-8(b)(1)(i) (hereinafter "§ 1.355-8").

[11] § 1.355-8(b)(1)(ii).

[12] § 1.355-8(d)(1).

[13] *See* Preamble at 67,874.

[14] *Id*.

itself a predecessor of Distributing.[15] However, more than one corporation may be a predecessor of Distributing.[16] Finally, the Proposed Regulations include a substitute asset concept pursuant to which assets received in exchange for acquired assets in a transaction in which gain or loss is not recognized in whole, are also treated as assets acquired from the predecessor in the "combining transfer".[17]

Given the focus on situations that might otherwise permit the tax-free division of predecessor assets, a definition of a predecessor of Controlled is for the most part unnecessary as, generally, Controlled cannot divide property tax-free between itself and Distributing in the same way as Distributing can.[18] However for certain technical purposes, a corporation that transfers property to Controlled in a transaction to which Section 381 applies will be a predecessor of

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[15] § 1.355-8(b)(3). The preamble explains that the IRS and Treasury "recognize that such transfers of assets to a predecessor may be part of the plan that includes the distribution," but were concerned about the "substantial complexity" of a contrary rule. Nonetheless, the Service intends to continue to consider whether such corporations should be treated as a predecessor of Distributing. *See* Preamble at 67,874.

[16] § 1.355-8(b)(4)(iii). This could happen where more than one corporation transferred property to Distributing in a transaction to which Section 381 applied.

[17] § 1.355-8(b)(4)(i). For example, assets acquired in exchange for acquired assets in a § 1031 exchange would retain the acquired assets taint.

[18] One notable exception would be where Controlled dropped some of the acquired assets into a corporation and spun it off to Distributing. However, in this case Controlled is functionally a distributing corporation, and could then itself implicate the definition of a predecessor of Distributing.

Controlled.[19] One application of this special rule applies to identify a predecessor of Controlled in order to identify a predecessor of Distributing.[20]

Special Gain Limitation Rules

As noted, the enacted version of Section 355(e) requires Distributing to recognize the full gain inherent in the Controlled stock on the date of distribution if the distribution and an acquisition of a 50% or greater interest in the stock of Distributing or Controlled are part of a plan. The Proposed Regulations provide three special gain limitation rules in the case of transactions that divide the assets of a predecessor between Distributing and Controlled where there is also an acquisition (or deemed acquisition) of a 50% or greater interest in the stock of the predecessor or Distributing. The first rule, which applies in the case of a 50% or greater acquisition of an interest in the predecessor, triggers gain only with respect to the separated predecessor assets, rather than the entire gain on Controlled stock. For example, assume that T, which is smaller than Bigco,

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[19] This rule applies solely for the purpose of calculating the gain limitations of § 1.355-8(e)(2), the special affiliated group rule of § 1.355-8(f), and for determining whether a corporation is predecessor of Distributing under § 1.355-8(b)(1).

[20] For example, assume T, which owns the stock of X, merges into D, which owns the stock of C. T shareholders receive D stock and cash in an "A" reorganization. Thereafter, D causes X to merge into C in a "D" reorganization. D then distributes the stock of C pro rata to its shareholders. In this case, if the definition of a predecessor of Distributing were applied alone, without the definition of a predecessor of Controlled, neither of the two definitions of a predecessor would be implicated: § 1.355-8(b)(1)(i) requires that the basis of the acquired property in the hands of Controlled must be determined by reference to the basis that Distributing had in such property, however, D had basis only in the stock of X, not in the assets of X, while C, after the "D" reorganization only has basis in the former assets of X and not the stock of X; § 1.355-8(b)(1)(ii) requires that the acquired assets include stock in C, and absent the predecessor of Controlled definition, the acquired assets included no such stock. However, since X is a predecessor of C (it transferred its assets to C in a "D" reorganization – a Section 381 transaction), the stock of X is deemed to be stock in a predecessor of C. Consequently, the property acquired by D from T, included stock in a predecessor of Controlled. Thus, under Section 1.355-8(b)(1)(ii), T is a predecessor of D, because T transferred property including stock in a predecessor of C, and D did not transfer all of the acquired assets received to C.

