New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200

NYSBA

December 8, 1998

The Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report of the New York State Bar Association Tax Section recommending guidance in defining the scope of a "plan" under section 355(e) of the Internal Revenue Code. Our report contains two principal recommendations:

1. We recommend that a relatively narrow definition of "plan" be adopted. We believe that a "plan" should exist only when, at the time of the distribution, there is some mutual expectation on behalf of both parties to the transaction, evidenced through some concrete action, that an acquisition of control will occur. Informal contacts, internal analyses and unilateral intentions should not be evidence of a "plan".

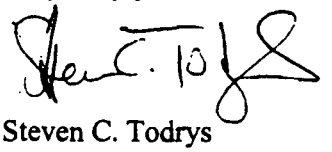
2. Because of the potentially disastrous tax consequences of violating section 355(e), we expect that taxpayers will often seek the certainty of a ruling from the Internal Revenue Service in connection with an acquisition of control following a

section 355 distribution. We recommend generally that the Service adopt a policy to rule that section 355(e) does not apply if (i) the taxpayer represents that there were no agreements or understandings that were reasonably expected, at the time of the distribution, to result in an acquisition of control transaction and (ii) no agreement to effect an acquisition of control is actually entered into within six months after the distribution. We believe that, in the absence of pre-distribution understandings, this six-month window should be sufficient to enable taxpayers to overcome the two-year statutory presumption that a post-distribution transaction is part of a "plan".

We understand that guidance in this area is, ultimately, a question of line-drawing. We believe that our recommendations draw the line at a reasonable point, in light of the transactions at which section 355(e) was aimed. Most importantly, we believe the guidance we suggest will help to provide certainty for both taxpayers and the Service in applying and administering a difficult statutory provision.

Please let me know if we can be of further help.

Very truly yours,



Steven C. Todrys
Chair

cc: Department of the Treasury
The Honorable Jonathan Talisman
Joseph M. Mikrut, Esq.
Karen G. Gilbreath, Esq.

Internal Revenue Service
The Honorable Stuart L. Brown
Philip J. Levine, Esq.
William D. Alexander, Esq..

NEW YORK STATE BAR ASSOCIATION TAX SECTION
COMMITTEES ON CORPORATIONS AND REORGANIZATIONS

REPORT ON SECTION 355(e)

December 8, 1998

I. INTRODUCTION

This Report[1] makes recommendations for guidance in defining the scope of the phrase "plan (or series of related transactions)" in Internal Revenue Code section 355(e)(2)(A)(ii), (B) and (C)[2], enacted by Section 1012 of the Taxpayer Relief Act of 1997 (the "Act"). The Report also discusses standards the Internal Revenue Service (the "Service") might incorporate into a Revenue Procedure dealing with the issuance of private rulings under section 355(e).[3]

Section 355(e) provides that stock and securities of a controlled corporation in a distribution to which section 355(a) otherwise applies are not treated as "qualified property" under section 355(c) if the distribution "is part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation." As a result, gain

---

[1] This report was drafted by Dale L. Ponikvar with significant assistance provided by Andrew Berg, Peter Canellos, Kathleen Ferrell, Robert Jacobs, Glen Kohl, Stephen Land, Richard Loengard, Richard Reinhold, Michael Schler, David Schnabel, Jodi Schwartz, Steven Todrys and Dana Trier.

[2] All "Section" references, except as expressly otherwise provided, are to the Internal Revenue Code of 1986, as amended.

[3] The Report does not address the question of how to compute whether an acquisition of control under section 355(e) has occurred in cases involving overlapping ownership, an issue on which guidance should be provided.

is recognized by the distributing corporation as if the stock and securities of the controlled corporation had been sold by the distributing corporation at their fair market value. A "plan" is presumed to exist if the prohibited acquisition occurs during the 4-year period beginning 2 years before the date of the distribution "unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions." The application of section 355(e) to the distributing corporation does not affect the tax-free treatment of the distribution to the shareholders of the distributing corporation.

