Report No. 1333

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE ALLOCATION OF EARNINGS AND PROFITS IN CONNECTION WITH DIVISIVE TRANSACTIONS

DECEMBER 1, 2015

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I. INTRODUCTION

This report ("**Report**")[1] of the New York State Bar Association Tax Section makes proposals regarding the allocation of earnings and profits ("**E&P**") in connection with divisive transactions described in section 355 of the Internal Revenue Code of 1986, as amended (the "**Code**").[2] In a section 355 transaction, the controlled corporation ("**Controlled**") is separated from the distributing corporation ("**Distributing**").[3] Because a section 355 distribution results in the division of a single corporation into two corporations, it is necessary to have rules to determine the post-transaction E&P of Distributing and Controlled after the division in order to preserve the relationship of the shareholders to the E&P.

Section 312(h), enacted in 1954 as section 312(i), provides that a proper allocation of E&P must occur in the connection with a section 355 distribution. Pursuant to the authority granted by Congress, in 1955, the Treasury Department ("**Treasury**")

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1 The drafters of this Report were Karen Gilbreath Sowell, James Coss, Shane Kiggen, and Brian Reed. Helpful comments were received from Lee Allison, Kimberly Blanchard, Kathleen Ferrell, Larry Garrett, David Hardy, Josh Holmes, Charles Kingson, Deborah Paul, Matthew Rosen, Michael Schler, David Schnabel, Jodi Schwartz, David Sicular, Eric Solomon, Linda Swartz, and Gordon Warnke. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

2 Unless indicated otherwise, all "**section**" references are to the Code and all "**Treas. Reg. §**" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this Report.

3 A section 355 transaction may take the form of a pro rata distribution to shareholders ("**spin-off**"), a distribution in redemption of shares ("**split-off**"), or a distribution in liquidation of Distributing ("**split-up**"). This Report generally refers to all forms of section 355 distributions as "spin-offs" for ease of reading. In some spin-offs, Controlled is newly formed in connection with the spin-off (a "**Newco Controlled**") pursuant to section 368(a)(1)(D) (a "**divisive D reorganization**") while, in others, Controlled is pre-existing and may have its own E&P (an "**Oldco Controlled**"). For a more thorough examination of section 355 in general, *see New York State Bar Association Tax Section, Report on the Role of the Step Transaction Doctrine in Section 355 Stock Distributions: Control Requirement and North-South Transactions* (Report No. 1292, November, 4, 2013) (the "**Section 355 No-Rule Report**").

and Internal Revenue Service (the "**Service**") issued Treas. Reg. §1.312-10 (the "**Regulations**"), governing the allocation of E&P in connection with a spin-off. The Regulations are ambiguous in certain respects, resulting in uncertainty as to the precise allocation of E&P after many section 355 transactions. Additionally, the Regulations were developed at a time when individuals were taxed at significantly higher rates on dividend income than capital gains, multinational corporations with complex structures and attribute profiles were uncommon, and the tax law generally was less complex. Consequently, the Regulations do not reach appropriate results in certain contexts.

Today, the location and category of E&P following cross-border section 355 transactions is critical for determining the tax consequences of future distributions by foreign corporations. In this context, clear rules are essential in order to minimize inappropriate repatriation opportunities and provide taxpayers with certainty.[4] In the domestic context, the amount of E&P allocated is critical when the dividing company does not have E&P in excess of contemplated shareholder distributions by Distributing and Controlled, or where Controlled must manage its E&P for qualification as a real estate investment trust ("**REIT**").[5]

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4 For example, if a foreign Distributing or Controlled corporation is allocated minimal or no E&P in a spin-off of Controlled to the U.S., it may be possible to repatriate earnings more tax efficiently than could have been achieved absent the spin-off.

5 The Report does not address the interactions of E&P allocations with the E&P tiering rules in Treas. Reg. §1.1502-33. For a thoughtful discussion of these consolidated return issues, *see* Bryan P. Collins, Andrew W. Cordonnier & Darin A. Zywan, *Allocation of E&P in a Spin-Off by a Consolidated Group: New Developments Answer Some Questions but Leave Many Unanswered*, Corporate Tax Practice Series, Vol. 17, Ch. 212 (PLI 2014). The examples in the Report assume that Distributing and Controlled are not members of a consolidated group.

Our examination has concluded that there is no practical allocation system that will reach appropriate results in all contexts. Therefore, the Report focuses on balancing the various policy objectives, including minimizing opportunities for inappropriate tax planning, and removing the uncertainties that exist under the Regulations. The proposals in the Report are applicable to all spin-offs, including cross-border spin-offs.[6]

Part II of this Report summarizes our recommendations. Part III of the Report reviews the relevant provisions of the Code and regulations governing E&P adjustments in section 355 transactions and the case law, legislative history, and commentary that provide insight into the purpose of these provisions. Part IV summarizes the relevant policy objectives for revising the Regulations. Part V explores methods for allocating Distributing's E&P to Newco Controlled in a divisive D reorganization. Part VI focuses on allocations of Distributing's E&P to Oldco Controlled. Part VII addresses the allocation of Distributing's E&P in a divisive D reorganization where assets are transferred to Oldco Controlled. Part VIII addresses related issues commonly raised when allocating E&P in a spin-off: (i) the determination of Distributing's E&P available to be allocated; (ii) the impact of section 301 distributions on the amount of Distributing's E&P available to be allocated; and (iii) the allocation of E&P where Controlled is less than 100 percent owned.

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6 There are issues specific to cross-border spin-offs that are not addressed in this Report and that require an examination of additional policies. For example, the Report does not address the treatment of E&P deficits, whether and how foreign taxes and section 959 previously taxed income should be allocated, or whether a cross-section of all of Distributing's E&P should be allocated.

II. SUMMARY OF RECOMMENDATIONS[7]

This Report proposes modest changes to the Regulations in order to: (i) provide certainty to taxpayers and the government, (ii) minimize inappropriate tax planning, (iii) minimize differences between a spin-off of a Newco Controlled and an Oldco Controlled, and (iv) provide guidance for Oldco divisive D reorganizations. Our recommendations provide consistent results regardless of whether there is a divisive D reorganization and regardless of whether Controlled is a Newco Controlled or an Oldco Controlled. Specifically, the Report recommends:

Spin-off of Newco Controlled:

a. Retain the Fair Market Value Method for allocating Distributing's E&P to Newco Controlled.

b. In order to address the inadequacy of the Fair Market Value Method to maintain the shareholders' relationship to potential E&P created by the recognition of gains following the spin-off, consider adjusting the basis of Distributing's and Controlled's assets *solely for purposes of computing their E&P*.

c. Eliminate the ambiguity created by the provision that the Net Basis Method (or any other method) may be used in a "proper" case.

[7] All defined terms in this Part II not previously defined are defined later in the Report.

Spin-off of Oldco Controlled:

d. Retain the Regulation's rule that Distributing's E&P is reduced by the amount by which Distributing's E&P would have been reduced had it transferred the stock of Controlled to Newco Controlled.

e. Eliminate the net worth limitation in the Regulations.

f. Eliminate the possibility of disappearing E&P when Distributing reduces its E&P by a larger number than Oldco Controlled increases its E&P (because Oldco Controlled has its own E&P). While there are alternatives for accomplishing this goal, we propose increasing Controlled's E&P by the entire amount of the reduction in Distributing's E&P.

Oldco divisive D reorganizations:

g. Treat the assets transferred in the divisive D reorganization as pre-existing assets of Oldco Controlled and apply the allocation rule for a spin-off of Oldco Controlled.

In addition, the Report addresses certain related common issues raised in the context of allocating E&P in a spin-off for which clear guidance is needed:

Determining the amount of E&P to be allocated in a spin-off:

h. Except for extraordinary items, pro rate Distributing's E&P for the year on a daily basis to the day immediately prior to the spin-off.

i. Allocate extraordinary items on a closing-of-the-books basis.

j. Reduce Distributing's current E&P available for allocation by all section 301 distributions, regardless of the timing of such distributions.

k. If Controlled is less than wholly-owned, allocate E&P on the basis of the value of Controlled owned by Distributing.

III. BACKGROUND

A. E&P in General

1. The Meaning of E&P

The term “earnings and profits” is not inclusively defined in the Code or in the Regulations. It has no counterpart outside the tax law; it is neither identical with taxable income or with retained earnings for financial accounting purposes. Rather, it is an economic concept used by the tax law “to approximate a corporation’s power to make distributions which are more than just a return of investment.”[8] Thus, theoretically, E&P should reflect all items of economic gain or loss realized by the corporation.[9]

Although a corporation’s accumulated E&P is not necessarily equal to its accumulated taxable income or to its retained earnings, there is generally a relationship among the three amounts. As stated by Bittker and Eustice:

> Starting with taxable income, for example, both earnings and profits and surplus can be derived by going through the corporation's books and records and adjusting for items and transactions that are treated one way in computing taxable income and another way in computing either earnings and profits or surplus. By a similar process, with surplus as a starting point, taxable income and earnings and profits can be derived; alternatively, with earnings and profits as a base, taxable income and surplus can be computed.[10]

[8] *Henry C. Beck Co.*, 52 T.C. 1, 6 (1969), *aff’d per curiam*, 433 F.2d 309 (5th Cir. 1970).

[9] William N. Colby, Boyd A. Blackburn & Dana L. Trier, *Elimination of Earnings and Profits from the Internal Revenue Code*, 39 Tax Law. 285, 287 (1985-1986).

[10] *See* Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 8.04 Earnings and Profits, (7th ed. 2000 & Supp. 2015-02).

This relationship among the three concepts has led some to conclude that E&P is properly conceived of as an equity account on a tax basis balance sheet.[11] On this view, the left side of the tax basis balance sheet lists the corporation's assets (with property shown at adjusted tax basis) and the right side lists the sources of those assets – debt, capital, and E&P. Whereas capital is an historical figure that reflects contributions (including property at adjusted tax basis) from shareholders less distributions (including property at adjusted tax basis) to shareholders, E&P is a mere balancing figure that reflects the difference between a corporation's net assets and its debt and capital account. Thus, any change in a corporation's net asset basis that is not accompanied by a corresponding change in its debt or capital must result in a corresponding change to its E&P. Although the balance sheet conceptualization of E&P has a certain appeal, it does not provide a wholly satisfactory account of the operation of the concept under current law. Indeed, as discussed below, because of the important role the concept plays in determining shareholder income, the rules for adjusting E&P in various corporate transactions often sacrifice the integrity of the tax basis balance sheet to prevent abuse.

2. The Function of E&P

The amount of a corporation's E&P is significant for a number of federal income tax purposes. Traditionally, the most important of these has been the determination of the tax treatment of shareholders receiving a distribution of property. The rules governing property distributions are set out in sections 301 and 316. Section 301(c) provides that

[11] Debra J. Bennett, *Corporate Tax Watch – Earnings and Profits: A Balance Sheet Account*, Taxes, February 2008, at 10; Charles R. Nesson, *Earnings and Profits Discontinuities Under the 1954 Code*, 77 Harv. L. Rev. 450, 457 (1964); Daniel Halperin, *Carryovers of Earnings and Profits*, 18 Tax L. Rev. 289, 292 (1963).

any distribution that constitutes a dividend is included in the gross income of the shareholder, while amounts distributed in excess of those treated as a dividend are treated first as a tax-free return of capital to the extent of the shareholder's stock basis, and then as gain from the sale of the stock. In turn, section 316 defines the term "dividend" as any distribution of property made by a corporation out of current or accumulated E&P. Thus, E&P operates as a limitation on dividend income.

B. Effect on E&P from Other Non-Dividend Distributions

Most of the fundamental problems that arise in determining the proper treatment of E&P in the context of a tax-free corporate division also arise in the context of other non-dividend distributions, such as redemption distributions and partial liquidations.

1. Section 312(a)

Section 312(a) provides that E&P is reduced by a distribution of property by a corporation with respect to its stock. Such reduction is equal to the amount of money,[12] principal amount of the distributing corporation's obligations,[13] or adjusted basis of the property[14] so distributed. In the case of appreciated property, section 312(b) increases the distributing corporation's E&P by the amount of unrealized appreciation in the property, and then changes the amount of the E&P reduction to the fair market value of the property so distributed. This equalizes the effect of a distribution of appreciated property with the result if the corporation had sold the property and distributed the proceeds, makes the amount of the appreciation available in E&P for purposes of

[12] Section 312(a)(1).

[13] Section 312(a)(2).

[14] Section 312(a)(3).

determining the extent to which the distribution is a dividend, and results in a net reduction to E&P equal to the adjusted basis of the property.[15]

2. Section 312(n)(7)

Section 312(n)(7), enacted by the Deficit Reduction Act of 1984, provides that, if a corporation makes a distribution in redemption to which section 302(a) or section 303 applies, the amount of the distribution that is properly chargeable to E&P shall be an amount which is not in excess of the ratable share of E&P attributable to the redeemed stock. Section 312(n)(7) responds to an extensive and complex line of case law that evolved concerning the effect of non-dividend equivalent redemptions on E&P.[16] Prior to the enactment of section 312(n)(7), section 312(e) and its predecessors stated that the part of a distribution that is "properly chargeable to capital account" did not reduce E&P. By implication, the portion of the distribution not chargeable to capital reduced E&P. However, it was unclear as to what items properly constituted the "capital account" and as to how the redemption price should be allocated between the capital account and E&P.

In *Helvering v. Jarvis*,[17] the Board of Tax Appeals considered this issue in the context of a non-pro-rata redemption distribution. There, a corporation with capital of $1,910,000 and accumulated E&P of $1,448,000 redeemed 10% of its stock for $1,160,000. The Board of Tax Appeals held that the amount of the redemption

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15 *See* Bittker and Eustice, *supra* note 9 at ¶ 8.04.

16 *See generally* Haskell Edelstein & Herbert J. Korbel, *The Impact of Redemption and Liquidating Distributions on Earnings and Profits: Tax Accounting Aberrations Under Section 312(e)*, 20 Tax L. Rev. 479 (1964-1965); Arthur R. Albrecht, *"Dividends" and "Earnings and Profits"*, 7 Tax L. Rev. 157 (1951-1952); Rev. Rul. 79-376, 1979-2 C.B. 133 (*obsoleted by* Rev. Rul. 95-71, 1995-2 C.B. 323).

17 Helvering v. Jarvis, 123 F.2d 742 (4th Cir. 1941), *aff'g* 43 B.T.A. 439 (1941), *acq.*, 1979-2 C.B. 1.

distribution chargeable to the capital account was equal to the redeemed shares' pro-rata portion of the capital account, or $191,000 (10% of $1,910,000). The balance of the distribution ($969,000) reduced E&P. Accordingly, after the distribution, the corporation had just $479,000 of E&P – 67% less than it had before the redemption.

The following year, in *Woodward Investment Company v. Commissioner,*[18] the Board of Tax Appeals used a different formula to determine the effect on E&P of a pro-rata distribution in partial liquidation. The Board of Tax Appeals held that the distribution should be deemed made partly out of capital and partly out of E&P, based on the relative balances of those accounts. Thus, the court determined the amount of the reduction to the E&P was computed by multiplying the amount of the distribution by a ratio, the numerator of which was the amount of E&P and the denominator of which was the sum of E&P and capital. The underlying rationale was that a proportionate amount of E&P and capital should be treated as standing behind each of the corporation's assets.[19] Consequently, as other commentators have noted, the *Woodward* formula produces the same reduction to E&P as would a formula that reduces E&P in proportion to the basis of the assets distributed over the basis over the assets retained.[20]

Section 312(n)(7) reduces the amount of the reduction to E&P beyond that of the *Woodward* approach, limiting the amount of the reduction to the "ratable share of earnings and profits" of the redeemed stock, where such ratable share is determined by taking the ratio of the value of the redeemed shares over the total value of all the

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[18] *Woodward Investment Co. v. Commissioner*, 46 B.T.A. 648 (1942), *acq.*, 1970-2 C.B. XVIII.

[19] *See* Edelstein and Korbel, *supra* note 15, at 506.

[20] *Id.*

corporation's shares outstanding immediately before the redemption transaction.[21] Thus, under the facts of *Jarvis*, the ratio would be 10%, and the reduction to E&P would not exceed $144,800 ($1,448,000 x 10%).

