COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 355(d)

These comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association.

These comments were prepared by individual members of the Committee on Corporate Taxation and the Committee on Affiliated and Related Corporations of the Section of Taxation. Principal responsibility was exercised by Joseph M. Pari and Robert H. Wellen. Substantive contributions were made by Dana L. Trier and Thomas F. Wessel. The Comments were reviewed by William J. Wilkins of the Section’s Committee on Government Submissions and by Terrill A. Hyde, Council Director for the Committees on Corporate Taxation and Affiliated and Related Corporations.

Although members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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SUMMARY

I. Overall Excellence of the Proposed Regulations. The proposed regulations are a model for drafting regulations on complex tax statutes. Particularly welcome are the focus on the purpose of the statute and the willingness to exercise regulatory power so as to ensure sensible practical operation of the statute.

II. Suggested Refinements to the Proposed Regulations. Notwithstanding the overall excellence of the proposed regulations, certain refinements are needed.

A. Proposed Reg. § 1.355-6(b)(3)(i)(A) (dealing with increases in stock ownership) is too broad.

1. Ownership Changes. The focus should be on the relative changes, not on absolute changes, in proportionate ownership. Changes of less than a minimum should be disregarded.

2. “Any Related Transaction.” The term “any related transaction” should be explained and limited.

3. Purchased Stock Basis. An increase in ownership interest should not violate the purposes of section 355(d) if, as a practical matter, purchased stock basis cannot be availed of.

B. Administrative Relief. The rules relating to the purposes of section 355(d) should be supplemented with administrative relief.

1. Private Rulings. The Service should be empowered to issue private rulings that, even if an ownership interest has increased, the purposes of section 355(d) are not violated under all the facts and circumstances.

2. Gain Recognition Agreements. A regime of gain recognition agreements like those under Reg. §§ 1.367-3 and 1.367-8 should be adopted.

3. Stock Basis Waiver. Ideally, it should be possible to substitute for “purchased” stock basis, a lower basis determined by methods that do not violate the purposes of section 355(d).
C. Technical Recommendations.

1. **Proposed Reg. §§ 1.355-6(c)(3)(v)(B) and (vi)(B) – Compensatory Stock Appreciation Rights.** In contrast to the proposed regulations, final regulations should deem options to be exercised only in accordance with the principles of the rules contained in Reg. § 1.382-4(d)(2)(i). Under this standard, final regulations should not deem options to be exercised for purposes of section 355(d) unless a principal purpose for the issuance, transfer, or structuring of the option (alone or in combination with other arrangements) is to avoid section 355(d). If this approach is not accepted, at a minimum, the exceptions to option treatment, and the consequent deemed exercise rules, should be expanded to include stock appreciation rights (“SARs”). In addition, the final regulations should eliminate (or at a minimum, explain) the deemed conversion mechanism of certain cash-settled instruments into stock pursuant to Proposed Reg. § 1.355-6(c)(3)(iv)(B).

2. **Proposed Reg. § 1.355-6(c)(4) – Vote on Acquisition by Unrelated Shareholders.** Final regulations should provide that target corporation shareholders will not be treated as acting pursuant to a plan or arrangement (and then treated as a single person under section 355(d)(7)(B)) by reason of the fact that they vote in respect of an acquisition of the target corporation.

3. **Proposed Reg. § 1.355-6(d)(3)(iv) – Transfers of Active Business Assets After Section 351 Transfer.** Final regulations should clarify that an acquisition of stock in a section 351 transaction will not fail to qualify for the exception for cash transferred as part of an active business, merely because the transferee transfers the active business to one or more other members of its section 1504(a)(2) group. In addition, in accordance with the principles of Reg. § 1.368-1(d)(1), we suggest that the final rules treat the active business as being continued if (a) the transferee continues the business or (b) uses a significant portion of the transferred assets in an active trade or business.