conducts two businesses in division form: the widget business and the service business. If T were to drop the service business into Newco and spin it off to the T shareholders, followed by Bigco's acquisition of T pursuant to a plan, Section 355(e) would apply to tax T on the distribution of the service business. If instead, T were to approach Bigco and suggest that Bigco acquire T for less than 50% of Bigco's stock, then drop the service business into Bigco's Newco, or Bigco's existing subsidiary Controlled, then spin off Newco (or existing Controlled), how should Section 355(e) apply? The Proposed Regulations would apply Section 355(e) to require corporate level gain on the distribution of Controlled, but only to the extent of built-in gain with respect to the predecessor's service business.[21]

The second gain limitation rule in the Proposed Regulations applies where an acquisition of T (the predecessor) by a smaller D (resulting in a 50% or greater acquisition of D by T shareholders) is followed by a distribution of Controlled. In that "reverse acquisition" case, the Proposed Regulations provide the symmetrical result that D's Section 355(e) gain relates only to the historic Controlled assets and does not include built-in gain attributable to Target assets transferred to Controlled.[22]

In effect, if there is an actual 50% or greater acquisition of stock of Distributing in connection with the "predecessor" transaction, but the "predecessor" could have spun off the separated assets prior to combining with Distributing without triggering Section 355(e) (apparently without regard to

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[21] § 1.355-8(e)(2)(i).

[22] § 1.355-8(e)(3).

whether Section 355 could have applied generally) the gain triggered will exclude the gain on the separated predecessor assets. Finally the rules limit the total amount of gain that may be recognized to the gain inherent in the C stock on the date of the distribution.[23]

As discussed more fully below, while we believe these rules generally reach the right policy result, the fictions employed by the regulations to implement the special gain limitation rules are somewhat confusing. More important, application of these special gain limitation rules may pose a number of administrative difficulties, including requirements for tracing assets and valuing assets at a point in time later than the arm's length transaction in which the assets of the predecessor (or the entity that becomes the predecessor) were acquired. We are also concerned that by virtue of their technical nature, these rules may also present substantial tax planning opportunities. In addition, we note that the basic gain recognition rule with respect to predecessors may be harsh where substantially all, but not 100% of the predecessor's assets are transferred to Controlled.

Application of the "Plan" Rules to Predecessors

The Proposed Regulations define "predecessor" without regard to whether the distribution of Controlled, the acquisition of assets by Distributing in the "combining transfer" (if this does not occur at the time of the original

[23] § 1.355-8(e)(4).

acquisition),[24] or the division of the target's assets between Distributing and Controlled was envisioned at the time of the original acquisition of the predecessor entity. Presumably, Section 355(e) and the Proposed Regulations would operate to require gain recognition with respect to predecessor assets transferred to Controlled only if the deemed acquisition of a 50% or greater interest in the predecessor (which technically occurs at the time of the "combining transfer") was effected pursuant to a "plan" including the distribution. The Proposed Regulations do not otherwise attempt to explain how the "plan" concept is intended to apply in this context.

As an analytical matter, the Proposed Regulations would be improved by including the "plan" concept in the definition of predecessor. As currently drafted, the Proposed Regulations seem to contemplate the possibility that an acquired entity (or even an historic subsidiary) can become a "predecessor" (which, other than in the case where the predecessor assets include Controlled shares, technically requires that there be a "separating transfer") at some time after a "combining transfer", and that it might not be known at the time of the original acquisition of the entity and/or its assets whether it will later become a predecessor by reason of such a "separating transfer". The structure of these rules thus leaves open the possibility that it is only the "separating transfer" itself, which retrospectively precipitates an acquisition of a predecessor of Distributing,

[24] For example, D could produce a predecessor by acquiring the stock of T, in a taxable or tax-free acquisition, then later liquidating T (the "combining transfer") and dividing the assets between D and C (the "separating transfer").

that need occur pursuant to a "plan," particularly if the plan concept adopted in this context relates only to the intentions of Distributing.