C. A Brief History of the Treatment of E&P in Tax-Free Corporate Divisions

(i) Early Case Law: Evolution of the *Sansome* Principle

The current rules governing the treatment of E&P in tax-free transactions have their roots in a series of landmark cases beginning with *Commissioner v. Sansome*.[22] As discussed below, these cases represent an attempt to overcome the discontinuities arising out of the E&P limitation on dividend income by preserving the relationship of the shareholders to the E&P of the corporation existing at the time of the division.

In *Sansome*, a corporation transferred all of its assets to a newly formed corporation and in return, the new corporation issued all of the shares of its stock to the old corporation's shareholders, in proportion to their shareholdings in the old corporation. Subsequently, the old corporation dissolved. The overall transaction qualified as "a mere change in identity, form, or place of organization" of the old corporation, and hence a reorganization under the Revenue Act of 1921. The question presented was whether the E&P of the old corporation carried over to the new corporation for the purpose of determining whether subsequent distributions by the new corporation were taxable

[21] *See* I.R.S. Priv. Ltr. Rul. 200352015 (Dec. 26, 2003).

[22] 60 F.2d 931 (2d Cir. 1932).

dividends to its shareholders.[23] The Board of Tax Appeals determined that the E&P did not carry over, on the ground that the new corporation did not acquire any E&P as such from the old corporation; rather, it acquired assets, which, under basic tax-accounting principles, should be treated as capital.[24] The Second Circuit, however, reversed. Judge Learned Hand, writing for the court, inferred, from the theory underlying the tax-free reorganization provisions, that Congress did not intend for the transaction at issue to convert the old corporation's E&P into capital. He expressed the court's holding as follows: "a corporate reorganization which results in no gain or loss… does not toll the company's life as [a] continued venture … and that what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor."[25]

The *Sansome* rule was applied to other types of tax-free transactions, including tax-free corporate divisions.[26] Although the cases involving corporate divisions made plain that an allocation of E&P was required, they did not squarely address how that

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[23] *Sansome* was decided before the introduction of section 381 in the Internal Revenue Code of 1954. Prior to this, the rules governing the carryover of attributes in reorganizations was judicially developed through a series of cases, including *Sansome*.

[24] *Sansome v. Commissioner*, 22 B.T.A. 1171, 1175 (1931) ("Although the new corporation took over all the assets of the old company in exchange for its stock, any undivided profits or earnings of the old company were not acquired as profits or earnings of the new corporation. Any amount appearing on the books of the old company as surplus or undivided profits, which was carried forward on the books of the new corporation as surplus, was a part of its capital, and in any event was nothing more than paid-in surplus.").

[25] *Sansome*, 60 F.2d at 933.

[26] *See, e.g., United States v. Kauffman*, 62 F.2d 1045 (9th Cir. 1933) (applying *Sansome* to a tax-free combination of three corporations); *Robinette v. Commissioner*, 148 F.2d 513 (9th Cir. 1945) (applying *Sansome* to a tax-free liquidation); *Harter v. Helvering*, 79 F.2d 12 (2nd Cir. 1935) (applying *Sansome* to a tax-free liquidation of a corporation with an E&P surplus into a corporation with an E&P deficit).

allocation was to be made.[27] For example, in *Mandel v. Commissioner*,[28] Distributing transferred 60 percent of the book value of its assets to newly formed Controlled and then split off Controlled to its shareholders in a divisive D reorganization. The taxpayer argued that because the assets transferred to Controlled were originally received by Distributing as capital contributions, none represented the E&P of Distributing, and therefore the amount of E&P allocable to Controlled was zero. The Tax Court, however, rejected the premise that a corporation's E&P and capital accounts represent or stand for specific assets on its balance sheet, and held that Distributing's E&P should be allocated based on relative book values.[29] The decision does not disclose the relationship of those figures to fair market value or tax basis.

Early applications of the *Sansome* rule emphasized the importance of a continued venture. For example, in *Campbell v. United States*,[30] the Third Circuit held that the *Sansome* rule extended only to those cases involving a continuation of the corporate venture by the same shareholders, and declined to apply the rule where the shareholders of the old corporation received less than half the stock of the new corporation. Over time, however, the scope of the *Sansome* rule expanded and the theory underlying it evolved. The first major development came in *Commissioner v. Munter*,[31] where the Supreme Court declined to follow the narrow interpretation of the Third Circuit and

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27 *See, e.g.*, *Murchison's Estate v. Commissioner*, 76 F.2d 641, 642 (5th Cir. 1935); *Estate of McClintic v. Commissioner*, 47 BTA 188 (1942); *Barnes v. United States*, 22 F. Supp. 282 (E.D. Pa. 1938).

28 5 T.C. 684 (1945). See also *Barnes*, 22 F. Supp. 282.

29 *Mandel*, 5 T.C. at 689.

30 144 F.2d 177 (3d Cir. 1944).

31 331 U.S. 210 (1947).

applied the *Sansome* rule on facts similar to *Campbell*. In the process, the Court clarified and restated the rationale underlying the *Sansome* rule. As the Court stated in *Munter*:

> A basic principle of the income tax laws has long been that corporate earnings and profits should be taxed when they are distributed to the stockholders who own the distributing corporation.. . . Thus unless those earnings and profits accumulated by the predecessor corporations and undistributed in this reorganization are deemed to have been acquired by the successor corporation and taxable upon distribution by it, they would escape the taxation which Congress intended. . . . The congressional purpose to tax all stockholders who receive distributions of corporate earnings and profits cannot be frustrated by any reorganization which leaves earnings and profits undistributed in whole or in part.[32]

Thus, the Court suggested, the basis for the *Sansome* rule is not the continuity of the corporate venture but the congressional intent that tax-free reorganizations not facilitate tax-avoidance.

Two years later, the Court made this plain in *Commissioner v. Phipps*.[33] In that case, a parent corporation liquidated, on a tax-free basis, five wholly owned subsidiaries. Four of the subsidiaries had deficits in E&P, which, in total, exceeded the parent's E&P. The following year, the parent made a distribution to its shareholders, including the taxpayer. The taxpayer claimed that the *Sansome* rule required the subtraction of the subsidiaries' net deficit from parent's E&P for purposes of determining whether that distribution was taxable as a dividend or a tax-free return of capital to its shareholders. The Court, however, disagreed. As the Court stated, "[i]f the assets of the parent and subsidiary are combined via a tax-free reorganization or liquidation, the effect of the

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[32] *Id.* at 214, 215.

[33] 336 U.S. 410 (1949).

Sansome rule is this: a distribution of the assets that would have been taxable absent the reorganization does not lose that character by virtue of the tax-free transaction."

(ii) Section 312(i)

The Revenue Act of 1954 (the "**1954 Act**") codified much of the case law that had developed addressing the treatment of E&P in tax-free reorganizations.[34] Included in the 1954 Act was section 312(i), the forerunner to section 312(h), which required a proper allocation of E&P following a spin-off. The enacted provision, which provided that the allocation should be made under regulations to be promulgated by the Secretary, was originally introduced by the House of Representatives (the "**House**") as a more detailed provision.

1. House Version

The form of the statute adopted by the House, section 310(c), provided:

> Upon the distribution by a corporation of securities or property…in a corporate separation…its earnings and profits shall be decreased by an amount which bears the same relation to the earnings and profits immediately prior to the transaction as the amount of money and the adjusted basis of the assets (plus the principal amount of securities, if any) distributed bears to the amount of money and the adjusted basis of the total assets immediately prior to such distribution…For the purpose of this subsection, the adjusted basis of the total assets of the corporation shall be reduced by the principal amount of its liabilities immediately prior to the distribution and the adjusted basis of the assets distributed shall be reduced by the amount of the liabilities to which such assets are subject.[35]

Thus, the House version contained an express provision to reduce Distributing's E&P in the same proportion as the net basis of Distributing's assets that were spun off.

[34] For an analysis of the law enacted regarding acquisitive reorganization, see *New York State Bar Association Tax Section, Report on Proposed Regulations §1.312-11:Allocation of Earnings and Profits in Connection with Asset Reorganizations* (Report No. 1275, October 16, 2012).

[35] H.R. 8300, 83d Cong. (1954).

As mentioned, this is essentially the same approach adopted by the Board of Tax Appeals in *Woodward*. However, section 310(c) did not expressly provide that a corresponding amount of E&P be allocated to Controlled. Instead, the House Committee on Ways and Means noted it did not intend "a result, under existing law, which [would] produce more earnings and profits in existence immediately after the transaction, than were in existence immediately prior to the transaction." [36] Thus, the Committee seemed primarily concerned with calculating a proper reduction to E&P, and preventing the creation of additional E&P in the system.

The Committee on Taxation of the Association of the Bar of the City of New York recognized this omission, and recommended that "express provision should be inserted in the bill with regard to the amount of earnings and profits to be transferred to the transferee corporation in corporate separations which would be consistent with the reduction of the transferor's earnings and profits provided by section 310(c)."[37]

2. Enacted Senate Version

In the version passed into law, the Senate Finance Committee abandoned the detailed allocation method of the House. Instead, the Finance Committee provided that the allocation should be made under regulations promulgated by the Secretary. However, the Finance Committee Report on section 312(i) set forth a number of guidelines, which were substantially incorporated into the Regulations.[38]

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36 H.R. Rep. No. 1337, 83d Cong., A95-A96 (1954).

37 The Committee on Taxation of the Association of the Bar of the City of New York, *First Report on H.R. 8300* (1954), *reprinted in* 7 Internal Revenue Acts of the United States: The Revenue Act of 1954 with Legislative Histories and Congressional Documents, 557 (Bernard D. Reams, Jr., ed. 1982).

38 Treas. Reg. §1.312-10 (1955).

First, the Finance Committee recommended a net worth limitation on the allocation, indicating that "as a result of such allocation, in no case may the earnings and profits of a corporation exceed its total net worth," with net worth defined to mean the sum of the bases of the properties plus cash minus all liabilities.[39] Second, in a divisive D reorganization, the Finance Committee gave the general admonition that "the principle of the Sansome case…will be applied to allocate a portion of the earnings and profits of the distributing corporation to the controlled corporation." Finally, the Finance Committee provided that "no deficit of a distributing corporation will ever be allocated to a controlled corporation."[40]

(iii) The Regulations

The Regulations were issued shortly after enactment of section 312(i) and reflected the guidance provided in the legislative history. In separate subsections, the Regulations provide rules for the allocation of E&P in a spin-off of Newco Controlled in a divisive D reorganization, and rules for adjusting E&P in the case of a spin-off of Oldco Controlled which is not preceded by a divisive D reorganization. No rules are explicitly provided for a divisive D reorganization where assets are transferred to Oldco Controlled.

1. Treas. Reg. §1.312-10(a)

The Regulations provide generally that Distributing's E&P immediately before a divisive D reorganization shall be allocated between Distributing and Controlled. In the case of Newco Controlled, the Regulations provide the allocation generally "shall be

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[39] S. Rep. 83-1622, 250-251 (1954).

[40] *Id*. at 250.

made in proportion to the fair market value of the business or businesses (and interests in any other properties) retained by the distributing corporation and the business or businesses (and interests in any other properties) of the controlled corporation immediately after the transaction." The proposed regulations issued prior to the Regulations did not limit the application of the fair market value allocation method to Newco Controlled corporations. The 1954 proposed version of Treas. Reg. §1.312-10 provided, in the case of a divisive D reorganization transaction, that "[g]enerally, such allocation shall be made in proportion to the fair market value of the business or businesses retained by the distributing corporation and the controlled corporation." The final version of the Regulations, issued in 1955, modified this language to state "*In the case of a newly created controlled corporation*, such allocation generally shall be made in proportion to..." (emphasis added). There was no explanation for the change in scope in the preamble to the Regulations.[41]

The Regulations further provide that, "[i]n a proper case, allocation shall be made between the distributing corporation and the controlled corporation in proportion to the net basis of the assets transferred and of the assets retained or by such other method as may be appropriate under the facts and circumstances of the case." The term "net basis" is defined as the basis of the assets less liabilities assumed or liabilities to which such assets are subject. No explanation or examples are provided that elucidate what is a "proper case." Significant uncertainty under current law stems from this element of the Regulations. Some have suggested that, in light of the change in scope of the

41 Prop. Treas. Reg. §1.312-10(a), 19 Fed. Reg. 8236, 8251 (Dec. 11, 1954).

Regulations from the proposed version to the final version, as described above, a transfer of assets to Oldco Controlled in a divisive D reorganization may be "a proper case."[42]

2. Treas. Reg. §1.312-10(b)

Treas. Reg. §1.312-10(b) provides a two-step method for adjusting the E&P of Distributing and Oldco Controlled in the case of a section 355 distribution that is not preceded by a divisive D reorganization. Step 1 determines the reduction to the E&P of Distributing, which is the lesser of two amounts:

1. The amount by which Distributing's E&P would have been reduced had it transferred the stock of Oldco Controlled to Newco Controlled in a divisive D reorganization (the "**Hypothetical D/355 Amount**");[43] or
2. The sum of Controlled's basis in all of its properties, plus cash, minus all liabilities (the "**Controlled Net Basis Amount**").[44]

Step 2 determines the adjustment to Oldco Controlled's E&P, which has two possible options:

1. If Oldco Controlled's pre-spin-off E&P is *less* than the reduction to Distributing's E&P computed in Step 1 (including if Oldco Controlled has an E&P deficit), then Oldco Controlled's post-spin-off E&P is *equal*

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[42] *See* John H. Alexander, *Some Earnings and Profits Aspects of the Internal Revenue Code of 1954*, 7 Hastings L.J. 285 (1955-1956); Thomas F. Wessel, Joseph M. Pari, Richard D'Avino, Stephen G. Charbonnet & M. Todd Prewett, *Corporate Distributions Under Section 355*, Corporate Tax Practice Series, Vol. 15, Ch. 201 (PLI 2014). *See also* Devon M. Bodoh, J. Brian Davis, Greg W. Featherman & Blake D. Bitter, *Reconciling the Irreconcilable: Earnings and Profits in Cross-Border Separations*, 55 Tax Management Memorandum 155 (May 5, 2014).

[43] Treas. Reg. §1.312-10(b)(1).

[44] Treas. Reg. §1.312-10(b)(2). The Controlled Net Basis Amount implements the Congressional recommendation for a net worth limitation on the allocation of E&P to Controlled.

to the decrease computed in Step 1 (the amount by which Oldco Controlled's E&P is increased is referred to as the "**Top-up Adjustment**"); or

2. If Oldco Controlled's pre-spin E&P is *greater* than the reduction to Distributing's E&P computed in Step 1, then Controlled's E&P is unchanged.

Therefore, if Oldco Controlled has pre-spin-off E&P, Distributing's reduction will exceed the Top-up Adjustment to Controlled, if any, and the excess E&P reduced from Distributing will "disappear" from the system.

It is interesting to note that Congress's directive to apply the *Sansom*e principle in the legislative history was only in reference to divisive D reorganizations.[45] At the same time the 1954 Act enacted section 312, it also eliminated the prior law requirement that the distribution be part of a reorganization, allowing for the first time a section 355 distribution of Oldco Controlled.[46] As a result, it is unclear what to make of the lack of a direct reference to the *Sansome* principle in the context of Oldco Controlled. Presumably, the goal of neutralizing the effect of a spin-off on the taxability of future distributions should be relevant regardless of whether the spin-off follows a divisive D reorganization.

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[45] *See* S. Rep. 83-1622, at 250-251 ("In a distribution or exchange to which section 355 applies *and which is pursuant to a reorganization as defined under section 368(a)(1)(D)* (and takes place immediately after the corporate transfer of assets) the principle of the *Sansome* case will be applied to allocate a portion of the earnings and profits of the distributing corporation to the controlled corporation." (internal citations omitted, emphasis added).

[46] *See* H. Rep. No. 1337, 83d Cong., at 267 (1954). The purpose for this change was to eliminate the need to form a holding company solely to effect a tax-free division of a pre-existing subsidiary. For a more complete history of the spin-off provisions, see the Section 355 No-Rule Report.