4. **Proposed Reg. § 1.355-6(d)(4) — Stock Basis After Reverse Triangular Reorganization.** Final regulations should replace the letter ruling/closing agreement procedure of Proposed Reg. § 1.355-6(d)(5) (relating to stock basis after a reverse triangular merger) with an irrevocable election mechanism (pursuant to which a taxpayer could irrevocably elect to determine stock basis in a particular manner under Reg. § 1.358-6 and Reg. § 1.1502-30(b)) at any time following the acquisition.

5. **Proposed Reg. § 1.355-6(f) — Reliance on Securities Filings.** Final regulations should provide that taxpayers are entitled to rely on a combination of (i) the absence of actual knowledge to the contrary and (ii) the absence of securities filings regarding a 5-percent-or-greater shareholder’s ownership of stock in the distributing and/or controlled corporation even though there is a delayed filing requirement under the securities laws as long as taxpayer made a bona fide attempt to discover any late filers (e.g., requesting information in transmittal letter, if any, etc.).
I. Overall Excellence of the Proposed Regulations

Section 355(d) applies to distributions of subsidiary stock that qualify under section 355(a). It requires the distributing corporation (“D,” or sometimes “D1,” “D2,” etc.) to recognize as gain any appreciation in the distributed stock of the controlled corporation (“C,” or sometimes “C1,” “C2,” etc.), if, immediately after the distribution, any person owns “disqualified stock” that constitutes 50% or more of the stock of either D or C (by either vote or value, and taking into account constructive ownership and aggregation rules). “Disqualified stock” is stock that either was acquired by “purchase” within the five years preceding the distribution or is attributable to such stock. The term “purchase” is defined broadly to include, along with cost basis stock acquisitions, certain stock issuances under section 351, carryover basis acquisitions of D or C stock from persons who acquired such stock by “purchase,” and acquisitions of interests in entities that own (directly or indirectly) D or C stock (referred to as “deemed purchases”).

Section 355(d) was enacted to prevent spin-offs from being used to facilitate tax-deferred break-ups in violation of General Utilities repeal principles. Because these transactions can take a variety of forms, section 355(d) is complex and far-reaching. Falling aforesaid of section 355(d) can be disastrous. If section 355(d) applies to a distribution, taxable gain is recognized to D on appreciation in the C stock, but this taxable gain results in no receipt of cash and no increase in the basis of any asset to any taxpayer. This result is particularly harsh since, in the context of multiple section 355 distributions, the same gain may be recognized and taxed more than once.

On April 29, 1999, the Service and the Treasury Department proposed regulations under section 355(d). Proposed Reg. § 1.355-6. Along with numerous clarifications and interpretations of statutory language, the proposed regulations identify the purposes of section 355(d) and provide generally that transactions not in violation of the identified purposes will not be taxed. Although the proposed regulations generally rely on the legislative history, they deviate from the specifics of the legislative history when necessary to limit the statute to its intended purposes.

We believe that, with adoption of regulations based on the proposed regulations, the Service and the Treasury Department will accomplish a meaningful improvement to the tax law.

The focus on the purpose of section 355(d) is a most welcome aspect of the proposed regulations. Even the description of statutory purpose itself, without more, would be important as guidance to taxpayers and their advisers, especially those not steeped in the history of General Utilities repeal, “mirror transactions,” and section 355(d). Even more important is the provision explicitly limiting the application of section 355(d) to transactions that violate its purposes. We believe this provision balanced as it is by a broad anti-avoidance rule (and particularly if the final regulations incorporate our comments), will cause the statute to do what Congress
intended but eliminate many traps for the unwary.¹ In many ways these proposed regulations could serve as a model for drafting regulations on complex tax legislation.

In addition, the proposed regulations would effectively clarify many ambiguities and correct many technical problems in the statutory language and the legislative history. We commend the Treasury Department and the Service for taking the initiative on these points.

II. Suggested Refinements to the Proposed Regulations

Although we agree with the overall approach of the proposed regulations, we have some suggestions for improvement. Some of our suggestions relate to the purposes of section 355(d), which we believe should be described with greater precision. Others involve administrative relief which we believe should be made available. Still others relate to various technical points.