Section 355(e) responded to a series of widely-reported transactions in which a section 355 distribution of the stock of a controlled corporation was coupled with an integrated transaction – either a corporate reorganization or a share issuance – that resulted in a direct or indirect acquisition of 50-percent or more of the stock of the distributing or controlled corporation. Many of these transactions relied upon the authority of *Mary Archer W. Morris Trust v. Commissioner*, 42 T.C. 779 (1964), *aff'd*, 367 F.2d 794 (4th Cir. 1966), *acq.*, Rev. Rul. 68-603, 1968-2 C.B. 148, and some were the subject of favorable private letter rulings issued by the Internal Revenue Service (the "Service").[4] A number of these transactions also involved the shifting of liabilities and cash between the distributing corporation and the controlled corporation. In the post-distribution acquisition transaction, the acquiring corporation would indirectly assume the newly-incurred liabilities, leaving the cash behind with the remaining business. The combination of these factors caused Congress to conclude that the transaction "more closely resembles a corporate level disposition" than a two-step tax-free reorganization

[4] Rev. Proc. 96-30, 1996-1 C.B. 696, which sets forth the Service's requirements for a favorable ruling under section 355, includes as an acceptable business purpose for a ruling the combination of the distributing corporation and an acquiring corporation in a tax-free reorganization. Section 4.04(4), and Appendix A, sections 1, 2.07 and 2.08.

under sections 355 and 368.[5] Of particular importance to the issue addressed in this Report, we note that each of these transactions was characterized by a level of planning by the distributing corporation, controlled corporation and acquiring corporation entailing extensive pre-distribution negotiations and agreements among the parties.

On July 2, 1997, the Tax Section submitted a Report on the legislative proposals that led to the enactment of section 355(e) (the "1997 Report").[6] The 1997 Report suggested the legislation target transactions that involve the shifting of liabilities and cash (*i.e.*, that had "sale attributes"), and not transactions that merely result in an ownership change of the distributing or controlled corporation. Our suggestions generally were not adopted by Congress.

Since the enactment of section 355(e), practitioners have been confronted with the difficulty of advising corporations on the meaning of the phrase "plan (or series of related transactions)." The legislative history to the provision is sparse on the meaning of this phrase, except to note the "plan or arrangement [must be] in existence on the date of distribution."[7]

Certain transactions are clearly within the scope of section 355(e) – for example, the classic *Morris Trust* transaction involving a post-distribution acquisition of the distributing or controlled corporation pursuant to an agreement executed prior to, and in connection with, the

---

[5] H. Rep. 105-48, 105th Cong., 1st Sess. 462; S. Rep. 105-33, 105th Cong., 1st Sess. 139-140.

[6] "Report on Section 355," New York State Bar Association Tax Section, Committees on Corporations and Reorganizations (July 2, 1997).

[7] H. Rep. 105-48 at p.463; S. Rep. 105-33 at p. 141. The General Explanation prepared by the staff of the Joint Committee on Taxation also states that "[a] public offering of sufficient size can result in an acquisition that causes gain recognition under the provision." Staff of Joint Comm. on Tax'n, 105th Cong., 1st Sess., General Explanation of Tax Legislation Enacted in 1997, at 199.

distribution. In addition, we would expect that a post-distribution acquisition pursuant to negotiations undertaken prior to the distribution – based upon a standard similar to that enunciated in *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), and Rev. Rul. 96-30, 1996-1 C.B. 36[8] – would also be subject to section 355(e). However, the breadth of the statutory language is unclear, and suggestions that internal plans of the distributing or controlled corporations, or of a potential acquiring corporation, may also be prohibited "plans" under section 355(e) raise serious concerns among tax advisors.

In the context of the transactions at which section 355(e) was directed, we believe a relatively narrow definition of the phrase "plan (or series of related transactions)" would be appropriate. Moreover, we believe a broad definition of a "plan" will be impossible for corporate taxpayers to interpret and for the Service to administer. As a practical matter, corporations – whether in the context of section 355 distributions or otherwise – are constantly approached by other corporations and by investment bankers concerning possible business combinations. Many corporations have their own strategic planning departments that are responsible for identifying potential acquisitions and combinations. Further, in the public market context, it is impossible to predict or control the activities of a potential acquiror.