3. Treas. Reg. §1.312-10(c)

The final subsection of the Regulations provides that if Distributing has a deficit in E&P, no part of the deficit shall be allocated to Controlled.[47]

(iv) Case Law Interpreting the Regulations: *Bennett*

Despite being in effect for 60 years, there is a surprising dearth of authority exploring the ambiguities and unanswered questions of the Regulations.[48] The most notable authority addressing the Regulations is *Bennett v. United States*[49], where the Court of Claims considered the meaning of the "proper case" language in Treas. Reg. §1.312-10(a). In *Bennett*, Distributing transferred property to Newco Controlled in a divisive D reorganization and, years later, Newco Controlled made a series of distributions to its shareholders. The determination of whether the distributions were taxable as dividends or as nontaxable return of capital distributions depended upon the amount of E&P allocated to Newco Controlled. The taxpayer took the position that net basis was a proper method of allocation under their facts; while the government asserted that the fair market value method was the appropriate allocation method for allocating E&P.

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47 This Report does not consider the policy implications of E&P deficits or whether a deficit should be allocated in a spin-off.

48 Other cases that have mentioned the Regulations have not considered the allocation issues addressed in this Report. *See IU Int'l Corp. v. United States*, 116 F.3d 1461 (Fed. Cir. 1997) (amount and method of E&P allocation not at issue where Distributing sought to increase basis in Controlled in an amount equal to E&P allocated to Controlled); *HIE Holdings, Inc. v. Commissioner*, 97 T.C.M. (CCH) 1672 (2009) (the Regulations were relevant to determining E&P in tax deficiency case involving, in part, a nontaxable spin-off, but otherwise directing parties to independently provide E&P calculations).

49 427 F.2d 1202 (Ct. Cl. 1970).

The court relied heavily on the legislative history of section 312(h)(1) to interpret the meaning of “proper case,” noting that section 312(i) as enacted was intended to be flexible, as evidenced by the abandonment of the proposed House version of the provision.[50] While the Commissioner was given broad authority to determine an allocation method, Congress provided that the allocation of E&P must comply with the *Sansome* principle. The court observed that the Regulations create a general preference for the fair market value method, but that the ultimate selection of an appropriate method was dependent on the facts and circumstances of each case.[51] Under the facts and circumstances of *Bennett*, the court held that the fair market value method was the appropriate method because (i) it would protect the *Sansome* principle, expressed as “the prevention of tax avoidance at the shareholder level”[52]; (ii) the net worth limitation, if relevant, would not be violated; and (iii) the value of both Distributing and Controlled, as publicly traded companies, was easily ascertained.

The *Bennett* case perpetuates the uncertainty regarding the potential scope of the “proper case” language in light of its fact-specific analysis that seemingly focused on finding the distributions were taxable. However, the court noted that the issue of taxability is not “dispositive” and that where there are “compelling countervailing circumstances,” a proper case may not maximize taxability.[53] Interestingly, the *Bennett* case rejected the taxpayer’s criticism that E&P allocations under the fair market value

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[50] *Id.* at 1209.

[51] *Id.* at 1210.

[52] *Id.* at 1210-1211.

[53] *Id.* at 1212.

method improperly reflect the appreciation in value of the properties transferred to Controlled because additional E&P will be generated when Controlled later disposes of the properties. As discussed further below, the Service has put forth a similar line of reasoning in support of the net basis method in the context of proposed regulations dealing with cross-border spin-offs.[54]

The *Bennett* case could be interpreted as a results-oriented decision. The court, with the benefit of hindsight, concluded that the taxpayer's chosen allocation method was not proper because it eventually led to a reduction in shareholder tax liability of a post spin-off corporate distribution. Nevertheless, the *Bennett* case supports the proposition that upholding the *Sansome* principle – that continuity of shareholder taxability is not to be obliterated by the intervention of a tax-free reorganization – guides the overriding determination of whether an allocation method is appropriate under the facts and circumstances.[55]

(v) Section 367 Proposed Regulations

In 2000, Treasury and the Service considered the allocation of E&P in situations where Distributing, Controlled, or both, are foreign, and proposed to modify the rules of the Regulations in those contexts pursuant to the authority of section 367(b) (the "**Section 367 Proposed Regulations**").[56] While a discussion of specific international tax implications of spin-offs is beyond the scope of this Report, the Section 367 Proposed Regulations are relevant to the fundamental questions of E&P allocation in a spin-off.

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[54] *See* section III.F, below, discussing Prop. Reg. §1.367(b)-8.

[55] *Bennett*, 427 F.2d at 1212.

[56] Prop. Treas. Reg. §1.367(b)-8, 65 Fed. Reg. 69138-01 (Nov. 15, 2000).

The Section 367 Proposed Regulations generally adopt the principles of section 312(h), but modify their mechanics to meet the objectives of certain international provisions, such as the sourcing and foreign tax credit rules, and provide clarity as to what rules should apply in ambiguous cases, such as a divisive D reorganization involving a transfer of assets to Oldco Controlled. The modifications apply to three categories of transactions: (1) a transfer of assets to Newco Controlled in a divisive D reorganization; (2) a spin-off of Oldco Controlled where there is no transfer of assets; and (3) a transfer of assets to Oldco Controlled in a divisive D reorganization.

In the context of a transfer of assets to Newco Controlled in a divisive D reorganization, the Section 367 Proposed Regulations propose to modify Treas. Reg. §1.312-10(a) by expressly requiring that the allocation of Distributing's E&P be made based on the relative net basis[57] of assets transferred to Controlled in order "to [reflect] the view that net basis is the most accurate measure of the appropriate amount of earnings and profits that should be allocated to the assets transferred by a distributing corporation in the D reorganization."[58] To illustrate the concern regarding accuracy, the Section 367 Proposed Regulations give an example in which Controlled later recognizes gain on appreciated property transferred in the spin-off (and, thus, creates additional E&P). However, the Section 367 Proposed Regulations do not address scenarios where allocating E&P based on net basis can lead to other distortions, as described below.

[57] The Section 367 Proposed Regulations clarify that "net basis" means "net tax basis." *See* Examples 1 and 2, Prop. Treas. Reg. §1.367-8(c)(3), 65 Fed. Reg. 69138-01 (Nov. 15, 2000) (in a transaction where Distributing recognizes gain immediately prior to the distribution, net basis is increased by the amount of tax gain recognized).

[58] Prop. Treas. Reg. §1.367(b)-8, 65 Fed. Reg.at 69145.

In the context of a spin-off of Oldco Controlled, the Section 367 Proposed Regulations provide the E&P of Distributing is reduced by the amount that E&P would have been reduced if it had transferred the stock of Controlled to a new corporation and allocated based on net basis with no net worth limitation on such reduction.[59] The Section 367 Proposed Regulations would not increase or substitute Controlled's E&P as a result of Distributing's reduction.[60]

In the context of a transfer of assets to Oldco Controlled in a divisive D reorganization, the Section 367 Proposed Regulations provide a hybrid method incorporating the concepts of the two previously described rules.[61] Distributing's E&P would be decreased both for the net basis of assets transferred in the divisive D reorganization and for the distribution of Oldco Controlled stock. Oldco Controlled's E&P would be increased only to the extent of the E&P attributable to the assets received in the divisive D reorganization. In the preamble to the Section 367 Proposed Regulations, the Service states that Treas. Reg. §1.312-10(a) "does not specifically address the allocation and reduction of earnings and profits in connection with a D/355 distribution that involves a preexisting controlled corporation."[62]

In all cases, the Section 367 Proposed Regulations provide that an allocation or reduction of Distributing's E&P generally shall be pro rata out of a cross-section of Distributing's E&P. The preamble states that this is preferable to "some other measure,

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59 *See* Prop. Treas. Reg. §1.367(b)-8(b)(1)(ii)(A), 65 Fed. Reg. 69138-01 (Nov. 15, 2000).

60 The E&P that is reduced disappears unless otherwise included in income, such as under Treas. Reg. §1.367(b)-5.

61 *See* Prop. Treas. Reg. §1.367(b)-8(b)(4) , 65 Fed. Reg. 69138-01 (Nov. 15, 2000).

62 *See* Preamble to Prop. Treas. Reg. §1.367(b)-8, 65 Fed. Reg. 69138-01, 69145 (Nov. 15, 2000).

such as by determining the earnings and profits attributable to the income generated by assets transferred or distributed (a tracing model) or by decreasing most recently accumulated earnings and profits to the extent of assets transferred or distributed (a dividend model)."[63]

IV. POLICY CONSIDERATIONS

As explored below, there is no possibility of devising a perfect system for allocating Distributing's E&P when it engages in a spin-off. There are too many factual permutations that can alter the efficacy of a particular model. Because precision is not attainable, there must be a balancing of competing policy goals. In the analysis of possible E&P allocation methods that follows, these policy considerations are taken into account in assessing merits and demerits of each method. As demonstrated, each method will reach appropriate result for some cases, and each will reach inappropriate results for other cases. Because there is no "one size fits all" solution to this problem, the tax system will be required to make choices among the relevant policies as some of them cannot co-exist.

A. Achieving Continuity in the Taxation of Distributions

As the Court of Claims noted in *Bennett*, the purpose of allocating E&P in a tax-free corporate division is to promote continuity of shareholder tax liability as to future distributions of money or property. Accordingly, the allocation of E&P should be such that the potential dividend liability of shareholders with respect to future distributions

[63] *See Id.* at 69146.

after the division is no greater or lesser than it would have been in the absence of the division.

This principle reflects two distinct aims. The first, and arguably most important, is that the allocation should maintain the relationship of the shareholders to the E&P accumulated prior to the division. This goal is rooted in the *Sansome* principle, which holds that a tax-free transaction should not have the effect of converting a distribution that would have otherwise been a dividend into a tax-free return of capital or capital gain. Support for this goal is abundant: it is manifest in the early case law, the legislative history to section 312(i), Treas. Reg. §1.312-10, and the *Bennett* case, which elevated it to a criterion of the adequacy of any allocation method.

The second aim is that the allocation should maintain the relationship of the shareholders to the "potential E&P" – that is, Distributing's pre-division E&P adjusted for any net unrealized built-in gain or loss at the time of the division.[64] This objective is satisfied when E&P is allocated such that, if all built-in gain or losses were realized, the E&P of the Distributing and Controlled corporations would be in proportion to their respective fair market values at the time of division. This goal finds implicit support in the legislative history to section 312(i) (the forerunner to section 312(h)), which contemplates a "net worth" limitation on any adjustment to Controlled's E&P in connection with a straight section 355 distribution, and explicit support in the preamble to the Section 367(b) Proposed Regulations. It also comports with the balance sheet conceptualization of E&P – the notion, discussed below, that E&P is essentially a

[64] Colby et al., *supra* note 8.

balancing figure on the tax basis balance sheet that represents the difference between the corporation's net basis in its assets and its capital account.

B. Role of the Tax Basis Balance Sheet

If a corporation has a balanced tax basis balance sheet, then, after all gains and losses have been recognized, accumulated E&P will equal the value of the corporation's assets less contributions from shareholders. As discussed above, as a conceptual matter, E&P ought to equal the difference between the tax basis of a corporation's assets and its debt and equity capital.

Because the tax basis balance sheet has played a significant role in the development of general E&P rules, it should be taken into account in balancing the various objectives at play in the E&P allocation rules for spin-offs. Nevertheless, a balanced tax basis balance sheet is not currently a fundamental principle underlying the tax law as it relates to movements of assets and E&P. Leaving aside the debt and shareholder capital elements of the tax basis balance sheet consider the fact pattern in which Y corporation, which has $200 of asset basis (cash) and $200 of E&P, acquires the stock of X corporation for $200 in a qualified stock purchase. Further assume that X's assets have a net fair market value of $200 and a $0 basis, and X has no E&P. If following the acquisition X liquidates into Y under section 332, Y would succeed to X's basis in its assets ($0), and X's E&P ($0).[65] In this case, Y would have an unbalanced tax basis balance sheet — asset basis of $0 and E&P of $200 (i.e., its historic E&P).

[65] *See* sections 334(b) and 381(a). *See also* Rev. Rul. 90-95, 1990-2 C.B. 67 (a qualified stock purchase of a target corporation followed by a liquidation of the newly acquired target corporation is respected as a stock acquisition followed by a liquidation rather than a direct asset acquisition).

Similar results may occur, for example, in (i) section 368(a)(1) reorganizations where the acquiring corporation issues boot as part of the consideration (e.g., an acquisitive D reorganization using solely cash[66]), (ii) section 304 transactions, (iii) non-dividend equivalent redemptions, (iv) triangular reorganizations, and (v) divisive section 368(a)(1)(D) reorganizations.[67] For instance, assume that Y, which has $200 of asset basis (cash) and $200 of E&P, instead acquired the stock of X corporation for $200 from Parent, the sole shareholder of Y and X, in a section 304(a)(1) transaction. Further assume that Parent's basis in its X stock is $200. This transaction similarly unbalances Y's tax basis balance sheet –asset basis of $200 (carryover basis in the X stock) and E&P of $0 ($200 of historic E&P less $200 of deemed dividend to Parent). In fact, except for the few transactions that are governed by rules that require a connection between E&P and tax basis, most transactions in which assets move today result in unbalanced balance sheets. Consequently, it is likely that a large number of corporations with any significant history will not have a balanced tax basis balance sheet.

As discussed above, in *Bennett*, the Claims Court specifically rejected the taxpayer's argument that E&P was a function of a tax basis balance sheet. There does not seem to be any indication from Congress or the case law that maintaining a balanced tax basis balance sheet was a policy driver for section 312(h). In a tax system that generally does not pursue the balance between E&P and tax basis, it does not seem that maintaining equilibrium between E&P and tax basis in connection with a spin-off is a

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66 *See* Treas. Reg. §1.368-2(l).

67 For further discussion, *see* Charles R. Nesson, *supra* note 10.

worthwhile pursuit. Nevertheless, we also recognize that harmonizing shareholder capital/E&P and tax basis may be a principle to be considered in the income tax system more generally, with a view to addressing the myriad of transactions that implicate the relationship in a consistent manner. Absent such significant changes to the tax system as a whole, however, we do not believe this policy should drive the outcome of the E&P allocation rules if there are more important policies to balance.

C. Net Worth Limitation

The principles of the tax basis balance sheet have, to some extent, manifested themselves in the current law addressing E&P allocation in spin-offs. Specifically, as described above, under Step 1 of Treas. Reg. §1.312-10(b), the reduction to Distributing's E&P cannot be greater than the Controlled Net Basis Amount – i.e., the sum of Controlled's basis in all of its properties, plus cash, minus all liabilities.

In some ways, the net worth limitation is a close relative to a balanced tax basis balance sheet; it doesn't always ensure a balanced tax basis balance sheet, but it prevents Controlled's E&P from exceeding its tax basis in its assets.

The origins of the net worth limitation can be traced to the legislative history to section 312(h). In providing that an allocation of E&P would be made under regulations, the Senate Finance Committee stated that "[a]s a result of such allocation, in no case may the earnings and profits of a corporation exceed its total net worth."[68] For this purpose, the net worth limitation is a tax basis, rather than fair market value, concept.[69]

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[68] *See* S. Rep. 83-1622, 250; 3 U.S.C.C.A.N. 4621, 4887-4888 (1954).

[69] See S. Rep. 83-1622, 250-251; Treas. Reg. §1.312-10(b). *See also Bennett v. United States*, 427 F.2d 1202, 1211 (Ct. Cl. 1970) ("it is evident that for purposes of the limitation Congress envisioned net

Interestingly, the Senate's direction that the E&P of a corporation may never exceed its net worth was not specifically directed to a straight section 355 distribution or a divisive D reorganization followed by a spin-off. Indeed, the court in *Bennett* acknowledged that the net worth limitation should similarly apply to allocations under Treas. Reg. §1.312-10(a), despite the lack of a direct reference to such a limitation in the Regulation.[70] Further, the court reconciled the presence of a net worth limitation with the direction to follow the *Sansome* principle as follows:

> Not only does a corporation's net worth form no part of [the principle of the *Sansome* case], but to credit plaintiffs' claim it must be assumed that, contrary to the clear purport of its words, the Committee really meant that an allocation incident to a "D" reorganization was only to be governed by the *Sansome* principle if it did not attribute earnings and profits to a corporation in an amount greater than its net worth. It cannot be reasonably assumed that Congress was so inarticulate. The more rational view, and that applied here, is that net worth was intended to function as a general relief measure in the nature of a cutoff point -- a point beyond which no allocation could go no matter how appealing and well-grounded in its own right. It is also worth noting that on the facts of this case the practical effect of plaintiffs' proposition would be to discard the fair market value method, though it demonstrably attains the *Sansome* principle because it pierces Canal's net worth ceiling, and replace it with the net tax basis method which gives no accommodation to *Sansome* and imputes earnings and profits to Canal amounting to only one-half of its net worth. So bizarre a result should not be sanctioned in the absence of compelling circumstances not present here.[71]

In effect, the court concluded that the net worth limitation may act as an overall governor to an E&P allocation resulting from the *Sansome* principle, but it does not otherwise inform how such principles should be carried out. However, the court in

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worth in its conventional and generally understood balance sheet sense; not the hybrid net worth, based on market value rather than book value of assets, that has been infrequently employed and, when employed, specifically defined.").