A. Proposed Reg. § 1.355-6(b)(3) – Refinements to the Rules Relating to the Purpose of Section 355(d)

Proposed Reg. § 1.355-6(b)(3)(i) is probably the single most important provision in the proposed regulations. It provides that a stock distribution will not be taxed under section 355(d) unless the purposes of section 355(d) are violated. It then describes these purposes:

A distribution does not violate the purposes of section 355(d) if the effect of the distribution and any related transaction is neither –

(A) To increase direct or indirect ownership in the distributing corporation or any controlled corporation by a disqualified person; nor

(B) To provide a disqualified person with a purchased basis in the stock of any controlled corporation.

We agree with this overall approach to reduce the overbreadth in the literal language of section 355(d). Focus on the purpose of the statute, especially based on considered guidance from the legislative history, is the most reliable and most easily-communicated way to administer a complex statute.

We believe the purpose of section 355(d) was to prevent deferral of taxable gain on breakups of corporations that were acquired during the statutory five-year period. Without a cost basis in stock from a transaction within this time frame, or the functional equivalent, such a deferral is not possible. To us, the main focus of the “purpose” rule in Proposed Reg. § 1.355-6(b)(3)(i) should be on purchased stock basis, as in Proposed Reg. § 1.355-6(b)(3)(i)(B).

Because Proposed Reg. § 1.355-6(b)(3)(i)(B) applies only to purchased basis in C stock, Proposed Reg. § 1.355-6(b)(3)(i)(A) is needed to ensure that section 355(d) applies where the purchaser of D stock retains the D stock after a split-off of C to non-purchasing shareholders. Otherwise, at most, Proposed Reg. § 1.355-6(b)(3)(i)(A) should be a backup to prevent a purchase of stock in a higher-tier entity. The case described in Proposed Reg. § 1.355-6(b)(3)(v) Example 5, illustrates this point:

P owns 50 percent of the stock of D, the remaining D stock is owned by unrelated persons, D owns all the stock of C, and A purchases all the P stock from the P shareholders. Within 5 years of A’s purchase, D distributes all of the C stock to P in exchange for P’s D stock.

Thus, after the stock purchase but before the split-off, A owns all the P stock; P owns 50%, and others own 50%, of the D stock; and D owns all the C stock. After the split-off, A owns all the P stock; P owns all the C stock; and the other D shareholders own all the D stock (without C). The proposed regulations state that the purposes of section 355(d) are violated, because A’s indirect ownership interest in C (through P) is increased from 50% to 100%.

As a preliminary technical point, we note that the purpose of section 355(d) is said to be violated if the distribution increases a shareholder’s “direct or indirect” stock ownership. Here, although A’s indirect ownership of C stock is increased from 50% to 100%, A’s direct ownership of C stock is increased from 0% to 100%. We believe an example should be added to make clear that direct and indirect stock ownership are to be aggregated, not considered separately. Otherwise, by definition every spin-off would violate the purpose test.

In the example, taxable gain is properly recognized to D in the split-off under section 355(d), again, because A’s indirect ownership interest in C (through P) is increased from 50% to 100%. The same result would prevail if, instead of distributing the C stock to P, D either (i) distributed the C stock to the other D shareholders in exchange for their D stock, leaving P as the owner of all the D stock, or (ii) transferred its assets (other than the C stock) to C1 and distributed the C1 stock to the other D shareholders in exchange for their D stock, leaving P as the owner of 100% of the D stock, and D owning all the C stock. In any of these cases, but for section 355(d), D would be broken up with no tax at the D level, and A would own, indirectly, all the stock of one of the parts of D (the C stock or the D stock) with a cost basis through its ownership of the purchased P stock.

This result would not prevail if A acquires its 50% stock interest in P in a non-purchase transaction. In this case, because A does not acquire any P stock or D stock by purchase, the P stock would not constitute disqualified stock. Thus, A would not be not a disqualified person,
and the split-off would be outside Proposed Reg. § 1.355-6(b)(3)(i)(A).² (Naturally, section 355(e) could be implicated.)