> **Example**: Assume that D acquires the assets of X pursuant to a tax-free merger prior to forming a plan to spin off C. Under the Proposed Regulations, X will be a predecessor of D if D divides the assets of X between itself and C in a carryover basis transaction. Assume that at the time of the acquisition of X, D had no intention to divide X's assets. Nevertheless, in response to unanticipated business developments, D decides to spin off C, and in connection with that plan D contributes a portion of X's assets to C immediately before the spin off of C.

We do not believe that the Proposed Regulations were intended to impose upon companies the burdensome task of having to trace assets following any acquisition of a target corporation just in case some of the target's assets wind up in Controlled. Accordingly, the fact that the division of the assets of X (which is the "separating transfer" that results in "predecessor" status) occurs pursuant to a plan, should not be sufficient, standing alone, to constitute a plan that triggers Section 355(e) consequences. We recommend that the Proposed Regulations be revised to specifically incorporate the "plan" concept so that the rules would identify a "predecessor" only if the "combining transfer" and the "separating transfer" are both part of a plan with the distribution. Additional guidance should address which formulation of the plan rules are relevant for these purposes.

The final "plan" regulations provide some additional guidance with respect to acquisitions preceding a spin off generally, but they do not address the circumstances under which the deemed acquisition of the stock of a predecessor by Distributing's shareholders will be considered to be part of a plan with the

distribution.[25] It would be helpful for the "plan" regulations to be supplemented with safe harbors and "plan" and "non-plan" factors tailored for this purpose, taking into account the fact that Distributing, as acquiror, will always have knowledge of Distributing's own intentions to effect a distribution that includes predecessor assets, but will not always need to communicate those intentions to the target/predecessor. For example, where Distributing acquires the stock of Target for cash, intending to liquidate Target and separate its assets in connection with the distribution of Controlled, it would not appear to be relevant whether Target or its shareholders were aware of Distributing's intentions. Existence of a plan might rather turn, in these circumstances, on whether officers and directors of Distributing had discussed with investment bankers a plan for a distribution that would include Target assets. On the other hand, where stock of Distributing is issued in exchange for Target assets, we believe the deemed acquisition of predecessor stock (as well as the actual acquisition of Distributing stock) is not likely to be part of a plan if the intention to effect a distribution has not been disclosed to the new shareholders of Distributing. Accordingly, we believe a safe harbor crafted along the lines of Safe Harbor VI in the final "plan" regulations would appropriately address such circumstances.[26] Finally, we also recommend that consideration be given to promulgating a safe harbor for acquisitions of

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[25] *See* Treas. Reg. § 1.355-7.

[26] *See* Treas. Reg. § 1.355-7(d)(6). Safe Harbor VI provides that a distribution and an acquisition involving a pre-distribution public offering are not part of a "plan" if the acquisition occurs before the date of the first disclosure event regarding the distribution in the case of non-publicly traded stock, or before the date of the first public announcement regarding the distribution in the case of publicly traded stock.

predecessors occurring more than a certain amount of time (say 6 months or a year) before the distribution. We think this would be particularly appropriate where the "separating transfer" is only incidental to the business purpose otherwise underlying the acquisition of Target and/or its assets.

In addition to tailoring the "plan" rules to fit predecessor fact patterns, the Proposed Regulations should be revised to clarify that a "combining transfer" that does not result in a change in the indirect ownership of the assets involved will not ordinarily give rise to an acquisition that "counts" for purposes of Section 355(e). This point is discussed below.

What Acquisitions are Taken into Account

In addition to clarifying the application of the "plan" concept for predecessor acquisitions, the Proposed Regulations should be revised to clarify the circumstances under which an "acquisition" for purposes of Section 355(e) is deemed to occur. Specifically, we do not believe the Proposed Regulations were intended to find an "acquisition" cognizable by Section 355(e) in cases in which the combining transaction occurs with respect to a wholly owned subsidiary the shares of which were *not* acquired pursuant to a plan. The regulations should be revised to clarify that a "combining transfer" results in a deemed "acquisition" of the stock of the predecessor for purposes of Section 355(e) that "counts" for purposes of Section 355(e) only to the extent the indirect ownership of the acquired assets changes, unless the stock of T was earlier acquired pursuant to a plan.[27] We believe this is consistent with the rule in the Proposed Regulations

[27] *See* § 355(e)(3)(A)(iv).

that provides that an acquisition of Distributing (or a successor) that occurs after Distributing's combination with a predecessor will be taken into account not only as an acquisition of Distributing, but also as an acquisition of the predecessor.[28] This rule is necessary only if there can be circumstances in which the "combining transfer" results in a less than 50% deemed acquisition.