70 The question of whether a net worth limitation applied to the facts of the *Bennett* case was not relevant to the final holding.

71 *Bennett*, 427 F.2d at 1213- 1215.

Bennett was seemingly not confronted with a situation in which the net worth limitation created an E&P allocation result that was inapposite of the *Sansome* principle.

This leads to a broader question of whether a net worth limitation and the *Sansome* principle can coexist, and if not, which principle should trump. As explained above, the overriding policy objective for allocating E&P in a spin-off is to preserve continuity in future shareholder taxability – i.e., the *Sansome* principle. On the other hand, the net worth limitation is grounded on the premise that a corporation's tax basis balance sheet should balance. As explained in the previous section, there are numerous instances in which a corporation's tax basis balance sheet may become unbalanced. As such, it is questionable what role, if any, the policy of preserving a balanced tax basis balance sheet should play in the rules governing E&P allocations in spin-offs. When weighing the importance of protecting the *Sansome* principle against the secondary concerns of a balanced tax basis balance sheet, we believe it is clear that the *Sansome* principle should take priority.

A net worth limitation could easily frustrate the *Sansome* principle in many spin-offs. For instance, it is common for a Controlled corporation to be leveraged equal to the basis in its assets. As a result, many Controlled corporations would have a $0 net worth, and thus would be allocated no E&P in a spin-off. For example, in cases where a Controlled corporation is leveraged in an amount equal to the basis in its assets, such leverage is only economically sustainable because the fair market value of Controlled's assets exceeds the basis in its assets. As explained further below in the section discussing the Net Basis Method, while there is some logic to this approach, the results may be inconsistent with the *Sansome* principle.

In sum, although the legislative history to section 312(h) provided for a net worth limitation, we believe that the directive to follow the *Sansome* principle is more important and thus should control. Accordingly, we recommend that future guidance addressing E&P allocations in spin-offs does not contain a net worth limitation.

D. Other Objectives

In addition to focusing on preserving continuity in the taxation of shareholder distributions, there are several other policy objectives that should be considered and balanced in designing a new system for E&P allocation. In light of the inherent complexity of the E&P system generally and the further complexity created by its allocation in a divisive transaction, any allocation system should promote administrability and certainty for taxpayers and the Service alike. Also, the difference in results from the allocation rules that apply to Newco Controlled corporations and Oldco Controlled corporations should be minimized to eliminate the need that exists today to create additional corporations as well as to minimize tax planning.

E. Need for a Presumptive Allocation Method

Congress gave authority to the Treasury to provide rules for the allocation of E&P in connection with a spin-off. An allocation is consistent with the complete separation of Distributing and Controlled, and provides the only practical means of dividing an attribute that was earned while the businesses were united. Specific allocation rules are provided for other attributes as well.[72]

Instead of allocating, in theory, Distributing's pre-spin-off E&P could remain in a pool which would be jointly available to both Distributing and Controlled following the spin-off (the "**Pooling Model**").[73] Even if there were authority to adopt the Pooling Model, its detriments outweigh any conceptual appeal it may have. However, it provides perspective for assessing the allocation methods below and, therefore, is worthy of elaboration.

Under the Pooling Model, if either corporation were to make a post-spin-off distribution, it would have E&P available first from its own post-spin-off operations and then from the common pool, in an amount up to its fair market value immediately after the spin-off. The main attraction of the Pooling Method is that, by making the entire amount of Distributing's pre-spin-off E&P available to Distributing and Controlled following the spin-off, it neutralizes the effect of a spin-off in some circumstances in which an allocation-based method does not.

> **Example:** D contributes part of its assets to newly formed C in exchange for all C's stock, and then spins off the C stock to its shareholders in a divisive D reorganization. Assume that D has $50 of E&P at the time of the transaction. Further, assume that the assets transferred to C, and retained by D, have a fair market value of $200 and a net basis of $50.

72 *See, e.g.*, Treas. Reg. § 1.1502-9T(c)(2), providing that when a member of a consolidated group leaves the group, it is allocated a pro rata portion of each of the group's consolidated overall foreign loss accounts, consolidated separate limitation loss accounts and consolidated overall domestic loss accounts are determined accounts based on the member's share of the group's assets that generate income subject to recharacterization under the corresponding loss account at the time the member ceases to be a member.

73 *See Corporate Reorganization and Continuity of Earnings History: Some Tax Aspects*, 65 Harv. L. Rev. 648 (Feb. 1952); Nesson, *supra* note 10, at 475.

Under the Pooling Model, D's $50 of pre-spin-off E&P would be left in a pool which would be available to both D and C following the spin-off. Consequently, if either corporation were to distribute $50, the entire $50 distribution would be out of the common pool, and hence would be taxable as a dividend, and hence no distortion would arise.

Although the Pooling Model generally would result in a more thoroughgoing application of the *Sansome* doctrine to spin-offs than an allocation-based approach, it would fall short of fully neutralizing the effect of the spin-off. In particular, where Distributing and Controlled come to be held by different shareholders, the Pooling Model could result in a post-spin-off distribution being treated more favorably than it would have been treated absent the spin-off.[74]

Moreover, any benefits associated with the Pooling Method would come at the cost of considerable complexity. Each of Distributing and Controlled would need to know the amount of post-distribution E&P and distributions of the other in order to know how much E&P remains in the pool. As one example, suppose that Distributing (but not

[74] Consider the following example: USP owns all the stock of FD1 and FD1 owns all the stock of FD2. In a divisive D reorganization, FD2 contributes part of its assets to newly formed FC in exchange for all FC's stock, and then spins off the FC stock to FD1. Immediately thereafter, FD1 spins off the FC stock to USP in a distribution described in section 355. Assume that at the time of the transaction, FD1 has no E&P and FD2 has $50 of E&P. Further, the fair market value of the assets transferred to FC, as well as the fair market value of the assets retained by FD2, is greater than $50. Following the spin-off, in an unrelated transaction, FD2 distributes $50 to FD1. The following year, FC distributes $25 to USP. FD2's $50 distribution to FD1 would be out of the pool of FD2's pre-spin-off E&P, and hence would be taxable as a dividend. The common pool having thus been exhausted, no portion of FC's subsequent $25 distribution to USP would be taxable as a dividend. This is a result that could not have been obtained but for the spin-off, and, moreover, one that would not have been available had a portion of FD2's E&P been allocated to FC in connection with the divisive D reorganization.

Controlled) generates an E&P deficit from its own post-spin-off operations.[75] In order to neutralize the effect of the spin-off on subsequent property distributions, the deficit would reduce the pool. The upshot – that the amount of E&P in the pool is subject to change, based on the post-spin-off operations and distributions of Distributing and Controlled – would pose serious practical issues. For one, in order to compute the amount of E&P available in the pool, Distributing and Controlled would be required not only to share information about their respective operations but also to coordinate their tax reporting positions on matters affecting E&P. And if they were unable to agree about a particular tax reporting position – a likely prospect, given the pervasive uncertainty surrounding the computation of E&P – intractable disputes among Distributing, Controlled, and the Service could ensue.[76]

The Pooling Model could entangle Distributing and Controlled in other respects as well. Inevitably, there will be cases in which Distributing and Controlled each make property distributions in the same year, and the total amount of the distributions during the year exceeds the amount of E&P in the pool. Thus, there would be a need for ordering rules governing post-spin-off distributions. Each of the obvious options, however, would create problems. If the distributions are charged against the pool

[75] A similar issue would arise if Distributing or Controlled were to redeem certain of its shares in a transaction to which section 302(a) applies. Specifically, should the amount of E&P subject to reduction under section 312(n)(7) include the pool of pre-spin-off E&P available to both Distributing or Controlled or, instead, should it be limited to E&P arising out of the redeeming corporation's own post-spin-off operations?

[76] If Distributing or Controlled were to undergo a subsequent divisive D reorganization before exhausting the amount of E&P in the pool from the original division, the burden of complying with, and administering, the Pooling Method would become greater still, as there would now be three entities whose separate activities could affect the amount of E&P available in the pool.

according to the order in which they are made, there could be disputes between Distributing and Controlled as to which corporation declares dividends first. alternative – allocating a pro rata portion of the E&P in the pool to each distribution – is hardly better, as it would allow a distribution by one corporation to be affected by a subsequent distribution by the other In the public company context, this could frustrate the ability of Distributing and Controlled to comply with tax reporting obligations applicable to property distributions.[77]

V. ALLOCATION OF E&P TO NEWCO CONTROLLED

Much has been written on the issue of allocating E&P to Newco Controlled, around the time of the promulgation of the Regulations[78] and more recently with the proliferation of section 355 distributions involving multinational corporations with significant foreign entities.[79]

Below we analyze five basic potentially meritorious models for allocating E&P to Newco Controlled.

- Under the "**Fair Market Value Method**," E&P would be allocated based on the relative fair market values of Distributing and Controlled. As discussed above, allocating E&P on the basis of relative fair market values is the "general" rule in the Regulations for allocating Distributing's E&P to Newco Controlled.

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77 *See, e.g.*, section 6043(c).

78 *See, e.g.*, John S. Pennell, *Divisive Reorganizations and Corporate Contractions,* 33 Taxes 924 (1955); Alexander, *supra* note 41; Halperin, *supra* note 10, at 292; Haskell Edelstein, *Searching for Some Logic in the Earnings and Profits Rules: Some Recent Developments*, 23 Proc. Ann. Tul. Tax. Inst. 73 (1974).

79 *See, e.g.*, Collins et al., *supra* note 4; Bodoh et al., *supra* note 41; Jasper L. Cummings, Jr., *E&P in Spinoffs – Part 2*, 2014 TNT 33-5 (Feb. 19, 2014).

Presumably the fair market value allocation rule was adopted to maintain the relationship of the shareholders to the E&P accumulated prior to the division, which was the subject of case law at the time the Regulations were adopted.[80]

- Under the "**Net Basis Method**," as it has been used in the modern tax law, E&P would be allocated based on the net basis of assets transferred to Controlled relative to those retained by Distributing. The Net Basis Method has its underpinnings in the balanced tax basis balance sheet, which would suggest that if basis is transferred to Controlled, some amount of E&P should move with it. However, it does not address what happens to the shareholder capital in the spin-off. As discussed above, the Section 367 Proposed Regulations proposed to adopt the Net Basis Method for all cross-border section 355 distribution because it takes into account potential E&P.
- Under the "**Tracing Method**," to attempt to allocate E&P as if Distributing's and Controlled's businesses were always separate, E&P would be traced to the assets that generated the E&P and allocated to the corporation that receives those particular assets. As discussed below, while the Tracing Method has been endorsed by commentators, it is complex and will often lead to inappropriate results.
- Under the "**Balance Sheet Method**," to address all the elements of a truly balanced tax balance sheet, both shareholder capital and E&P would be allocated

[80] Some have observed that because fair market value most closely indicates the corporation's future earning power, it is a close proxy for the Tracing Method. *See* Alexander, *supra* note 41.

between Distributing and Controlled. First, capital would be allocated according to the relative fair market values, and then E&P would be allocated according to the difference between tax basis and capital.[81] The Balance Sheet Method will achieve similar results as the Net Basis Method in a fact pattern in which shareholder capital is small relative to E&P. However, where shareholder capital is significant relative to E&P, the amount of E&P allocated to Controlled will be less than the amount allocated in the case of the Net Basis Method.

- Under the "**Modified Fair Market Value Method**," to address the fact that the Fair Market Value Method does not maintain the shareholders' relationship to potential E&P, adjustments to the bases of the assets of the resulting corporations would be made *solely for purposes of computing their E&P* on subsequent dispositions of those assets. The E&P basis adjustments will address the longer-term issue of Distributing and Controlled having too much or too little E&P where there is unrealized appreciation in the assets.

A. The Fair Market Value Method

The chief virtue of the Fair Market Value Method is that it preserves the relationship of the shareholders to Distributing's pre-division E&P. This effect clearly can be seen in the case of a non-pro rata split-off.

> **Example 1.** (i) Facts. At the beginning of year 1, individuals X and Y each contributed $50 to newly formed Distributing in exchange for 50% of its stock. During years 1 through 5, Distributing accumulates $100 of E&P. At the end of Year 5, Distributing forms Controlled, transfers part of its assets to Controlled in exchange for all of Controlled's stock, and then splits off Controlled by

[81] This is consistent with basis allocations under section 358.

redeeming out all of Y's shares of Distributing stock in a divisive D reorganization. Immediately after the transaction, Distributing's assets have a fair market value of $200 and a net basis of $150, while Controlled's assets have a fair market value of $200 and a net basis of $50.[82]

(ii) Results. Under the Fair Market Value Method, Distributing's pre-division E&P is reduced by an amount equal to the pre-division E&P times the fair market value of the assets transferred to Controlled divided by the fair market value of the assets held by Distributing immediately before the transaction ($100 × ($200 ÷ $400) = $50). Accordingly, after the transaction, Distributing has $50 of E&P ($100 - $50). The $50 reduction in Distributing's pre-division E&P is allocated to Controlled.

Immediately before the division, the first $50 of a distribution from Distributing to X or to Y would have been taxable as a dividend. Immediately after the division, the first $50 of a distribution from Distributing to X, and from Controlled to Y, would be taxable as a dividend. Therefore, the relationship of X and Y to the pre-division E&P has been maintained.[83]

The Fair Market Value Method does not necessarily achieve the second shareholder continuity goal of making an allocation, which is to preserve the relationship of the shareholders to Distributing's potential E&P. This defect stems from the fact that Fair Market Value Method does not take into account differences in the net basis of the assets of the corporations.[84] In Example 1, immediately after the division, Distributing's

[82] For purposes of the examples used in this Report, we have assumed the deferred tax liability associated with the underlying assets of Distributing and Controlled does not alter the fair market value of the stock of each corporation.

[83] We note that a corporation's ability to pay a dividend may depend not just on the fair market value of its assets, but also on a variety of legal and economic factors such as liquidity position, debt repayment needs, cash flow, access to financing.

[84] With the repeal of the *General Utilities* doctrine, this problem has become more acute. *See* Robert Willens, *Allocating Earnings and Profits in a Spinoff – Time for a Change?*, 119 Tax Notes 1369 (June 30, 2008) ("To prevent a "double dose of E&P" from a single taxable event involving the same properties -- a result that can no longer be avoided by bringing one's case under the umbrella of the

assets had a net unrealized built-in gain of $50, whereas Controlled's assets had a net unrealized built-in gain of $150. If each corporation were to sell its assets, Distributing's E&P would be increased to $100 ($50 (allocated E&P) + $50 (gain) = $100), whereas Controlled's E&P would be increased to $200 ($50 (allocated E&P) + $150 (gain) = $200). Note that X's potential dividend liability with respect to future distributions is $50 less than it would have been in the absence of the division, and Y's potential dividend liability with respect to future distributions by Controlled is $50 greater than it would have been in the absence of the division. Because the E&P of Distributing and Controlled ultimately would not be in proportion to their respective fair market values at the time of the division, the Fair Market Value Method fails to preserve the relationship of the shareholders to Distributing's potential E&P.

This can result in distortions in the timing and character of X's and Y's income with regard to their respective investments. Suppose that after the built-in gains in their respective assets have been recognized, Distributing and Controlled each makes a distribution of $175. Of the $175 distributed by Distributing to X, the first $100 would be considered a dividend, even though $150 is in substance a distribution of corporate income. Thus, $50 of ordinary income has been permanently converted into capital gain. Further, because the next $50 would be considered a tax-free return of capital, the shareholder-level tax would be delayed. Y, on the other hand, is not so fortunate.[85]

General Utilities doctrine -- the net basis method of allocating a parent's E&P to a spun-off subsidiary, in the case of a divisive D reorganization, should be anointed as the default method.").