Although we agree that Example 5 presents a section 355(d) abuse, we believe the element of the “purpose” rule relating to increased ownership, as stated in the Proposed Reg. § 1.355-6(b)(3)(i)(A), is overbroad in several respects. Using the facts and terminology of Example 5, we have the following recommendations, each of which is discussed below:

- The focus should be on the change in A’s proportionate ownership in D relative to its interest in C, not on the absolute change in A’s proportionate interest in either D or C. Changes in relative ownership of less than a designated minimum should be disregarded.
- The term “any related transaction” should be explained and limited.
- An increase in A’s ownership interest in C without D (or in D without C) should not violate the purposes of section 355(d) if, as a practical matter, (a) A cannot avail itself of its purchased basis in the stock of P to dispose of its interest in C without D or D without C, and (b) A was not motivated substantially by an intent to break up D.

1. Relative Increase in A’s Ownership of D or C

A distribution is said not to violate the purposes of section 355(d) only if the effect is not to increase a disqualified person’s direct or indirect ownership in D or C. We believe this part of the rule should apply only to situations where A’s purchased basis in the P stock allows A to avail itself of purchased stock basis in selling either (i) an indirect interest in C without a corresponding interest in D, or (ii) an indirect interest in D without a corresponding interest in C. In other words, we believe the rule should apply only where A’s indirect interest in D and C become significantly disparate and then only if this disparity results from certain potentially abusive transactions.

We believe the touchstone for a rule relating to changes in indirect interests should be changes in relative ownership interests in D and C. If A’s interests in D and in C both increase by the same amount, there can be no use of purchased stock basis to dispose of the D stock without C stock or C stock without D stock. A small change in relative ownership interest should not

² In Proposed Reg. § 1.355-6(b)(3)(v) Example 6, D owns all the stock of D1 and D2; D1 and D2 each owns 50% of the stock of D3; and D3 owns all the stock of C. A purchases all the stock of T, and T merges into D in a tax-free reorganization. In the merger, A receives 60% of the stock of D. Within five years after A’s purchase of the T stock, D3 distributes all the stock of C to D1 in exchange for all of D1’s D3 stock. Thus A still owns 60% of the D stock; D still owns all the D1 and D2 stock; D1 now owns all the C stock; and D2 now owns all the D3 stock. The Example concludes that the purposes of section 355(d) are not violated:
- A did not increase its ownership interest in either D3 (Distributing) or C (Controlled).
- Even though A has a purchased basis in the D stock (A purchased the T stock, and A’s basis in the T stock became its basis in the D stock), there was no purchased basis in the stock of either D3 or C.

We believe Example 6 should be clarified to state that the purposes of section 355(d) would not be violated in any event if A had acquired its D stock without a purchase.
invoke section 355(d). For example, cash distributed in a spin-off in lieu of fractional shares of C stock should be disregarded. At least such a clarification should not be controversial.

More broadly, we believe a transaction should not be subject to section 355(d) unless there is a meaningful shift in A’s investment as between indirect interests in D and C. Consider the following example, based on Proposed Reg. § 1.355-6(b)(v) Example 5:

Example: P owns 50% of the stock of D (50 shares); the remaining 50% of D stock (50 shares) is owned by unrelated persons; D owns all the stock of C (20 shares), and C comprises 20% of the value of D. A purchases all the P stock from the P shareholders. In a split-off within 5 years of A’s purchase, P surrenders 12 shares of D stock for 12 shares (60%) of the stock of C; and certain other D shareholders surrender a total of 8 shares of D stock for the remaining 8 shares (40%) of the C stock. Thus after the split-off P owns 47.5% of the stock of D (38/80) and 60% of the stock of C (12/20).

Here, P’s proportionate interest in C has not increased much, and P’s proportionate interest in D has not decreased much. The split-off should not be considered to facilitate a tax-free breakup of D with a purchased stock basis. If A avails itself of its purchased basis in the P stock, it will dispose of 60% of C, but it will also dispose of 47.5% of D.