> **Example 1**: Distributing directly conducts two lines of business, "A" and "B," and has a historic subsidiary "Sub" which holds intangible assets used in the conduct of both the "A" and "B" businesses, as well as other business assets used in the conduct of the "C" business. As part of a plan involving the spin off of the "A" business, Distributing causes Sub to be liquidated into Distributing. Distributing then forms Controlled by contributing the assets related to the "A" business and then distributes the stock of Controlled pro rata to its shareholders. Under the Proposed Regulations, Sub is a predecessor of Distributing.
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> **Example 2**: Distributing directly conducts two lines of business, "A" and "B." Prior to forming a plan to spin off the "A" business, Distributing acquires the stock of X (which then is renamed "Sub"). In response to unanticipated business developments, D decides to spin off the "A" Business. As part of a plan involving that spin off, Distributing causes Sub to be liquidated into Distributing. Distributing then forms Controlled by contributing Sub assets related to the "A" business, and then distributes the stock of Controlled pro rata to its shareholders. Under the Proposed Regulations, Sub is a predecessor of Distributing.

We do not believe that Section 355(e) should apply in either of the examples above to trigger gain with respect to so much of Sub's assets as were transferred to C. Under the structure of the Proposed Regulations as currently

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[28] § 1.355-8(d)(1)(ii).

drafted, the correct result could be produced by clarifying that D's shareholders are already deemed to own the shares of the "predecessor," so long as the shares of Sub were not acquired pursuant to a plan, so that the "combining transfer" does not result in an acquisition that must be taken into account for purposes of Section 355(e). The definition of predecessor could also be revised to preclude application to wholly owned subsidiaries (or perhaps at least 80% owned subsidiaries) the stock of which was not acquired pursuant to a plan.

"Section 351" Fiction for Acquisitions of Predecessors Where no 50% or Greater Acquisition of Distributing

The first gain limitation rule of the Proposed Regulations applies in the case of an acquisition of a 50% or greater interest in a predecessor where there is not also an acquisition of a 50% or greater interest in Distributing. In this case, the Proposed Regulations provide that Distributing is required to recognize only the amount of gain, if any, that the predecessor would have recognized if, immediately before the distribution, the predecessor had transferred the acquired assets[29] that were transferred to Controlled (including any stock of Controlled that it transferred to Distributing) to a newly formed, wholly owned corporation solely for stock of such corporation in an exchange to which Section 351 applied (even if Section 351 could not actually have applied), and then sold the stock to an unrelated person in exchange for cash equal to its fair market value.[30] For this

[29] If the acquired assets were transferred by either Controlled or Distributing, in a transaction in which gain or loss is not recognized in whole, the property received in exchange by Controlled or Distributing, would be treated as acquired assets for the purposes of this gain limitation calculation. § 1.355-8(e)(2)(ii)(A).

[30] § 1.355-8(e)(2)(i).

purpose, the basis of the property (other than Controlled stock) deemed transferred in the fictional Section 351 transaction is the basis in the hands of Controlled immediately before the distribution.[31]

It appears that one purpose of the Section 351 fiction may have been to produce a netting result. However, it is not at all clear whether the fiction is intended to have other technical consequences. For example, do the loss importation rules of Section 362(e) apply? We are concerned that this fiction may raise technical issues (and perhaps opportunities) unintended by the drafters. We would suggest that the rule simply state that, with respect to predecessor assets transferred to Controlled, the gain recognized is measured by the difference between the aggregate basis in those assets in Controlled's hands and the aggregate fair market value of those assets on the date of (or immediately before) the distribution. In the case of Controlled stock, there is no apparent purpose for the fiction.