85 We acknowledge that the conversion of ordinary income into capital gain, or vice versa, is not easily distinguished as either taxpayer favorable or unfavorable. Rather, such a determination is highly dependent on the facts. For example, if Y were a corporation, additional dividend income may be more

Despite the fact that her original investment appreciated by only $150, she would have a dividend of $175 – an instance of "the miracle of income without gain."[86]

While Example 1 depicts a non-pro rata split-off, the principles are relevant in pro rata spin-offs as well. In some cases, where shareholders retain their proportionate interest in both businesses following the division (e.g., in a pro rata spin-off), the distortions may be harmonized from the overall investment perspective. However, this is impossible when a corporation is allocated E&P in excess of its net basis in its assets. Suppose the facts are the same as in Example 1, except that at the time of the division, the assets transferred to Controlled have a tax basis of $0. Upon recognizing the $200 built-in gain in the assets, Controlled's E&P would be increased from $50 to $250. Because Controlled cannot make a distribution in excess of its fair market value of $200, $50 of potential future E&P effectively disappears from the system.[87]

It is important to keep in mind, though, that the distortions wrought by the Fair Market Value Method are merely potential in nature. First of all, it is possible that the built-in gains may never be realized, and hence may never be reflected in E&P. example, to the extent the built-in gain is reflected in stock of a controlled subsidiary, it may be eliminated upon a future distribution qualifying under section 355 or a complete

tax-favorable if Y is eligible for a dividends received deduction, which itself could lead to additional complexities and considerations, such a section 1059.

86 Thomas Reed Powell, *Income from Corporate Dividends*, 35 Harv. L. Rev. 363 (1921-1922).

87 The "net worth" limitation contained in Treas. Reg. §1.312-10(b) protects against this result in a straight section 355 distribution. However, it is unclear whether such limitation applies in the case of divisive D reorganization subject to Treas. Reg. §1.312-10(a). *See supra* Part IV.C.

liquidation qualifying under section 332.[88] Moreover, it is possible that neither Distributing nor Controlled will make a distribution in excess of its share of pre-division E&P, in which case, in the domestic context at least, the distortion would be confined to the corporate level.[89]

B. The Net Basis Method

The Net Basis Method does not necessarily preserve the relationship of the shareholders to Distributing's pre-division E&P. This is the case because the Net Basis Method ignores differences in the fair market value of the assets of the corporations.

> **Example 2.** (i) Facts. Same as Example 1.
>
> (ii) Results. Under the Net Basis Method, Distributing's pre-division E&P is reduced by an amount equal to the pre-division E&P times the net basis of the assets transferred to Controlled divided by the net basis of the assets held by Distributing immediately before the transaction ($100 × ($50 ÷ $200) = $25). Accordingly, after the transaction, Distributing has $75 of E&P ($100 - $25). The $25 reduction in Distributing's pre-division E&P is allocated to Controlled.

On the facts of Example 2, X is worse off as a result of the division and the resultant allocation. Immediately before the division, the first $50 of a distribution to her would have been a dividend; immediately after, the first $75 will be a dividend. Y, on the other hand, is better off: immediately before the division, the first $50 of a distribution to her would have been a dividend; immediately after, only the first $25 will be a dividend.

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[88] When there is parity between the basis of the liquidating subsidiary's stock and the net basis of the subsidiary's assets, the built-in gain will be preserved. *See* section 334(b).

[89] *But cf.* section 1248 (under specified conditions, gain from the sale or exchange of stock of a foreign corporation included in gross income as a dividend to the extent of the foreign corporation's E&P).

Failure to maintain the relationship of the shareholders to the pre-division E&P can also distort the timing and character of income at the shareholder level. Suppose that Controlled makes a distribution of $50 to Y before the built-in gains in its assets are realized. Of that distribution, the first $25 would be considered a dividend and the second $25 would be considered a return of capital. If it is assumed that Controlled would have made a $50 distribution to Y in any case, the division has the effect of permanently transforming $25 of ordinary income into capital gain. This result is inconsistent with the *Sansome* rule insofar as the division and resultant allocation has the effect of converting a distribution that would have otherwise been a dividend into a tax-free return of capital.

If it were the general rule, the Net Basis Method would frequently place shareholders in position to realize such a benefit. When Distributing has debt outstanding, it is often necessary to shift a portion of Distributing's debt to Controlled to rationalize their capital structures – especially in the case of a division of a public company. Further, it is common for the amount of the debt shift to equal or exceed the net basis of the assets transferred to Controlled. Accordingly, there would be a significant class of cases in which Controlled would be allocated no E&P. This could raise significant policy concerns in a variety of contexts, including cross-border spin-offs and REIT spin-offs.

To be sure, there are other constraints on the ability of shareholders to exploit the distortions created by the Net Basis Method. For one, it is a requirement of section 355 that the division not principally be a device for the distribution of E&P of Distributing or

Controlled. However, relying on the device requirement to fix the problems created by the Net Basis Method has several disadvantages. First, while the device requirement would thwart obvious bailout schemes, it would not accomplish the broader objective of section 312(h), which, again, is to assure future distributions are taxed as dividends to the extent of pre-division E&P. For example, the device requirement generally does not apply in the case of a non-pro rata split-off, such as Example 2.[90] Moreover, the device requirement generally would not apply if, following the division, Distributing or Controlled were to make a return-of-capital distribution that was not planned at the time of the division. In such situations, discontinuities could arise innocently. Second, the device requirement is a balancing test, and, as such, its application can be indeterminate. Where the Net Basis Method yields, serendipitously, a significant potential benefit to shareholders, the prospect of that potential benefit could interject uncertainty regarding the qualification of the distribution under section 355.

The main justification for the Net Basis Method is that it is more effective than the Fair Market Value Method at preserving the relationship of the shareholders to Distributing's potential E&P. Therefore, it promotes continuity in the taxability of future distributions over the long run. This is certainly true in Example 2. There, if each corporation were to sells its assets, Distributing's E&P would be increased to $125 ($75 (allocated E&P) + $50 (gain)), and Controlled's would be increased to $175 ($25 (allocated E&P) + $150 (gain)). Notice that this is still distortive: X's potential dividend liability with respect to future distributions by Distributing is $25 less than it would have

90 Treas. Reg. §1.355-2(d)(5)(iv).

been in the absence of the division, and Y's potential dividend liability with respect to future distributions by Controlled is $25 greater than it would have been in the absence of the division. However, on these facts, the distortion is half as great as it was under the Fair Market Value Method.[91]

C. The Tracing Method

The Tracing Approach presents practical difficulties and limited utility in accomplishing policy objectives. As an initial matter, the Tracing Method is apt to prove unworkable. Requiring corporations to reconstruct the historical source of their E&P would impose undue compliance burdens and uncertainties on taxpayers and would create immense administrative difficulties for the Service. In fact, Treasury and the Service specifically rejected the Tracing Method in the Section 367 Proposed Regulations.[92] Similar tracing methods have been rejected as overly complicated in other contexts.[93]

Second, even if it were feasible, the Tracing Method would not necessarily result in neutralizing the effect of the division on shareholder tax liability. Allocating E&P so as to mimic the state of affairs that would have existed if the shareholders originally had

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[91] Note that the amount of the distortion changes as the proportion of built-in gain changes.

[92] Preamble to Prop. Treas. Reg. §1.367(b)-8, 65 Fed. Reg. 69138-01, 69146 (Nov. 15, 2000) ("The proposed §1.367(b)-8(b) cross-section rule decreases the earnings and profits of a distributing corporation without regard to the type of income generated by the assets of the controlled corporation. This is consistent with the general assumption in §1.312-10 and the proposed regulations that the earnings and profits of the distributing corporation should be decreased proportionately to reflect the transfer or distribution of assets, rather than by some other measure, such as by determining the earnings and profits attributable to the income generated by assets transferred or distributed (a tracing model)…").

[93] *See* , *e.g.* , T.D. 9424, 2008-2 C.B. 1012 (preamble to Treas. Reg. §1.1502-36 , which expressly rejected a tracing approach); *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957).

set up the different businesses as separate corporations does not necessarily serve this purpose. In some cases, the Tracing Method will disrupt the relationship of the shareholder to the pre-division E&P, leading to the same short-run distortions as the Net Basis Method.

> **Example 3(a)**. (i) Facts. Same as Example 1, except that the $100 of pre-division E&P was generated by the business retained by Distributing.
>
> (ii) Results. Under the Tracing Method, immediately after the division, Distributing would have $100 of E&P and Controlled would have $0.

In other cases the Tracing Method will disrupt the relationship of the shareholder to the potential E&P, leading to the same long-run distortions as the Fair Market Value Method.

> **Example 3(b)**. (i) Facts. Same as Example 1, except that half of the $100 of pre-division E&P was generated by the business retained by Distributing and the other half was generated by the business transferred to Controlled.
>
> (ii) Results. Under the Tracing Method, immediately after the division, Distributing and Controlled each would have $50 of E&P.

D. The Balance Sheet Method

Some commentators have argued that the allocation of E&P in a tax-free corporation division should comport with the balance sheet conceptualization of E&P – the notion that E&P is essentially a balancing figure on a tax basis balance sheet representing the difference between the corporation's net basis in its assets and its capital account. At least two courts have specifically rejected the notion that E&P is a function of a tax basis balance sheet.[94]

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94 *See Bennett v. U.S.*, 192 Ct. Cl. 448, 470 (Ct. Cl. 1970) ("The short answer to this, as explained at the outset, is that the earnings and profits figure is not an ingredient of a corporation's balance sheet structure. Earnings and profits are neither a corporate resource nor liability. Since, aside from

On this view, where Distributing has a balanced tax basis balance sheet immediately before the division, Distributing's E&P would be allocated according to the following procedure: first, Distributing's capital account[95] would be allocated between Distributing and Controlled in proportion to their respective fair market values; then, Distributing and Controlled would each be allocated a portion of the pre-division E&P equal to the difference between its net basis in its assets and its capital account (the "**Balance Sheet Method**").[96]

> **Example 4.** (i) Facts. Same as Example 1.
>
> (ii) Results. (A) Allocation of capital account. Distributing's capital account of \$100 is reduced by an amount equal to the capital account times the fair market value of the assets transferred to Controlled divided by the fair market value of the assets held by Distributing immediately before the transaction (\$100 × (\$200 ÷ \$400) = \$50). Accordingly, after the transaction, Distributing has a capital account of \$50 (\$100 - \$50). The \$50 reduction in Distributing's capital account is allocated to Controlled.
>
> (B) Allocation of E&P. Under the Balance Sheet Method, Distributing is allocated a portion of the pre-division E&P equal to the difference between its net basis in its assets and its capital. Thus, after the transaction, Distributing would have \$100 of E&P (\$150 - \$50 = \$100). Likewise, Controlled is allocated a portion of the pre-division E&P equal to the difference between its net basis in its assets and its capital. Thus, after the transaction, Controlled would have \$0 of E&P (\$50 - \$50 = \$0).

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corporate accumulation penalties, the earnings and profits account functions solely as a check valve on the taxable character of shareholder distributions, a balance sheet entry pertaining to it would properly be in the nature of an annotation for stockholder information purposes, not a part of the accounting portrayal of the corporation's own financial condition."); Brief of Margaret R. Phipps, Respondent, 336 U.S. 410 (1949) (No. 83). Altering the U.S. tax basis of controlled foreign corporations may give rise to additional complications; *cf.* section 901(m).

[95] In general, the capital account is an historical figure, reflecting the portion of the corporation's total assets attributable to amounts contributed by shareholders as capital. On the facts of this example, Distributing's capital account is \$100, that is, the amount of cash received on formation.

[96] Nesson, *supra* note 10; Halperin, *supra* note 10.

As this example demonstrates, the Balance Sheet Method would not maintain the relationship of the shareholder to the pre-division E&P. In fact, the potential for distortion here is even greater than it was under the Net Basis Method. Further, in cases where Distributing or Controlled's net basis in its assets exceeds its capital account, it would be necessary to create a deficit in E&P in order to maintain the integrity of the tax basis balance sheet.

However, the Balance Sheet Method would fully preserve the relationship of the shareholders to Distributing's potential E&P. Suppose Distributing and Controlled sell their respective assets following the division. Distributing's E&P would be increased to $150 ($100 (allocated E&P) + $50 (gain)), and Controlled's would be increased to $150 ($0 (allocated E&P) + $150 (gain)). Accordingly, the E&P of the corporations will be in proportion to their respective fair market values at the time of the division. Thus, provided that no return-of-capital distributions are made before the net unrealized built-in gains in the assets are realized, the Balance Sheet Method neutralizes the effect of the division on the taxability of future distributions.[97]

[97] This example presumes that Distributing has a balanced tax basis balance sheet before the spin-off transaction. In many circumstances, this may not be the case. For example, where Distributing has E&P in excess of the difference between Distributing's net basis in its assets and its capital account, application of the Balance Sheet Method would necessarily result in a net reduction to E&P. In other circumstances, the capital account of Distributing may not be known. For an application of tax basis balance sheet principles in either scenario, *see infra* note 98.

Comparison of Results

	X		Y	
	Pre	Potential	Pre	Potential
No division	$50	$100	$50	$100
FMV Method	$50	$50	$50	$150
Net Basis Method	$75	$50	$25	$150
Balance Sheet Method	$100	$50	$0	$150

E. The Modified Fair Market Value Method

The discussion above discloses a dilemma: the Fair Market Value Method maintains the relationship of the shareholders to Distributing's pre-division E&P, but at the cost of distorting the relationship of the shareholders to Distributing's potential E&P. Conversely, the Balance Sheet Method maintains the relationship of the shareholders to Distributing's potential E&P, but at the cost of distorting the relationship of the shareholders to Distributing's pre-division E&P. Is there a way out?

One potential option would be to allocate E&P according to the Fair Market Value Method, but to adjust the tax basis of the assets of Distributing and Controlled *solely for purposes of computing their E&P* on the disposition or consumption of those assets, to prevent future distortions.

Example 5. (i) Facts. Same as Example 1.

(ii) Results. The first step of the Modified Fair Market Value Method is to allocate Distributing's pre-division E&P between Distributing and Controlled according to the Fair Market Value Method. Thus, Distributing and Controlled would each have $50 of E&P following the transaction.

The second step is to determine how much of Distributing's pre-division E&P would have been allocated to Distributing and Controlled under the Balance Sheet

Method. As discussed in Example 3, under that method, Distributing would have had $100 of E&P after the transaction, while Controlled would have had $0.[98]

The third and final step is to adjust the aggregate E&P tax basis of the each corporation's assets by the difference between the amount of E&P actually allocated to it under the Fair Market Value Method and the amount of E&P that it would have been allocated to it under the Balance Sheet Method. Accordingly, the E&P tax basis of Distributing's assets would be reduced by $50, to $100, whereas the E&P tax basis of Controlled's assets would be increased by $50, to $100.

As a result, if the corporations sell their respective assets, no distortion would result. Distributing's E&P would be increased to $150 ($50 (allocated E&P) + $100 (gain for E&P purposes[99])), and Controlled's would be increased to $150 ($50 (allocated E&P) + $100 (gain for E&P purposes[100])). Accordingly, the shareholder's relationship to both the pre-division E&P and potential E&P is fully preserved under the Modified Fair Market Value Method.

The downside of the Modified Fair Market Value Method is that it would engender significant complexity. Rules would be needed for allocating the basis adjustments among the corporation's assets. Where Distributing or Controlled owns stock in subsidiaries, corresponding adjustments would need to be made to the E&P tax

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98 This example above presumes that Distributing has a balanced tax basis balance sheet before the spin-off transaction. As discussed above, there are many circumstances in which this may not be the case; in other instances, it may not be possible to determine Distributing's capital account. In either scenario, the tax basis balance sheet principles may still be applied through the following process: (1) allocate Distributing's E&P according to the Fair Market Value Method, (2) determine Distributing's potential E&P (i.e., Distributing's E&P if the net unrealized built-in gain in Distributing's assets was recognized) immediately before the spin-off, (3) hypothetically allocate Distributing's potential E&P according to the Fair Market Value Method, and (4) adjust the aggregate E&P tax basis of the assets of Distributing and Controlled by the difference between the hypothetical amount in (3) and the amount each would have under the actual allocation in (1) if all gains were recognized.

99 For regular federal income tax purposes, Distributing would recognize a gain of $50, the difference between its amount realized ($200) and its regular tax basis in its assets ($150).