To eliminate the overbreadth of the rule, we recommend that, where there is no purchased stock basis in either D or C stock (i.e., where the purchased basis is in the stock of a corporation that owns D stock, directly or indirectly), section 355(d) should apply only where, as a result of the distribution and related transactions, A’s interests in D and C change by more than a designated relative amount, e.g., 50%. That is, section 355(d) would apply only if P’s relative ownership interests (direct or indirect) in D or C increased or decreased by 50% or more (in our example, if A’s interest in D decreased from 50% to 25% or less, or if A’s interest in C increased from 50% to 75% or more). Of course, the line could be drawn in a different place (e.g., a 25% relative change), but in any event a significant relative change in ownership should be required.

2. “Any Related Transaction”

Under the proposed regulations, whether a shareholder increases its proportionate ownership interest in either D or C is measured by reference to the stock distribution along with “any related transaction.” One example would involve a pro rata spin-off and a “related” redemption of stock from another D or C shareholder, as in Proposed Reg. § 1.355-6(b)(iv) Example. A transaction may, however, be factually “related” to a stock distribution but still should not be taken into account in determining whether a stock distribution violates the purposes of section 355(d). (Again, these transactions would need to be analyzed separately under section 355(e).)

The most obvious such transaction is a “purchase” by which A acquires an indirect interest in D in the first place. If the purchase itself is taken into account, then every stock
distribution within five years thereafter, *pro rata* and non-*pro rata* alike, would violate the purposes of section 355(d). Another example based on Proposed Reg. § 1.355-6(b)(3)(v) *Example 5* will illustrate this point:

**Example:** P owns 50% of the stock of D, the remaining D stock is owned by unrelated persons. D owns all the stock of C. A purchases all the P stock from the P shareholders, and, within 5 years, D distributes all of the C stock to P (50%) and its other shareholders (50%), *pro rata*.

If A’s purchase of the P stock is a “related” transaction,” then Proposed Reg. § 1.355-6(b)(3)(i)(A) is violated. We believe the final regulations should make clear that this result is not intended.

A split-off distribution of the C stock by D is the paradigm of an increase in ownership interest in D or C, as the case may be. Otherwise, however, we believe an acquisition of C stock, whether from D, from C itself or from another C shareholder, should not be taken into account in determining whether the purposes of section 355(d) are violated.

**Example.** P owns 45% of the stock of D, and D owns all the stock of C. A, an unrelated person, buys 15% of the C stock from D and buys all the P stock from its owners. A *pro rata* spin-off of C by D will cause A to have a total 60% interest in the C stock (15% directly and 45% through P). Yet no breakup involving 50% or more of the C stock has occurred, and no section 355(d) problem is presented. The same result should prevail if A buys 15% of the C stock from C as newly-issued stock, or if D owns 85% of the C stock, and A buys the remaining 15% of the C stock from the other shareholders.

Similarly, a purchase or other acquisition by A (direct or indirect) of D stock *after* the distribution of the C stock should not be treated as a transaction “related” to the distribution under section 355(d). Because D and C are already separated at the time of the acquisition, we see no possible section 355(d) abuse (although section 355(e) may be implicated). We believe that consideration should be given to eliminating the “related transaction” rule and substituting a redemption rule, because the latter is the only type of transaction we believe should be taken into account for this purpose.

**3. Unusability of Purchased Stock Basis**

In some situations, A’s proportionate interest in D or C may increase, even significantly, but the transactions still cannot practically be used to allow A to avail itself of purchased basis to dispose of D without C or vice versa.

Again, consider the facts in Proposed Reg. § 1.355-6(b)(3)(v) *Example 5*, but change the facts so that P owns both 50% of the stock of D and other property of significant value. If A avails itself of its purchased basis in the P stock to dispose of C (as in the *Example 5*), A will also dispose of P’s other property. We believe the regulations should provide that, even if there is a
significant increase in A’s proportionate interest in D or C, section 355(d) will not apply if, at the time A purchased the P stock and at the time of the distribution, P owns significant property other than the D stock. Significance for this purpose could be determined in relation to the value of D’s stock in C.