Other Comments on Gain Recognition Rules

The application of the special gain limitation rules will generally require the tracing and valuation of assets, which may prove burdensome in some circumstances. Under the Proposed Regulations, for purposes of determining the gain to be recognized upon the distribution, the basis and fair market value of transferred assets is generally determined as of the time of the distribution, while the basis and fair market value in stock of Controlled transferred from the

[31] § 1.355-8(e)(2)(ii)(B).

predecessor are determined as of the time of the "combining transfer."[32] While the different treatments may be sensible, (for example, to allow investment basis adjustments in Controlled stock to be disregarded when determining the Section 355(e) penalty) this is a complication that may require Distributing to keep a record of the initial basis and fair market value of any subsidiary stock that Distributing purchases, just in case the subsidiary is ultimately spun off.

In addition, the rules might be viewed as harsh where substantially all, but not 100% of the predecessor's assets are transferred to Controlled. Perhaps in this case the purposes of the Proposed Regulations would be served by permitting the taxpayer to elect to "flip the fiction" and treat the predecessor assets retained by D as having been distributed by C to D.

General Approach to Successors

The Proposed Regulations define a "successor" of Distributing or Controlled as any corporation to which either transfers property after the distribution in a transaction to which Section 381 applies.[33] Significantly, the Proposed Regulations limit the definition of "successor" to other corporations,[34] and so do not purport to deal with post-distribution transfers to partnerships or corporations that receive assets in a transaction to which Section 381 does not apply (e.g., transfer pursuant to § 351 that is not also a "D" reorganization.) Unlike the case of a predecessor, a successor of a successor may be a successor of

[32] § 1.355-8(e)(2)(ii).

[33] § 1.355-8(c)(1).

[34] Id.

either Distributing or Controlled.[35] Additionally, more than one corporation may be a successor of either Distributing or Controlled.[36] We believe that the Proposed Regulations appropriately limit the reach of the successor concept. As discussed below, we would recommend that this approach not be expanded to track ownership changes in every case in which Distributing or Controlled contributes assets downstream, notwithstanding the possibility that a third party might thereby acquire a 50% or greater interest in those assets.

IV. Partnership Transactions

The Proposed Regulations request comments on the extent to which Section 355(e) should be applied to transfers of assets to a partnership or a corporation by Distributing or Controlled.[37] As a technical matter, Section 355(e) applies as a result of acquisitions of stock of Distributing or Controlled, or deemed acquisitions of stock of either by reason of a successor corporation having acquired assets. In a prior report,[38] we noted the potential to use the partnership form to replicate the specific kind of transaction at which Section 355(e) appears to have been aimed, but argued against dealing with this issue by treating all transferee partnerships as "successors." We would, however, support anti-abuse rules that apply Section 355(e) to asset transfers to a corporation or partnership in

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[35] § 1.355-8(c)(2). This is by default. There is only an explicit rule for a predecessor of a predecessor.

[36] This could happen where Distributing or Controlled transferred property to more than one corporation in a transaction to which § 381 applied.

[37] Preamble, at 67876.

[38] See NYSBA Tax Section Report No. 1046 (Jan. 13, 2004), *reprinted at* 2004 TNT 41-59.

cases in which the transactions are structured to achieve the functional equivalent of an acquisition of more than 50% of the vote or value of the *stock* of Distributing or Controlled (which we think means more than an interest in their assets.)

We do not believe that the purposes of Section 355(e) require that the successor concept be extended to every situation in which Distributing or Controlled transfers assets to a partnership or to a corporation (in transactions other than those to which Section 381 applies). If it is determined that guidance is needed in this area, rather than potentially treating all such transferee corporations or partnerships as successors of Distributing or Controlled, the guidance should focus on circumstances in which an acquisition of a partnership interest or of stock in a lower-tier corporation is tantamount to an acquisition of stock of Distributing or Controlled, or should be treated as an option to acquire stock of Distributing or Controlled. We believe those instances should be relatively circumscribed. Consider the following example:

> **Example**: D owns all of the stock of C. C contributes a significant portion but not substantially all of its assets to new partnership P in exchange for a managing interest in P which meets the requirements of Revenue Ruling 92-17 and Revenue Ruling 2002-49 (which address the circumstances under which the 5-year active trade or business requirement of Section 355(b) is satisfied by reason of the holding of an interest in a partnership or limited liability company.) The assets C has retained are also assets used in a business that may or may not also satisfy the Section 355(b) test. At the same time, A, an unrelated third party, contributes business assets to P in exchange for a greater than 50% economic

interest in P. Pursuant to a plan, D distributes all of the stock of C to its shareholders.