100 For regular federal income tax purposes, Controlled would recognize a gain of $150, the difference between its amount realized ($200) and its regular tax basis in its assets ($50).

basis of the assets of those subsidiaries, in order to prevent taxpayers from nullifying the E&P tax basis adjustments through a section 332 liquidation.[101] In large corporate groups, this exercise is apt to be particularly burdensome. Further, the taxpayers would be compelled to compute tax basis separately for both E&P and regular tax purposes. However, it bears mention that taxpayers are required to compute separate tax basis for E&P purposes in various other contexts. As one example, a corporation may have one basis in an asset for purposes of determining gain or loss upon disposition for regular federal income tax purposes (reflecting MACRS depreciation deductions) and another for E&P purposes (reflecting straight-line depreciation deductions). As another, the consolidated return regulations require separate stock basis calculations for regular federal income tax and E&P purposes.[102]

F. Recommendation

We believe preserving the *Sansome* principle – that the allocation should maintain the relationship of the shareholders to the E&P accumulated prior to the section 355 division – is the most important policy goal. Accordingly, we recommend that Treasury and the Service retain the rule in the Regulations that E&P be allocated based on the relative fair market values of Distributing and Controlled. In recognition that the Fair Market Value Method may not maintain the relationship of the shareholders to the "potential E&P" of the divided businesses, we further recommend that Treasury and the Service consider the Modified Fair Market Value Method.

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[101] For a similar approach, see section 732(f).

[102] *See* Treas. Reg. §1.1502-33(c)(1).

VI. ALLOCATION OF E&P TO OLDCO CONTROLLED

Thus far, this Report has focused on methodologies for allocating Distributing's E&P in a section 355 transaction where Distributing transfers assets to Newco Controlled in a divisive D reorganization and distributes the stock of Newco Controlled to its shareholders in a section 355 distribution. As explained above, on balance we believe that an allocation of Distributing's E&P should be based on the relative fair market value of Distributing and Newco Controlled. However, another category of corporate division transactions that must be considered is one in which Distributing distributes Oldco Controlled in a section 355 distribution that is not preceded by a divisive D reorganization (a "**straight section 355 distribution**").

Although a straight section 355 distribution differs from a divisive D reorganization in some respects, the underlying policy goals relating to E&P allocation remain unchanged. That is, regardless of whether Controlled is newly formed or preexisting, there must be an allocation of Distributing's E&P in order to promote continuity in shareholder taxation on future distributions.

A straight section 355 distribution does, however, invoke additional considerations related to E&P allocation, most notably, how to account for Oldco Controlled's existing E&P prior to the distribution.

A. Review of the Regulations

As explained above, Treas. Reg. §1.312-10(b) provides a two-step method for adjusting Distributing's and Controlled's E&P in a straight section 355 distribution. In Step 1, Distributing's E&P is reduced by the lesser of the Hypothetical D/355 Amount or the Controlled's Net Basis Amount. Next, in Step 2, if Controlled's E&P is not at least as much as the Step 1 reduction, Controlled's E&P becomes that amount; otherwise, Controlled's E&P is left unchanged.

In addition, as described above, under the Regulations, the Controlled Net Basis Amount imposes a ceiling on the reduction to Distributing's E&P As explained above, the imposition of a net worth limitation may frustrate the *Sansome* principle and we recommend future guidance not contain such a limitation (which would effectively remove the Controlled Net Basis Amount from Step 1). As such, the examples below do not take into account the Controlled Net Basis Amount.

B. Disappearing E&P

As discussed above, Treas. Reg. §1.312-10(b) utilizes a two-step system for adjusting E&P adjustment. Because the reduction to Distributing's E&P computed in Step 1 does not necessarily have a reciprocal relationship with the increase to Controlled's E&P provided in Step 2, these mechanics may allow E&P to effectively "disappear" from the corporate tax system, illustrated in the following example. Because we have recommended the Controlled Net Basis Amount not be taken into account for purposes of allocating E&P, assume that such limitation is not relevant in the following examples:

> **Example 6:** (i) Facts. Distributing's assets consist of business X assets (FMV: $200, basis: $150) and the stock of Oldco Controlled (FMV: $200; basis $20). Distributing has $70 of E&P and Oldco Controlled has $30 of E&P. Distributing distributes all of the stock of Oldco Controlled to its shareholders in a section 355 distribution.
>
> (ii) Results. The two-step method of Treas. Reg. §1.312-10(b) would apply as follows:
>
> **Step 1:** Distributing reduces its E&P by the Hypothetical D/355 Amount.

The Hypothetical D/355 Amount is computed by determining the reduction to Distributing's E&P if Distributing had contributed Oldco Controlled to Newco Controlled and distributed Newco Controlled in a divisive D reorganization. Under the Fair Market Value Method, Distributing's pre-division E&P is reduced by an amount equal to the pre-division E&P times the fair market value of the assets hypothetically transferred to Newco Controlled divided by the fair market value of the assets held by Distributing immediately before the transaction ($70 x ($200 ÷ $400) = $35). Accordingly, the Hypothetical D/355 Amount is $35.

Distributing reduces its E&P by $35, from $70 to $35, in Step 1.

Step 2: If Oldco Controlled's pre-existing E&P ($30) is less than the reduction computed in Step 1 ($35), Oldco Controlled's E&P is equal to the reduction in Step 1. Thus, under the assumed facts, Oldco Controlled's E&P is increased from $30 to $35 after the spin-off.

Following the spin-off, each of Distributing and Oldco Controlled would have $35 of E&P. On one hand, this appears to be a reasonable outcome – immediately before the spin-off, the shareholders of Distributing owned a corporation (Distributing) with a value of $400 and $70 of E&P, and immediately after the spin-off the shareholders collectively own two corporations (Distributing and Controlled), each with a value of $200 and each with $35 of E&P. Thus, the relationship of the shareholders to Distributing's pre-division E&P is fully preserved. Indeed, if Distributing had engaged in a divisive D reorganization whereby it contributed Oldco Controlled to Newco Controlled and distributed Newco Controlled, each of Distributing and Newco Controlled would have $35 of E&P under the Fair Market Value Method.

On the other hand, the mechanics of Treas. Reg. §1.312-10(b) have allowed E&P to be eliminated from the broader corporate tax system. Prior to the spin-off, Distributing had $70 of E&P and Oldco Controlled had $30 of E&P (aggregate E&P of $100). After the spin-off, each of Distributing and Oldco Controlled has $35 of E&P (aggregate E&P of $70). The loss of $30 of E&P from the system is the result of the non-reciprocal relationship between the Step 1 reduction to Distributing's E&P and the Step 2 adjustment to Controlled's E&P.

Is "disappearing E&P" appropriate in light of the policies of Treas. Reg. §1.312-10 and the broader framework governing corporate E&P? In Example 6, $35 of E&P for each of Distributing and Controlled after the spin-off arguably represents an appropriate division of Distributing's pre-spin-off E&P between Distributing and Oldco Controlled. Moreover, there may be compelling reasons why Distributing's E&P should be reduced, without regard to whether Controlled's E&P is increased, in a spin-off. First, the spin-off will reduce Distributing's ability to make distributions in the future – i.e., after the spin-off, Distributing is worth less than it was before the spin-off. Thus, to the extent that E&P is intended to measure the capacity of a corporation to pay dividends, a reduction of Distributing's E&P should seemingly be proper where Distributing distributes a valuable asset. Second, in addition to a loss of value, Distributing has also lost its basis in an asset – the stock of Controlled. As discussed above, in many instances in the tax law, there is a parallel relationship between E&P and tax basis. The Service has previously stated that when a corporation makes a disposition of property with respect to stock, E&P must be reduced by the adjusted basis of the distributed property because it is the adjusted basis that is reflected in the E&P of the corporation.[103] Neither of these principles turns on whether, or by how much, Controlled's E&P is increased.

[103] *See, e.g.*, Rev. Rul. 78-123, 1978-1 C.B. 87. *Cf.* section 312(d)(1) (The distribution to a distributee by a corporation of stock or securities in another corporation is not a distribution of E&P if no gain to such distributee from the receipt of such stock or securities was recognized under this title).

Viewed more broadly, however, E&P represents corporate earnings that have not yet been taxed at the shareholder level. Under this view, is it appropriate for E&P to disappear before it is taxed at the shareholder level? To be sure, there are many instances in which corporate E&P is reduced without a corresponding dividend to shareholders.[104] However, these instances and their related policy goals are different those present in a spin-off. For example under section 312(n)(7), discussed further above, a corporation's E&P is reduced in a section 302(a) (i.e., non-dividend equivalent) redemption by the ratable share of earnings and profits of the redeemed stock. A corporate redemption is fundamentally a corporate contraction transaction, and the reduction to a corporation's E&P in this case is primarily about preserving the correct amount of corporate E&P vis-à-vis the non-redeemed shareholders. A spin-off, on the other hand, is a corporate division. The prevailing policy goal of Treas. Reg. §1.312-10 is to prevent a spin-off from allowing a corporation to make a tax-free distribution of assets that would have been a taxable dividend but for the spin-off.[105]

In this light, the disappearance of E&P caused by Treas. Reg. §1.312-10(b) could have the effect of reducing the extent to which a future distribution would have otherwise been taxable absent the spin-off, because there is less E&P available within the corporate tax system for future distributions to shareholders. As such, this result would run contrary to the prevailing policy objectives of the E&P allocation rules.

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[104] *See, e.g.*, section 312(n)(7), Treas. Reg. §1.312-11(c), Rev. Rul. 72-327, 1972-2 C.B. 197.

[105] This policy goal does not turn on whether the shareholders of Distributing before the spin-off remain shareholders of both Distributing and Controlled after the spin-off and, thus, is equally applicable in the case of a split-off.

On balance, we believe the underlying policy objectives of Treas. Reg. §1.312-10 should generally preclude (or at least not promote) the elimination of E&P in the context of a section 355 distribution. In addition, disappearing E&P may lead to unnecessary adverse consequences in cross border spin-offs,[106] as well as planning opportunities.

C. Alternatives for Addressing Disappearing E&P

As explained above, disappearing E&P is driven by the lack of a reciprocal relationship between the reduction to Distributing's E&P and the increase to Controlled's E&P. In consideration of this, there are several possible alternatives for preventing the disappearance of E&P.

1. Reduction Limitation Alternative

One alternative to prevent disappearing E&P is to limit the reduction to Distributing's E&P in Step 1 to the amount of the Top-up Adjustment (if any) to Controlled in Step 2 (the "**Reduction Limitation Alternative**"). Under this alternative, in Step 1 Distributing would first compute a "tentative" E&P reduction amount, equal to the Hypothetical D/355 Amount. This "tentative" reduction amount would be used to determine the amount of the Top-up Adjustment to Oldco Controlled in Step 2. The actual Top-up Adjustment in Step 2 would then also be the amount of the actual

[106] For example, spin-offs involving controlled foreign corporations are subject to the rules of Treas. Reg. §1.367(b)-5. The historic policy objective of these rules is generally preserving the potential application of section 1248. To this end, Treas. Reg. §1.367(b)-5 requires a comparison of the section 1248 amounts associated with the stock of a foreign distributing and foreign controlled before and after a spin-off. To the extent there is a reduction in either section 1248 amount after the spin-off, Treas. Reg. §1.367(b)-5 results in stock basis reduction and/or income inclusion. Because E&P is a component of the section 1248 amount, disappearing E&P in the context of a spin-off by a controlled foreign corporation may cause a reduction to the section 1248 amount, thereby causing basis adjustment and income inclusion. Because the mechanics of Treas. Reg. §1.312-10(b) can cause E&P to disappear, when applied to a foreign divisive transaction, it creates a strong bias towards basis reduction and/or acceleration of income, rather than the preservation of the section 1248 amount.

reduction to Distributing's E&P – i.e., there would be a reciprocal relationship between the reduction to Distributing's E&P and the increase to Controlled's E&P.

> **Example 7.** (i) Facts. Same as Example 6.
>
> (ii) Results. Under the Reduction Limitation Alternative, Distributing's "tentative" Step 1 reduction would be $35. The Top-up Adjustment in Step 2 is $5 (i.e., Oldco Controlled's E&P is increased from $30 to $35). Thus, Distributing's E&P is actually reduced by an amount equal to the Top-up Adjustment, $5, thereby reducing Distributing's E&P from $70 to $65. Accordingly, after the spin-off, Distributing's E&P is $65 and Oldco Controlled's E&P is $35, and $100 of aggregate E&P survives the transaction.

Although the Reduction Limitation Alternative prevents E&P from disappearing from the corporate tax system, the shareholder's relationship to Distributing's pre-division E&P and/or Distributing's pre-division potential E&P may not be fully preserved.[107] In addition, taxpayers would seemingly be free to alter the ending E&P results by structuring the spin-off as a divisive D reorganization. For example, if Distributing contributed Oldco Controlled to Newco Controlled in a divisive D reorganization, Newco Controlled would be allocated $35 of Distributing's E&P under the Fair Market Value Method and each of Distributing and Newco Controlled would have $35 of E&P. Newco Controlled, in turn, would wholly-own Oldco Controlled, which would retain its $30 of historic E&P. This would largely make the results of the Reduction Limitation Alternative elective.

2. Unlimited Top-up Adjustment Alternative

A second alternative is to allow for an unlimited Top-up Adjustment to Oldco Controlled in Step 2 (the "**Unlimited Top-up Adjustment Alternative**"). Under this

[107] We note that special rules would need to be developed to address situations where Oldco Controlled has an E&P deficit.

alternative, the amount of the reduction to Distributing's E&P in Step 1 becomes the amount of the Top-up Adjustment, without regard to the pre-existing E&P of Oldco Controlled. The Unlimited Top-up Adjustment Alternative is essentially the inverse of the Reduction Limitation Alternative.

Example 8. (i) Facts. Same as Example 6.

> (ii) Results. Under the Unlimited Top-up Adjustment Alternative, Distributing's Step 1 reduction would be $35. Under the Unlimited Top-up Adjustment Alternative, the Top-up Adjustment in Step 2 is $35, and thus Oldco Controlled's E&P is increased by $35, from $30 to $65. Accordingly, after the spin-off, Distributing's E&P is $35 and Oldco Controlled's E&P is $65, and the $100 of aggregate E&P survive the transaction.

The Unlimited Top-up Adjustment Alternative prevents E&P from disappearing from the corporate tax system. However, it also suffers from similar infirmities as the Reduction Limitation Alternative discussed above in that the shareholder's relationship to Distributing's pre-division E&P and/or Distributing's pre-division potential E&P may not be fully preserved. However, the Unlimited Top-up Adjustment Alternative more closely resembles the end result if Distributing had contributed Oldco Controlled into Newco Controlled and distributed Newco Controlled in a divisive D reorganization. As noted above, if Distributing had contributed Oldco Controlled to Newco Controlled in a divisive D reorganization, Newco Controlled would be allocated $35 of Distributing's E&P under the Fair Market Value Method and each of Distributing and Newco Controlled would have $35 of E&P. Newco Controlled, in turn, would wholly own Oldco Controlled, which would retain its $30 of historic E&P.

In sum, Distributing's post-spin off E&P would be $35, regardless of whether the spin-off was undertaken as a divisive D reorganization; similarly, the combined E&P of

Newco Controlled and Oldco Controlled would be $65 in the case of a divisive D reorganization (although this E&P would be divided between corporate tiers), which is the same as Oldco Controlled's E&P under the Unlimited Top-up Adjustment Alternative. Accordingly, an advantage of the Unlimited Top-up Adjustment Alternative, as compared to the Reduction Limitation Alternative, is that it reduces, to a degree, the ability to control the allocation of E&P through transaction electivity (i.e., the decision to undertake a divisive D reorganization vs. a straight section 355 distribution).

3. Combined E&P Alternative

A third alternative is to "combine" the E&P of Distributing and Oldco Controlled for purposes of determining the appropriate amount of E&P for Distributing and Oldco Controlled following the spin-off (the "**Combined E&P Alternative**"). Under the Combined E&P Alternative, the E&P of Distributing and Oldco Controlled is added together (the "**Combined E&P**"), and the Combined E&P is then allocated between Distributing and Oldco Controlled on a hypothetical basis, under the Fair Market Value Method, to determine the proper amount of E&P for each of Distributing ("**Distributing's Hypothetical E&P**") and Oldco Controlled ("**Oldco Controlled's Hypothetical E&P**"). Because Distributing and Oldco Controlled are separate corporations with their own E&P, the hypothetical allocation above serves merely to determine the appropriate amount of E&P for each corporation. Once these amounts are determined, additional operating rules would need to provide for an actual allocation of E&P from Distributing to Controlled to arrive at, where possible, E&P of Distributing and Oldco Controlled equal to Distributing's Hypothetical E&P and Oldco Controlled's

Hypothetical E&P, subject to additional considerations and limitations discussed further below.