Of course, A could sell the P stock while retaining P’s other properties. A could do this by causing P to distribute these other properties to A or to sell the properties to A or an affiliate. But if these properties are appreciated in value, the tax cost of such a transaction could offset the tax benefit from the breakup. In at least such a case, section 355(d) should not apply to a split-off of C by D.

B. Administrative Relief

Even if Proposed Reg. § 1.355-6(b)(3)(i)(A) is narrowed as we have suggested, there will be situations in which the rule is not satisfied, but based on all the facts and circumstances it will be clear that the purposes of section 355(d) are not violated. Because section 355(d) has such harsh consequences, we believe the regulations should provide administrative relief where there is an increase in direct or indirect ownership of D or C stock but still no harm of the type at which section 355(d) is aimed. The relief could take the form of advance rulings, the availability of gain recognition agreements, waivers of stock basis, or some combination of these forms.

1. Rulings of No Violation of Section 335(d) Purposes Even if Increase in Ownership Occurs

The Service should entertain requests for private rulings to the effect that, even if P’s ownership in D or C has increased, the purposes of section 355(d) are not violated.

Although we have suggested several ways in which the rule on increased ownership may be narrowed, we recognize that a relatively broad rule is needed to prevent abuse. Still, an analysis of all the facts and circumstances may convince the Service that section 355(d) should not apply. Among the facts that might be relevant (again, using the facts and terminology of Proposed Reg. § 1.355-6(b)(3)(v) Example 5) are:

- A’s relative increased interest in D or C is small (see part II.A.1., above).
- P acquired an increased interest in D or C based on “related transactions” that do not present section 355(d) concerns (see part II.A.2., above).
- P has substantial assets other than the stock of D, particularly if these assets are substantially appreciated and are related to A’s business, or P can otherwise show a reluctance to sell them (see part II.A.3., above).
- A intends to retain the P stock for a substantial time period after the distribution and has business reasons for such retention.
• The business purpose for the distribution is compelling and is unrelated to the purchase or a sale by A of its P stock.

• The purchase transaction took place long before the distribution (although still within the five-year statutory period), and the distribution was not, or could not have been, planned at the time of the purchase.

We believe the final regulations should provide for such advance rulings, and that the Service should issue a revenue procedure setting forth factual considerations that the Service will use in considering such rulings. Such rulings should be available irrespective of whether a ruling was or could be issued on the applicability of section 355 to the distribution generally.

2. Gain Recognition Agreements

The abuse at which section 355(d) is addressed occurs only when the stock of D is disposed of without C, or the stock of C is disposed of without D. Yet, under the proposed regulations, section 355(d) can result in a distribution of C stock being taxable to D with no basis step-up, even if there is no disposition (direct or indirect) of D or C stock.

A similar situation can arise in connection with a transfer of stock or securities of a domestic corporation to a foreign corporation. Here, regulations allow the transferor to enter into a gain recognition agreement (a “GRA”) with the Service. The effect of a GRA is to allow the transfer to be tax-free, notwithstanding section 367(a), unless a later event (generally a disposition within five years by the foreign transferee of the transferred stock or securities) creates the abusive situation. Reg. §§ 1.367-3 and 1.367-8.

We believe a similar GRA regime should be implemented by regulation in connection with section 355(d). Under such a regime, D and the disqualified person would enter into a GRA with the Service within a designated time period after the distribution, with relief under Reg. § 1.9100-1 if the parties in good faith learn of the applicability of section 355(d) at a later time. Under the GRA, section 355(d) would be placed in abeyance unless and until the disqualified person (or a successor) avails itself of the purchased basis in stock of D or C (generally by selling D or C stock). In a situation like Proposed Reg. § 1.355-6(b)(3)(v) Example 5, the GRA would be triggered where A avails itself of its purchased basis in the P stock. The GRA would remain in effect for a fixed time period, like the five-year period under Reg. § 1.367-8.