II. SUMMARY OF RECOMMENDATIONS

1. We recommend that the phrase "plan (or series of related transactions)" be interpreted in regulations to require mutuality between the distributing or controlled corporation (or its controlling shareholders), on the one hand, and the person or persons acquiring stock in the distributing or controlled corporation, on the other hand (or, in certain cases, an underwriter).

---

[8] Revenue Ruling 96-30 was obsoleted by Rev. Rul. 98-27, 1998-22 I.R.B. 4.

In other words, at the time of the distribution, there must be either an express agreement or some mutual expectation on behalf of both parties to the transaction, evidenced through some significant concrete action, that a transaction resulting in an acquisition of control will occur. For these purposes, arrangements with an underwriter in the case of a public offering, or in an auction sale of a corporation, could satisfy the mutuality requirement. In addition, evidence of a "plan" could include concrete actions taken by a controlling shareholder of the distributing or controlled corporation. However, under this standard, internal plans of the distributing or controlled corporation, or of a potential acquiror, would not alone constitute a prohibited "plan."[9]

2. We recommend that the Service issue a revenue procedure stating it will rule that a post-distribution acquisition of control of the distributing or controlled corporation is not pursuant to a "plan (or series of related transactions)" if (i) the taxpayer represents that there were no Agreements or Understandings (as defined below) between the distributing corporation, controlled corporation and acquiror (or their controlling shareholders) that were reasonably expected, at the time of the distribution, to result in, or compel, an acquisition of control of either the distributing corporation or controlled corporation and (ii) no Agreement to effect an acquisition of control is entered into within six months after the distribution. For this purpose, an Agreement means a binding written or unwritten agreement (including a binding option agreement or a binding agreement to negotiate in good faith) to effect an acquisition of control and Understanding means a binding or nonbinding understanding as to the principal terms for an

---

[9] Some members have suggested that a pre-distribution public announcement (*e.g.*, required by the securities laws) by the distributing or controlled corporation of an intention to engage in an acquisition of control transaction following the distribution (such as a public offering of 50% or more of the stock of either corporation) should constitute a concrete action evidencing a prohibited "plan," especially where the public announcement is intended to make public trading values reflect the anticipated acquisition of control transaction.

acquisition of control.[10] The first prong of this test assures there is no mutual expectation of a post-distribution acquisition of control evidenced by concrete steps prior to the distribution (consistent with our first recommendation concerning the scope of a "plan"). The second prong gives the Service a "cushion" of time, which is significant in practical terms, to increase the certainty a "plan" did not exist at the time of the distribution.

III. DISCUSSION

A. What is a Plan?

We believe the phrase "plan (or series of related transactions)" should be interpreted in accordance with the intent of Congress to tax transactions that look "more like a corporate level disposition" based upon the facts in existence at the time of the distribution. As noted above, the transactions at which section 355(e) was directed involved significant pre-distribution agreements and coordination between the distributing or controlled corporation and the person acquiring control in the post-distribution transaction.

Prior to the enactment of section 355(e), the Service and the courts had to deal with cases that raised the issue whether a corporate distribution should be integrated with a post-distribution transaction. In these cases, integrated transaction treatment resulted in a corporate-level tax on the distribution – *i.e.*, the post-distribution transaction was attributed to the corporation. For example, in Rev. Rul. 96-30, 1996-1 C.B. 36 (now obsoleted, but still relevant to this analysis), the Service held that a distributing corporation would not be deemed to have sold the controlled corporation, where the controlled corporation was acquired soon after the

---

[10] The Service might also require a representation that neither the distributing corporation nor controlled corporation made a pre-distribution public announcement of an intention to effect a transaction that would result in an acquisition of control.

distribution but where there were no negotiations or agreements relating to the transaction prior to the distribution, "although an acquisition of C was a possibility recognized by the management of D and C at such time." The Service based its conclusion on the Supreme Court's holding in *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950), in which a sale of assets by shareholders received upon liquidation of a corporation was not taxable to the liquidated corporation where the facts at trial showed, "that the corporation had rejected an offer to sell the property and negotiations had been carried on by the shareholders after receipt of the property in liquidation." Id. The ruling distinguished the Supreme Court's holding in *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), in which a nominal shareholder sale of property distributed by a liquidating corporation was held a sale by the liquidating corporation where the facts showed the liquidating "corporation had in fact conducted all the negotiations and the terms of sale had been agreed upon prior to the distribution of the property."