> **Example 9.** (i) Facts. Same as Example 6.
>
> (ii) Results. Distributing's pre-spin-off E&P is $70 and Oldco Controlled's pre-spin-off E&P is $30. Thus, under the Combined E&P Alternative, there is $100 of E&P in the pool for the hypothetical allocation between Distributing and Oldco Controlled. This $100 would then be divided between Distributing and Oldco Controlled under the Fair Market Value Method. Because each of Distributing and Oldco Controlled has a value of $200, Distributing's Hypothetical E&P and Oldco Controlled's Hypothetical E&P should each be $50 (i.e., $100 of E&P is divided equally between Distributing and Oldco Controlled). Then, Distributing should allocate a portion of its actual $70 of E&P to Controlled in order to achieve the hypothetical E&P amounts above. Under the assumed facts, Distributing would allocate $20 of its E&P to Controlled, thereby leaving Distributing with $50 of E&P (i.e., $70 less $20 allocation) and Controlled with $50 of E&P (i.e., $30 of existing E&P plus $20 of allocated E&P).

Like the two methods discussed above, the Combined E&P Alternative prevents the problem of disappearing E&P currently possible under current law. Additionally, the Combined E&P Alternative is conceptually appealing for two reasons. First, it essentially treats Oldco Controlled as if it had been operated as a division of Distributing (or alternatively, as if Oldco Controlled had liquidated into Distributing in a section 381(a) transaction and then the assets of Oldco Controlled were contributed to a Newco Controlled). This provides general consistency between scenarios in which Distributing directly conducts the retained business and the business to be spun-off, and where the spun-off business is conducted through a subsidiary (i.e., Oldco Controlled). Second, and as a result of this consistency, this method generally will reduce possible distortions to the shareholder's relationship to Distributing's pre-division E&P and/or Distributing's pre-division potential E&P.

However, the Combined E&P Alternative presents at least several issues. First, the approach seems to be too far reaching in disregarding corporate tiers. Making Oldco Controlled's E&P available to Distributing for allocation purposes is fundamentally inconsistent with the general corporate tax framework and the rules governing E&P generally.

Second, unless the Combined E&P Alternative combines the E&P of all of Distributing's and Controlled's subsidiaries, it may not achieve its intended results if Distributing and/or Controlled is a holding company, which is often the case in a spin-off. In order to fully implement a Combined E&P Alternative, the E&P of subsidiaries should be included, resulting in administrative complexity and exacerbating the other detriments noted herein.

Third, where the amount of Distributing's Hypothetical E&P is greater than Distributing's actual E&P, would E&P be allocated from Oldco Controlled to Distributing? This result generally would be inconsistent with the fundamental focus of Treas. Reg. §1.312-10 on how much, if any, of Distributing's E&P should be allocated to Controlled, not vice versa. To address this concern, the Combined E&P Approach could include specific rules prohibiting, for example, an allocation of Oldco Controlled's E&P to Distributing. However, numerous and complex rules would be needed to fully assuage the myriad of issues raised by the Combined E&P Approach across a wide range of fact patterns (e.g., cross border spin-offs, spin-offs involving a partially owned Oldco Controlled, pre-spin-off dividends from Oldco Controlled to Distributing). This added complexity would both create uncertainty and be difficult to administer.

Lastly, similar to the Reduction Limitation Alternative, the ultimate allocation consequences of the Combined E&P Alternative could be avoided by structuring the spin-off as a divisive D reorganization. Further, the results of the Combined E&P Alternative could be easily manipulated by altering Oldco Controlled's E&P prior to the spin-off (e.g., a lower-tier subsidiary of Oldco Controlled could pay a dividend to Oldco Controlled).

D. Recommendation

As explained at the outset, we believe it is incongruent for rules designed to preserve continuity in shareholder taxation on future distributions to also allow for corporate E&P to disappear from the corporate tax system. Although each of the above approaches generally prevents the disappearance, we believe the Unlimited Top-up Adjustment Alternative is the best alternative. In sum, it prevents the disappearance of E&P, reduces transactional electivity by providing results that are consistent with a divisive D reorganization, and does not require deviations or complexities born from the introduction of additional operating rules not already present in the general E&P allocation rules. In addition, as explained further below, the Unlimited Top-up Adjustment Alternative promotes a single-set of principles for section 355 distributions, whether Controlled is newly formed or pre-existing, and whether or not assets are contributed to Oldco Controlled prior to the section 355 distribution.

VII. ALLOCATION OF E&P IN AN OLDCO DIVISIVE D REORGANIZATION

When assets are transferred to Oldco Controlled in a divisive D reorganization in connection with a distribution under section 355 (an "**Oldco divisive D**

reorganization”), there are additional considerations to those discussed in Parts IV and V. The Regulations do not provide specific guidance for Oldco divisive D reorganizations.[108] The fundamental challenge posed by an Oldco divisive D reorganization is that it involves both a transfer of assets from Distributing to Controlled, and a distribution of Oldco Controlled, which has its own pre-contribution value and E&P. In sum, the Oldco divisive D reorganization contains aspects of both a divisive D reorganization involving Newco Controlled and a straight section 355 distribution.[109]

A. Oldco Controlled Alternative

The principles of Treas. Reg. §1.312-10(b) as modified by this Report can be easily adapted for an Oldco divisive D reorganization. Specifically, the approaches discussed above regarding E&P allocation in a straight section 355 distribution of an Oldco Controlled could be applied by treating the assets transferred to Oldco Controlled in the Oldco divisive D reorganization as historic assets of Oldco Controlled, and dividing Distributing’s E&P based on the relative fair market values of Distributing and Controlled. In order to address the disappearing E&P issue, the Unlimited Top-up Adjustment Alternative may be applied to an Oldco divisive D reorganization.

[108] *See* Preamble to Prop. Treas. Reg. §1.367(b)-8, 65 Fed. Reg. 69138-01, 69145 (Nov. 15, 2000) (“Section 1.312-10 does not specifically address the allocation and reduction of earnings and profits in connection with a D/355 distribution that involves a preexisting controlled corporation.”); Collins et al., *supra* note 4 (“The regulation is unclear whether Treas. Reg. §1.312-10(a) is the exclusive guidance for an Oldco divisive D reorganization”).

[109] As discussed above, the government has recognized the hybrid nature of Oldco divisive D reorganizations and, in the cross border context, has proposed E&P allocation rules that essentially bifurcate the transaction into a Newco divisive D reorganization to the extent of the assets transferred, and a straight section 355 distribution of Oldco Controlled to the extent of Oldco Controlled’s pre-existing assets. *See* Prop. Treas. Reg. §1.367(b)-8.

B. Assets Transferred Alternative

Under current law, a plain reading of Treas. Reg. §1.312-10 indicates that subsection (a) is intended to apply to *any* spin-off that is preceded by a D reorganization, whereas subsection (b) is solely intended to apply to a straight section 355 distribution with no divisive D reorganization.[110] Although Treas. Reg. §1.312-10(a) does not provide precise rules for allocating E&P in an Oldco divisive D reorganization, it does provide that "[i]n a proper case, allocation shall be made between the distributing corporation and the controlled corporation in proportion to the net basis of the assets transferred and of the assets retained." The fact that the "proper case" language looks to the assets transferred and retained (as opposed to the relative values of distributing and controlled) may suggest that an Oldco divisive D reorganization is "a proper case." Accordingly, we considered whether the allocation of E&P in an Oldco divisive D reorganization should be based solely on the assets transferred from Distributing to Oldco Controlled (the "**Assets Transferred Alternative**").

[110] For instance, the opening sentence of Treas. Reg. §1.312-10(a) refers to a transaction where one corporation transfers part of its assets constituting an active trade or business to another corporation in a D reorganization. The use of the term "another corporation," without any qualifications, clearly allows for such corporation (i.e., the controlled corporation) to be newly formed or preexisting. Similarly, the opening sentences of Treas. Reg. §1.312-10(b) states that this subsection applies "[i]f a distribution or exchange to which section 355 applies...is not in pursuance of a plan meeting the requirements of a reorganization as defined in section 368(a)(1)(D)." This view is consistent with *Bennett v. United States*, 427 F.2d 1202, 1213 (Ct. Cl. 1970) (The court summarized Treas. Reg. §1.312-10 as follows: "In format, the regulation is drafted in three subparagraphs. Subparagraph (a), previously quoted herein, deals solely and expressly with spin-offs incident to "D" reorganizations, the case at hand. Subparagraph (b) deals exclusively with spin-offs in pursuance of non-"D" reorganizations, not this case. Subparagraph (c) concerns allocation of deficits, an issue not present here.").

Because this Report recommends the Fair Market Value Method for a spin-off of Newco Controlled, for purposes of the following examples, the Fair Market Value Method is used to apply the Assets Transferred Alternative.

> **Example 10.** (i) Facts. Distributing's assets consist of the following: (i) business X assets (FMV: $200, basis: $150); (ii) business Y assets (FMV: $50, basis: $20), and (iii) the stock of Oldco Controlled (FMV: $150; basis $20). Distributing has $90 of E&P and Oldco Controlled has $10 of E&P. Oldco Controlled's assets consist of business Y assets (FMV: $150, basis $30). Distributing transfers its business Y assets to Oldco Controlled, and distributes the stock of Oldco Controlled to its shareholders in a divisive D reorganization.
>
> (ii) Results. Distributing would allocate its E&P of $90 in proportion to the business Y assets transferred (FMV: $50) and the business X assets retained (FMV: $200), without regard to the value of the Oldco Controlled stock owned by Distributing. Thus, Distributing would allocate $18 of E&P to Controlled (($50 ÷ ($200 + $50)) x $90 = $18).

Immediately after the spin-off, Distributing's E&P is reduced from $90 to $72 and Oldco Controlled's E&P is increased from $10 to $28. Notably, Oldco Controlled would have a fair market value of $200, and a net inside asset basis of $50, which is the same as the Newco Controlled in Example 1 and the Oldco Controlled in the straight section 355 distribution discussed in Example 6. A comparison of the results in Examples 1 and 6 to this Example 10 reveals, not surprisingly, that Distributing ends up with more E&P in this Example 10 than either Example 1 or Example 6. The result in Example 10 is derived from an E&P allocation to Oldco Controlled that is based entirely on the assets transferred and without regard to the pre-existing value of Oldco Controlled. Moreover, in Example 10, based on the relative E&P of Distributing and Oldco Controlled, a portion of Distributing's E&P may have been earned by the assets held by Oldco Controlled prior to the spin. For example, Distributing may have formed Oldco Controlled in a prior year in an unrelated section 351 exchange, which would have resulted in Oldco Controlled succeeding to the basis of the business Y assets, but none of the E&P that h earned to create such asset basis.[111] Because neither the value nor basis in the Oldco Controlled stock (or the underlying assets of Oldco Controlled) is accounted for in the Assets Transferred Alternative, it presents the possibility that a disproportionately small amount of Distributing's E&P may be allocated.

This potential for inappropriate results from the Assets Transferred Alternative can be further highlighted through a more extreme example.

> **Example 11:** (i) Facts. Distributing's assets consist of the following: (i) business X assets (FMV: $200, basis: $150); business Y assets (FMV: $1, basis: $1), and (iii) the stock of Oldco Controlled (FMV: $199; basis $49). Distributing has E&P of $100 and Oldco Controlled has E&P of $0. Oldco Controlled's assets consist of business Y assets (FMV: $199, basis $49). Distributing transfers its business Y assets to Oldco Controlled, and distributes the stock of Oldco Controlled to its shareholders in a divisive D reorganization transaction.
>
> (ii) Results: In this example, under the Assets Transferred Alternative, Distributing's $100 of E&P would be allocated to Oldco Controlled based on the $1 business Y assets contributed. Thus, Distributing would allocate approximately $1 of E&P (rounded for illustrative ease), resulting in Distributing having $99 of E&P, and Controlled having $1 of E&P, despite each corporation having a FMV of $200.

C. Recommendation

In an Oldco divisive D reorganization, we recommend that Distributing's E&P be allocated between Distributing and Oldco Controlled based on their relative fair market values, after taking into account the transfer of assets from Distributing to Oldco Controlled. Consistent with our recommendation above for a straight section 355 distribution of Oldco Controlled, we recommend applying the Unlimited Top-up Adjustment Alternative in an Oldco divisive D reorganization. Because the Unlimited

[111] E&P is not allocated in a section 351 contribution. See Reg. 1.312-11(a).

Top-up Adjustment Approach bases the underlying allocation of E&P on the relative fair market values of Distributing and Controlled immediately after the spin-off, it also aligns the allocation methods for transactions involving a Newco Controlled or an Oldco Controlled.

Our recommendations for allocating E&P in a spin-off of Newco Controlled, Oldco Controlled and an Oldco divisive D reorganization result in the same allocation of Distributing's E&P regardless of the transactional form selected.

VIII. RELATED ISSUES

A. Determination of Distributing's E&P Immediately before the Spin-Off

Neither the Regulations nor section 312(h) provide guidance for determining Distributing's E&P immediately prior to a spin-off. The first sentence of Treas. Reg. §1.312-10(a) provides that the E&P of Distributing *immediately before the transaction* shall be allocated between Distributing and Controlled. In addition, the last sentence of Treas. Reg. §1.312-10(a) provides that the part of the E&P of the taxable year of Distributing in which the transaction occurs allocable to Controlled shall be included in the computation of the E&P of the first taxable year of Controlled ending after the date of the transaction. Taken together, it seems clear, at least in the context of a divisive D reorganization, that Distributing's allocable E&P should include both Distributing's E&P as of the end of the tax year preceding the spin-off, as well as some portion of Distributing's current year earnings (or deficit).

1. Methods for Determining Distributing's Allocable E&P

As outlined below, there are at least two reasonable methods that could be used to determine the amount of Distributing's current year E&P available for allocation in a spin-off.

(a) Proration Method

One reasonable method would be to compute Distributing's E&P for the entire tax year that includes the spin-off (without regard to any allocation), and then prorate such amount on a daily basis to the day immediately prior to the spin-off (the "**Proration Method**"). If Distributing's E&P for the year is positive, the pro rata portion of the positive current year E&P would be allocated under the principles of Treas. Reg. §1.312-10(a) and, consistent with the last sentence of Treas. Reg. §1.312-10(a), the amount of current year E&P of Distributing allocated to Controlled would be treated as current E&P of Controlled in Controlled's first tax year following the spin-off. If Distributing's E&P for the year is negative, the pro rata portion of the negative E&P would reduce Distributing's E&P available to be allocated.

The Proration Method finds support in the regulations under section 316. Specifically, Treas. Reg. §1.316-2(b) provides in relevant part that:

> "In any case in which it is necessary to determine the amount of earnings and profits accumulated since February 28, 1913, and the actual earnings and profits to the date of a distribution within any taxable year… *cannot be shown*, the earnings and profits for the year… in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made" (emphasis added).

Although a literal reading of this language could imply that a taxpayer must prove the amount of interim current E&P available on the date of the distribution "cannot be shown" in order to use the daily proration method, the Service has previously not required a taxpayer to show, even where possible, the actual amount of interim current E&P to the date of the distribution, and to instead rely on the Proration Method.[112] The Service has also applied the Proration Method to other circumstances where a taxpayer was required to determine the amount of E&P as of a certain date.[113]

(b) Closing of the Books Method

Another possible method would be for Distributing to determine its E&P by closing its books immediately before the spin-off (the "**Closing of the Books Method**"). The Closing of the Books Method would essentially treat the day of a spin-off as the last day of Distributing's tax year.

The efficacy of the Closing of the Books Method is supported by numerous other areas of the tax law in which allocations between two periods are determined by closing a

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[112] *See, e.g.,* I.R.S. F.S.A. 200225014 (June 21, 2002), where the Service was confronted with the question of whether a taxpayer is required to show, where it is possible, the actual interim E&P to the date of the distribution or if the taxpayer can instead use the Proration Method. The Service concludes that Treas. Reg. §1.316-2(b) contemplates using the Proration Method unless the taxpayer chooses to and can demonstrate the amount of interim E&P to the date of the distribution. Essentially, the Service concluded that the regulation allows the taxpayer to use the Proration Method as the default method.