If a prohibited event occurs, section 355(d) would be reinstated. D would be required to file an amended return for the year of the distribution, report the gain on the distribution and pay the tax plus interest. The taxpayers’ obligations under the GRA would end if section 355(d) ceases to be relevant. Examples of this situation include (a) gain recognition to D on the distribution without regard to section 355(d) (the distribution does not qualify under section 355(a), or section 355(e) applies); (b) the purchased stock basis is eliminated (see Proposed Reg. § 1.355-6(b)(3)(v) Example 7); and (c) in a situation like Proposed Reg. § 1.355-6(b)(3)(v) Example 5, P sells the C stock.
GRAs could be made available for all stock distributions to which section 355(d) otherwise would apply. Alternatively, GRAs could be made available only where section 355(d) applies due to an increase in the disqualified person’s direct or indirect proportionate interest in D or C. In these situations, there would be a need to track only one stock interest, not two. In addition, this type of situation is more likely to arise inadvertently. Nevertheless, although a narrow regime is possible, we believe GRAs should be made available in all section 355(d) situations.

3. Stock Basis Waiver

As an alternative to a GRA regime, the Service could be empowered to allow A to substitute for its cost basis in stock a basis determined by another method that prevents any violation of the purposes of section 355(d). The most obvious alternative method would be the net inside basis method, as in Reg. §§ 1.358-6(c)(1) and 1.1502-31. The substituted basis should be available only if it results in a reduction (or at least not an increase) in the basis of the stock.

Under such a regime, the substituted stock basis should be available at the taxpayer’s irrevocable election, without Service approval, so long as the election is evidenced in a timely manner (e.g., in a statement filed with the taxpayer’s return for the year of the distribution).

As with GRAs, stock basis waivers could be made available for all stock distributions to which section 355(d) otherwise applies or only where section 355(d) applies due to an increase in the disqualified person’s proportionate interest in D or C. Again, we believe it would be preferable for stock basis waiver to be available in all section 355(d) situations.

Overall, we believe a GRA regime would be preferable to stock basis waiver. GRAs have been part of the section 367 regulations for many years, and it should be relatively simple to adapt the section 367 regulations to section 355(d). We also believe a GRA regime would involve fewer technical problems than a stock basis waiver and would solve essentially the same problems. A stock basis waiver could, however, be a feature of a GRA regime. Under such a combined regime, if a transaction prohibited by a GRA is expected, the taxpayer could elect to waive its purchased stock basis at that time and so prevent triggering of the GRA.

C. Technical Recommendations

In addition, we have the following more specific technical suggestions:

1. Proposed Reg. §§ 1.355-6(c)(3)(v)(B) and (vi)(B) – Compensatory Stock Appreciation Rights

Because (i) the purpose of section 355(d) is, in very general terms, to prevent the use of section 355 to facilitate a basis step-up/disguised sale and (ii) we believe that it will be the rare case in which an option is actually used to avoid section 355(d)’s purposes, we suggest that the final regulations deem options to be exercised only in limited circumstances. We also believe that the section 382 regulations illustrate principles that should be imported into the section 355(d) regulations. Thus, we suggest that final regulations deem options to be exercised only in
In accordance with the principles of the rules contained in Treas. Reg. § 1.382-4(d)(2)(i). Under this standard, final regulations should not deem options to be exercised for purposes of section 355(d) unless a principal purpose for the issuance, transfer, or structuring of the option (alone or in combination with other arrangements) is to avoid section 355(d). In addition, if the foregoing approach is not acceptable to Treasury and the Service, we suggest the following, more limited modification to the option rules contained in the Proposed Regulations. Proposed Reg. § 1.355-6(c)(3)(v)(B) provides that SARs constitute “options” for purposes of section 355(d). The proposed regulations deem options (including SARs) to be exercised or converted into stock in certain circumstances for purposes of determining the application of section 355(d). Proposed Reg. § 1.355-6(c)(3)(iv). Proposed Reg. § 1.355-6(C)(3)(vi)(B) provides certain exceptions to the definition of option (and, therefore, deemed exercise treatment) for purposes of section 355(d). The proposed regulations generally exempt from option treatment, among other things, options to acquire stock having customary terms issued in connection with the performance of services. Unfortunately, and we believe inadvertently, this exception does not apply to typical cash-settled SARs having customary terms that are issued in connection with the performance of services because they are not “options to acquire stock.” We believe that final regulations should provide that such SARs fall within the exception to option treatment.