The asset-based approach of the Proposed Regulations could be extended to the example above to deem the C assets contributed to P as having been contributed to a Newco "successor" of C, whose assets are acquired by P in a carryover basis transaction. Applying the deemed stock acquisition rule of Section 355(e)(3)(B), A could be deemed to have acquired a greater than 50% interest in the stock of a "successor" of C. Applying the approach in the Proposed Regulations, gain would be triggered for D on the built-in gain inherent the "successor" assets.[39]

However, we do not believe that there is any compelling reason to apply Section 355(e) in this manner.[40] First, as a technical matter, there has not been an acquisition by an unrelated third party of the *stock* of C or D – the transaction form Section 355(e) was originally intended to police. Furthermore, in the

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[39] The following examples further illustrate how the principles of the Proposed Regulations could be (but we think should not be) extended generally to non-abusive partnership transactions.

Example 1. D conducts business H and owns 100% of the stock of C. C, directly and indirectly through a JV with X, conducts the G business. The JV was formed five years ago by C and X each of which contributed business assets. C is the managing member. C's directly held assets are worth 80x and C's interest in the JV is worth 20x. X's interest in the JV is worth 80x. For valid business reasons, D spins C pro rata to its shareholders. As part of a plan including the distribution, C contributes 40x of its directly held assets to the JV, increasing C's interest and decreasing X's interest, so that C and X each hold a 50% interest in the JV. Under an extension of the approach in the Proposed Regulations, even though X's interest in the JV has actually declined, X would be deemed to have acquired a 50% interest in the stock of a "successor" of C.

Example 2. Assume instead of contributing 40x, C instead contributes 70x of its directly held assets to the JV, increasing C's interest to 73 1/3% and decreasing X's interest to 26 2/3%. As part of the same plan C issues to Y a 30% voting preferred stock in C for cash. Under an extension of the approach in the Proposed Regulations, X and Y each would be deemed to have acquired a 26 2/3% interest, and a 30% interest, respectively, in the stock of a "successor" of C.

[40] We believe that results should be the same if P were formed as described above following the distribution.

absence of arrangements that permit the holders of interests in the transferee to control the transferor, we do not believe it is appropriate to find a deemed stock acquisition where less than substantially all the business assets have been transferred to the transferee entity. In such a case, ownership and control of the stock of the transferor entity is economically different from ownership and control of the interests in the transferee entity. Although the approach of the Proposed Regulations may be a sensible way to deal with the "predecessor" problem, we do not ascribe to the view that Section 355(e) demands more broadly that corporate level gain should be triggered with respect to assets the indirect ownership of which is changed by 50% or more as part of a plan or series of related transactions that includes a purported Section 355(a) transaction. We believe that Subchapter K already adequately polices disguised sales through Sections 707 and 737, and fixes the location of gain through Section 704(c). Furthermore, it seems to us that the rules of Revenue Ruling 92-17, Revenue Ruling 2002-49 and Section 355(b) already appropriately address the concerns raised by the transfer of business assets by D or C to a partnership.

On the other hand, if C contributed substantially all of its assets to the partnership, and in connection with its receipt of the P partnership interest, A also entered into a governance agreement with respect to C such that there were no meaningful legal or economic differences between owning stock of C or interests in P, it may be appropriate to treat A's acquisition of the partnership interest as an "indirect" acquisition of the stock of C. In cases in which a partnership interest is structured to include a right to exchange the partnership interest in P for stock

of C, we think the general rule should be that the option rules contained in Treasury Regulation section 1.355-7(e) apply to determine whether the actual exercise of that right results in an acquisition of the stock of C pursuant to a plan. However, there may be cases in which an exchange right is coupled with other arrangements that effectively permit A to control C. In those circumstances, we believe it might be appropriate to treat such an arrangement as resulting in an "indirect" acquisition of the stock of C. We believe the same principles should apply if P were a corporation rather than a partnership and the asset transfers by C and A to P qualified as Section 351 transactions rather than Section 721 transactions.