We recognize, however, that these authorities are not directly applicable to section 355(e) and that the phrase "plan (or series of related transactions)" should probably be read more broadly than a mere codification of the *Court Holding* doctrine. However, we believe the basic concept is similar – for section 355(e) to apply, the parties to the acquisition of control transaction must take some significant concrete steps towards the consummation of the transaction prior to the distribution.

B. Scope of a "Plan"

1. Formality of a "plan". We recommend the Service issue regulations that establish, as a general rule, that for section 355(e) and (f) purposes, discussions by and among officers and employees of the distributing or controlled corporations, or discussions with their financial or business advisors, do not – in and of themselves – constitute a proscribed "plan,"

unless those discussions are accompanied by concrete steps towards execution of a transaction resulting in the acquisition of control by another person, including, in general, negotiations that address substantive terms with the person acquiring control or its representatives. The existence of concrete steps is necessary to evidence that the parties to the transaction had, at the time of the distribution, a mutual expectation that the acquisition of control would occur. We believe an array of difficult distinctions can be avoided and some certainty brought to the area if the Service defines "plan" with an eye to the high level of advance coordination required to execute the transactions Congress clearly intended to tax. We know of no compelling policy reason to use a more informal definition of "plan," and we believe that a more informal definition will be difficult to administer, resulting in significant uncertainty for taxpayers and the Service.

Under this standard, internal financial analysis by the distributing or controlled corporation, or analysis by their investment bankers, concerning potential candidates for business combinations would not be taken into account in determining whether a "plan" existed. Observations by an investment banker that the distributing or controlled corporation would be "an attractive acquisition target" following the distribution would, similarly, be disregarded.

Pre-distribution contacts between the distributing or controlled corporation and the acquiring person, or their advisors, would be more closely scrutinized. However, these contacts should not be evidence of a "plan" unless they include negotiations that deal with substantive issues that would need to be addressed before prudent business people would execute a transaction.[11] Agreement on substantive issues is evidence that the parties had the mutual

---

[11] *See* Treas. Reg. §1.355-2(d)(2)(iii)(D), dealing with the "device" test: "If a sale or exchange was discussed by the buyer and the seller before the distribution and was reasonably to be anticipated by both parties, then the sale or exchange will ordinarily be considered to be pursuant to an arrangement negotiated or agreed upon before the distribution." (emphasis added)

expectation that the acquisition of control transaction would occur. Informal contacts should not, alone, constitute a "plan".

On the other hand, a concrete step towards execution could include a financial restructuring of the distributing or controlled corporation at the behest of a potential acquiror that was not consistent with a distribution alone, thus facilitating a disguised sale to the acquiror.[12] For example, if the distributing corporation's investment banker is approached by a potential acquiror or its representative prior to the distribution and the acquiror proposes that the distributing corporation incur increased indebtedness in the section 355 distribution in order to facilitate the post-distribution acquisition of the distributing corporation by the acquiror (*i.e.*, by reducing the stock that would have to be issued by the acquiror in the acquisition), the distributing corporation's implementation of that strategy would be strong evidence of a "plan".[13]

2. Hostile bids. Earlier proposals to limit *Morris Trust* transactions would have excluded hostile offers commenced after the distribution from the scope of transactions targeted by section 355(e),[14] but similar limiting language is absent from the legislative history accompanying the legislation as enacted. We recommend that the plans of would-be acquiring corporations or hostile bidders should not be deemed plans of the distributing or controlled corporation, unless they are adopted by the distributing or controlled corporation prior to the

---

[12] By analogy, in *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950), the corporation made a sale of assets available to its shareholders.

[13] As noted above, some members have suggested that certain pre-distribution public announcements by the distributing or controlled corporation of an intent to effect an acquisition of control transaction should be concrete evidence of a "plan."