[113] *See, e.g.,* Rev. Rul. 74-164, 1974-1 CB 74 where the Service analyzed how current E&P is prorated in four different situations involving X corporation, a calendar year taxpayer that makes a distribution of $15,000 to its shareholders on July 1, and makes no other distributions to its shareholders during the taxable year. In situations 3 and 4, X has accumulated E&P of $40,000 and a current E&P deficit of $5,000 and $55,000, respectively. The Service ruled that in the case of a deficit in E&P for the taxable year in which distributions are made, the taxable status of distributions is dependent upon the amount of accumulated E&P available on the dates of distribution. In determining the amount of such E&P, the Service stated that Treas. Reg. §1.316-2(b) provides, in effect, that the deficit in E&P of the taxable year *will be prorated to the dates of distribution*. Accordingly, the Service ruled that in situation 3, the current E&P deficit for the entire year must be prorated to the date of the distribution (1/2 of $5,000 = $2,500) such that the E&P available on July 1 is $37,500 ($40,000 less $2,500). The same proration method is applied in situation 4 such that the E&P available on July 1, after reducing accumulated E&P by half of the current E&P deficit (1/2 of $55,000 = $27,500), is $12,500 ($40,000 less $27,500). *See also* Rev. Rul. 74-339, 1974-2 CB 103 and Rev. Rul. 74-338, 1974-2 CB 101, *infra* Parts VIII.A 1 and 2, for examples of the Service applying the daily proration method to determine the amount of E&P available at the time of a redemption transaction.

corporation's books as of a particular date. For example, Treas. Reg. §1.382-6(b) allows an election to be made to close the books for purposes of allocating net operating loss or taxable income and net capital loss or gain of a loss corporation in the event of an ownership change, the general rule of Treas. Reg. §1.1502-76(b)(2)(i) requires a closing of the books for purposes of allocating items of income, gain, deduction, loss, and credit when a subsidiary becomes or ceases to be a member of a consolidated group, and a partnership termination under section 708 (b)(1)(B) requires a closing of the books to allocate U.S. taxable income between the old partnership and new partnership.

The Section 367 Proposed Regulations allocate Distributing's "pre-transaction earnings", indicating a Closing of the Books Method. While the Proposed Regulations do not define "pre-transaction earnings", Prop. Reg. §1.376(b)-8(b)(v) provides that the pre-transaction earnings that are subject to allocation or reduction under paragraph (b)(1)(i) shall include any increase in E&P from gain recognized or income included by the distributing corporation as a result of the foreign divisive transaction, which seems inconsistent with the pro-ration method. The Section 367 Proposed Regulations contain examples illustrating how the allocation rules are intended to work. In each example, the distributing corporation and the controlled corporation (whether foreign or domestic) use a calendar taxable year, and the contribution/distribution transaction occurs on January 1, 2002. Furthermore, each example provides that the distributing corporation's pre-transaction earnings (for purposes of allocation) consist of its accumulated E&P plus the amount of gain/income generated by the contribution/distribution transaction. Notwithstanding that the contribution/distribution occurs on the first day of the distributing corporation's taxable year, the examples neither pro-rate the gain/income generated by the contribution/distribution transaction nor take into account any earnings and profits generated by the distributing corporation during the portion of the taxable year after the date of the contribution/distribution.

We note, however, the Service has previously questioned "whether corporations ordinarily close their books prior to year-end so that an accurate computation of interim earnings can actually be made. Furthermore, even if an accurate interim account can be computed, the administrative burden to the Service in confirming that computation could be overwhelming."[114]

2. Recommendation

The amount of E&P available for allocation is a fundamental issue in need of clear guidance. We recommend that the Proration Method should be the general rule for determining the amount of Distributing's E&P available for allocation in a spin-off. For extraordinary items, however, we recommend that the Closing of the Books Method be applied to ensure that such items do not result in an inappropriate distortion to the amount of E&P available for allocation.[115]

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[114] *See e.g.*, I.R.S. G.C.M. 35307 (Apr. 16, 1973).

[115] Future guidance should address the allocation of other E&P-related accounts, including foreign taxes.

B. Effect of Section 301 Distributions

(i) Background

Current law does not specifically address the impact of a section 301 distribution on Distributing's allocable E&P.[116]

(a) Current E&P Considerations

As it relates to current E&P, section 316 provides, for purposes of determining whether a section 301 distribution constitutes a dividend (i.e., whether it is paid out of the distributing corporation's E&P), the distribution is first treated as paid out of the E&P generated during the current year (i.e., current E&P), and then, if necessary, out of the E&P accumulated since February 28, 1913 (i.e., accumulated E&P").[117] Current E&P is computed as of the close of the taxable year without diminution by reason of *any distributions* made during the taxable year. The phrase "any distribution" in this context has been commonly held to include non-section 301 distributions that would otherwise reduce E&P under section 312, and thus arguably should include section 355 distributions that reduce E&P under section 312(h).[118]

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116 *See, e.g.*, I.R.S. Priv. Ltr. Rul. 201330002 (July 26, 2013); I.R.S. Priv. Ltr. Rul. 201111003 (Mar. 18, 2011); I.R.S. Priv. Ltr. Rul. 200803012 (Jan. 18, 2008).

117 *See* section 316; Treas. Reg. §§1.316-1 and 1.316-2.

118 *See, e.g., Baker v. U.S.*, 308 F. Supp. 1129 (D. Neb. 1970), *aff'd*, 460 F.2d 827 (8th Cir. 1972) (Taxpayers were shareholders in a corporation that had no accumulated E&P at the beginning of the current year, and generated approximately $1.5 million of current E&P during the year. Within a single taxable year, the corporation first redeemed certain stockholders (not including the taxpayers) under section 302(a) for approximately $1.6 million, and it then distributed approximately $1.9 million in cash to its remaining shareholders under section 301. It was stipulated that approximately $0.1 million of the redemption was properly chargeable to the capital account, and the taxpayers contended that the remaining $1.5 million of the redemption should reduce E&P, leaving virtually zero E&P available for the section 301 distribution. The taxpayer argued that the phrase "any distribution" in the parenthetical of section 316(a)(2) disregards only section 301 distributions, and therefore current E&P was reduced on the date of the section 302(a) distribution under section 312(a), with only the

For example, Rev. Rul. 74-339[119] addresses a situation in which a corporation, with a $60x accumulated E&P deficit and $60x of current E&P, first redeemed a portion of its shareholders in a section 302(a) redemption, and then made a section 301 distribution to its remaining shareholders that exceeded its current E&P. The Service observed that whether the section 301 distribution is a dividend depends upon the rule used to determine the order in which ordinary distributions, redemption distributions, and other type distributions are charged to E&P. The ruling also interprets Treas. Reg. §1.316-2(b) to provide that, if current E&P (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of E&P at the time of the distribution) is sufficient to cover all the section 301 distributions during that year, each distribution is a taxable dividend. Based upon these

remaining E&P being available on the subsequent date of the section 301 distribution. The IRS, on the other hand, argued that the $1.9 million section 301 distributions should be given priority in drawing on current E&P, with only the remainder (if any) of E&P after the section 301 distribution being available for reduction by the section 302(a) distribution. The court held that the Congress intended the phrase "any distribution" in section 316(a)(2) to apply to all types of distributions, and that section 301 distributions should be given priority as it relates to actually drawing on current E&P.); *Anderson v. Commissioner*, 67 TC 522 (1976), *aff'd per curiam*, 583 F2d 953 (7th Cir. 1978) (similar). *See also* John Andrew Jones, , 27 Sw. L. J. 277 (1973) (noting that the court in *Baker* "reached the conclusion which Congress probably would have intended had it considered the problem.") and Haskell Edelstein, *Eighth Circuit's Baker Decision: Filling a Statutory Gap by Judicial Pragmatism*, 38 J. Tax'n 66 (1973) ("Section 312(a) deals with the effect of distributions on the earnings and profits account, without reference to the definition of 'dividend' contained in section 316(a) . . . section 316(a)(2) supplies a definition of 'dividend' needed principally to enable section 301(c)(1) to function to tax the shareholders. Accordingly, section 316(a)(2) contains its own special rules, which and must, operate independently of section 312(a). Accordingly, the priority and time of the effect of distributions on current earnings and profits, solely for purposes of determining whether a distribution comes within the 'dividend' definition of section 316(a)(2), must be determined by section 316(a)(2) alone, and not by section 312(a). If that Method is not taken, there will be an insoluble conflict between the requirements of the two rules. Since we have been told that redemption distributions are not encompassed with section 316(a), except in the parenthetical phrase of section 316(a)(2), they should not be taken into account in determining whether a distribution constitutes a distribution of current earnings and profits, and hence falls within the definition of 'dividend' provided by section 316(a)(2).").

[119] 1974-2 C.B. 103.

factors, the ruling concludes that, because distributions subject to section 301 have priority over distributions subject to section 302(a) in drawing current E&P, the current E&P is available to the section 301 distributions undiminished by the section 302(a) distributions.[120]

We believe this ruling reaches the appropriate results. By extension of these principles, Distributing should compute its current E&P as of the close of the taxable year without diminution by reason of an allocation or reduction to Distributing's E&P under Treas. Reg. §1.312-10 due to a spin-off made during the taxable year. As such, a section 301 distribution paid by Distributing during the same tax year as a spin-off – whether paid before or after the spin-off – would be applied against, and reduce, Distributing's current year E&P. This approach is also consistent with the policy goals of section 312(h) and the Regulations by preserving the taxability of a section 301 distribution that would have otherwise been taxable as a dividend absent a spin-off. Stated differently, if Distributing allocated a portion of its current E&P to Controlled the taxability of a section 301 distribution paid after, but during the same tax year as, a spin-off could be reduced.[121]

(b) Accumulated E&P Considerations

Similarly, Distributing's accumulated E&P should be reduced by section 301 distributions that precede a spin-off. This approach is consistent with the plain language of section 312(a), which provides that a corporation's E&P is reduced "on the distribution

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120 *See also* Rev. Rul. 74-338, 1974-2 C.B. 101, *infra*.

121 *But see* Cummings, *supra* note 79.

of property," and authorities addressing the interaction of section 302(a) redemptions and section 301 distributions. For instance, Rev. Rul. 74-338[122] addressed two situations where a corporation undertook both section 302(a) redemptions and section 301 distributions in the same taxable year. Citing Rev. Rul. 74-339, the ruling notes that, when both section 301 distributions and section 302(a) redemptions occur in the same taxable year, section 301 distributions have priority as to current E&P, but not as to accumulated E&P. In other words, a section 302(a) redemption occurring before a section 301 distribution reduces accumulated E&P before the subsequent section 301 distribution.[123]

The Service's private letter ruling policy is also in line with the view that section 301 distributions reduce the E&P available for allocation under Treas. Reg. §1.312-10 on subsequent section 355 distributions in the same taxable year.[124] Similar to the current

[122] 1974-2 C.B. 101

[123] *See also* Rev. Rul. 77-335, 1977-2 C.B. 95 the Service considered the section 306 implications of the distribution of common and preferred stock of a controlled corporation in a section 355 transaction. The controlled corporation's preferred stock was not section 306 stock to the distributing corporation, but the section 355 distribution of the preferred stock could have resulted in the preferred stock being section 306 stock to the recipient shareholders if their hypothetical receipt of cash in lieu of the preferred stock would have been treated by section 356(b) as a section 301 distribution taxable to the shareholders as a dividend. Notably, the ruling did not mention the Treas. Reg. §1.312-10 allocation/reduction in this hypothetical section 356(b) analysis, suggesting that, to the extent the distributing corporation is treated as making a section 301 distribution, the distribution's status as a dividend depends on the E&P of the distributing corporation without diminution by virtue of any allocation/reduction of the distributing corporation's E&P. This implicitly supports the conclusion that, where a distribution that is potentially taxable as a dividend is paid as part of a section 355 distribution, the dividend distribution is treated as being paid before the section 355 distribution, and the distributing corporation reduces E&P under section 312(a) prior to the allocation/reduction under Treas. Reg. §1.312-10.

[124] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 201330002 (July 26, 2013) (Prior to eight separate divisive D reorganizations, the respective distributing corporations each made a cash distribution to their shareholders. For each transaction, the Service ruled that "[E&P] of distributing, if any, will be allocated between [distributing] and [controlled] in accordance with section 312(h) and Reg. §1.312-10(a), after taking into account the decrease in [E&P] resulting from the [cash distribution]." I.R.S.

E&P considerations above, prioritizing E&P for use in section 301 distributions, as opposed to allocations, preserves the taxability of a section 301 distribution.

(ii) Recommendation

We recommend that Treasury and the Service issue guidance implementing the following operating rules addressing section 301 distribution made by Distributing in the same tax year as a spin-off:

- ***Current E&P:*** A section 301 distributions is sourced from, and thus reduces the amount of, current year E&P, if any, of Distributing, regardless of whether the section 301 distribution is made before or after the spin-off; and
- ***Accumulated E&P:*** If a section 301 distribution is made prior to the spin-off, the distribution reduces Distributing's E&P available for allocation. If a section 301 distribution is made after the spin-off, it should be sourced from Distributing's post-allocation E&P

Priv. Ltr. Rul. 201111003 (Mar. 18, 2011) (ruling 12: "After taking into account the Pre-Spin Cash Distribution, earnings and profits will be allocated between Distributing and Controlled in accordance with section 312(h) and Reg. §§1.312-10(a) and 1.1502-33"); I.R.S. Priv. Ltr. Rul. 200803012 (Jan. 18, 2008) (ruling 37: "Earnings and profits of Distributing, if any, will be allocated between Distributing and Controlled in accordance with Reg. §§312(h), 1.312-10(a) and 1.1502-33(e)(3), after taking into account the decrease in earnings and profits attributable to the portion of the Net Cash Amount distributed to the Distributing shareholders."); I.R.S. Priv. Ltr. Rul. 200732002 (Aug. 10, 2007) (ruling 17: "Earnings and profits of Distributing (if any) will be allocated between Distributing and Controlled in accordance with section 312(h) and Reg. §§1.312-10(a) and 1.1502-33(e)(3) after taking into account the decrease resulting from the Cash Distribution."); I.R.S. Priv. Ltr. Rul. 200708016 (Feb. 23, 2007) (ruling 17: "Earnings and profits of Distributing (if any) will be allocated between Distributing and Controlled in accordance with section 312(h) and Reg. §§1.312-10(a) and 1.1502-33(e)(3) after taking into account the decrease resulting from the Cash Distribution.").

C. Less-Than Wholly-Owned Controlled

(i) Background

The effects of the various allocation methodologies described above are considered in the context of situations where Distributing owns and distributes *all* of the stock of Controlled. In such cases, the allocation mechanism of a given methodology is applied in proportion to the two corporations after the distribution. Special rules are needed for a Controlled that is less-than wholly owned.

Example 12. Distributing has a fair market value of $180 and $200 of E&P. Pursuant to a single plan, (i) Distributing and unrelated X form Controlled, with Distributing transferring $80 of assets in exchange for 80% of Controlled's stock, and X transferring $20 of assets in exchange for 20% of Controlled's stock, and (ii) Distributing distributes its 80% interest in Controlled stock.

Immediately after the transaction, each of Distributing and Controlled has a value of $100. If Distributing's E&P were allocated according to the relative values of Distributing and Controlled after the distribution, Distributing and Controlled would both be allocated $100 of E&P even though Distributing only transferred 44% ($80 out of $180) to Controlled. This allocation would, effectively, shift a portion of Distributing's E&P associated with its own historic shareholders to X, despite X having no historic relationship to this E&P. This result appears inconsistent with the purposes of the allocation rules.[125]

[125] This distortion can arise in other contexts as well – such as, for example, when the distributing corporation distributes less than all of the stock that it owns in the controlled corporation.

(ii) Recommendation

Where Distributing distributes less than all of the controlled corporation's stock, we recommend that the allocation of the distributing corporation's E&P should be based on the relative fair market value of (i) the distributing corporation's retained businesses (and other properties), and (ii) the fair market value of the shares of Controlled stock distributed (not the fair market value of all controlled corporation businesses and other properties). We believe this should be the result under current law as well, but there is no clarity on this issue.

We note that if Distributing distributes *less than all* the stock of Controlled (but all the stock it owns) in a spin-off of Oldco Controlled with no divisive D reorganization, a similar result would be obtained under current law (and the Report's proposal).