[14] See General Explanations of Clinton Administration's Fiscal Year 1998 Revenue Proposals, Department of Treasury (February 1997); General Explanations of the Administration; Revenue Proposals, Department of Treasury (March 1996).

distribution. A hostile or unsolicited bid from another corporation is the plan of another person and, unless expressly shared and supported by corporate action of the distributing or controlled corporation prior to the distribution, should not be part of a plan with, or in a series of related transactions to, the distribution. Thus, we believe an unsolicited offer prior to the distribution that is rejected by the distributing or controlled corporation should not be evidence of a "plan".

3. Initial or primary public offerings and auction sales. The General Explanation of the staff of the Joint Committee on Taxation provides that "[a] public offering of sufficient size can result in an acquisition that causes gain recognition under the provision [section 355(e)]."[15] While this statement does not appear in the House, Senate or Conference reports, we believe share issuances, generally, and public offerings, in particular, can be "acquisitions" to be counted towards an acquisition of control under section 355(e). However, we do not believe the mere desire or intent of the distributing corporation or controlled corporation to issue shares to the public following the distribution is, by itself, a "plan". We recommend the regulations provide that a "plan" be found in connection with a public offering only where the distributing or controlled corporation either enters into an agreement with an underwriter to undertake a public offering before the distribution date, or, as of the distribution date, the distributing or controlled corporation has had negotiations with an underwriter that would allow it to reasonably anticipate that an agreement to effect a change in control offering through a public offering will be reached.[16] This approach is consistent with our recommendations above that some concrete steps

---

[15] Staff of Joint Comm. on Tax'n, 105th Cong., 1st Sess., General Explanation of Tax Legislation Enacted in 1997, at 199.

[16] Again, some members believe that a pre-distribution public announcement of an intent to effect a public offering of 50% or more of the stock of the distributing or controlled

be taken to demonstrate that the parties to the transaction (here, the issuer and the underwriter) have a mutual expectation the acquisition of control transaction will occur. A similar analysis would apply to an auction sale of either the distributing or controlled corporation.[17]

C. Advance Letter Rulings

In light of the potentially disastrous tax consequences of violating section 355(e), corporate taxpayers confronted with the possible application of section 355(e) to a post-distribution transaction will be inclined to seek rulings from the Service. We recommend the Service establish guidelines for issuing rulings, either on an initial or supplemental basis. In light of our principal recommendation that section 355(e) should not apply absent a mutuality between the distributing or controlled corporation and the other party to the acquisition of control transaction, we recommend the Service adopt a policy to rule that section 355(e) does not apply to a post-distribution transaction if (i) the taxpayer represents that there were no Agreements or Understandings (as defined below) between the distributing corporation, controlled corporation and acquiror (or their controlling shareholders) that were reasonably expected, at the time of the distribution, to result in, or compel, an acquisition of control of either the distributing corporation or controlled corporation and (ii) no Agreement to effect an acquisition of control is entered into within six months after the distribution. For this purpose, an Agreement means a binding written or unwritten agreement (including a binding option agreement or a binding agreement to negotiate in good faith) to effect an acquisition of control and Understanding means a binding or

---

corporation should be concrete evidence of a "plan," even without an agreement with an underwriter.

[17] To avoid violating the substantive requirements of section 355, the auction sale would presumably have to be a tax-free reorganization transaction.

nonbinding understanding as to the principal terms for an acquisition of control.[18] Under this standard, a pre-distribution nonbinding letter of intent that sets forth the principal terms of the acquisition of control transaction would be an Understanding, and an agreement for the payment of a fee if the proposed transaction is not consummated would be an Agreement. We believe that under these circumstances there will be little doubt that, under ordinary business conditions (in particular, involving public companies), the acquisition of control is not a part of a plan with the distribution. We recognize that the statute contains a 2-year presumption that the post-distribution transaction is part of a "plan," but believe that the representation that there were no Agreements or Understandings at the time of the distribution should be sufficient, together with the six-month window, to overcome the presumption and enable taxpayers to obtain the tax certainty they require to consummate the acquisition of control transaction.

[18] As noted above, the Service might also require a representation that neither the distributing corporation nor controlled corporation made a pre-distribution public announcement of an intention to effect a transaction that would result in an acquisition of control.