In addition, the proposed regulations provide that if a cash-settled instrument is treated as exercised, it will be treated as having been converted into stock of the issuing corporation. Final regulations should delete (or at a minimum explain) this conversion mechanism. Given the fact that section 355(d) is designed to prevent stock basis step-up abuses, a cash-settled instrument does not appear to give rise to a section 355(d) problem unless it is exercised prior to a section 355 distribution (because in the absence of an actual exercise, there is no stock having purchased basis relating to the instrument). Although we recognize that Reg. § 1.1504-4 has a similar rule, we note that the concern at which that regulation is aimed (ownership of beneficial interests in subsidiary stock) is much different than the concern at which section 355(d) is aimed. If the Service and Treasury are unwilling to delete the cash-settled instrument deemed stock exercise rule, we believe that the conversion mechanism should be explained, perhaps by way of an example.

2. Proposed Reg. § 1.355-6(c)(4) – Vote on Acquisition by Unrelated Shareholders

Proposed Reg. § 1.355-6(c)(4) describes the circumstances under which two or more persons will be treated as a single person under section 355(d)(7)(B). This is generally the case if such persons are acting pursuant to a plan if they have a formal or informal understanding among themselves to make a coordinated acquisition of stock. Final regulations should clarify that target corporation shareholders voting in favor of an acquisition of the target corporation for stock of the acquiring corporation (or stock plus other consideration) (regardless of whether the acquisition constitutes a reorganization) are not making a coordinated acquisition of stock in the acquiring corporation. Because the rules (i) would otherwise treat as a single shareholder persons having a formal or informal understanding among themselves to make a coordinated acquisition of stock and (ii) contain a broad anti-abuse rule, we do not believe that any such clarification must distinguish between public and non-public corporations. Thus, although target corporation shareholders might be treated as having purchased stock in the acquiring corporation (e.g., under
Proposed Reg. § 1.355-6(e)(3)), those shareholders should not be treated as a single person for purposes of section 355(d). We believe that the broad anti-abuse rule contained in Proposed Reg. § 1.355-6(b)(4) should alleviate any concerns regarding aggressive taxpayers using such a rule in an abusive fashion.

3. Proposed Reg. § 1.355-6(d)(3)(iv) – Transfers of Active Business Assets After Section 351 Transfer

Proposed Reg. § 1.355-6(d)(3)(iv) generally provides that an acquisition of stock in a section 351 exchange for cash or a cash item transferred as part of an active trade or business is not treated as a purchase provided certain requirements are met. One such requirement states that the transferee must continue the active conduct of the trade or business. Proposed Reg. § 1.355-6(d)(3)(iv)(4). We suggest that the final regulations be modified to permit the transaction to qualify for this exception even if the active trade or business is transferred to one or more members of the transferee’s section 1504(a)(2) group (e.g., in a double-drop-down as in Rev. Rul. 77-449, 1977-2 C.B. 110, or spread among various brother-sister members), provided the other requirements of Proposed Reg. § 1.355-6(d)(3)(iv) are met. In addition, in accordance with the principles of Reg. § 1.368-1(d)(1), we suggest that the final rules treat the active business as being continued if (i) the transferee continues the business or (ii) uses a significant portion of the transferred assets in an active trade or business.

4. Proposed Reg. § 1.355-6(d)(4) – Stock Basis After Reverse Triangular Reorganization

Proposed Reg. § 1.355-6(d)(5) provides that a taxpayer must obtain a letter ruling and enter into a closing agreement to determine its basis in the surviving corporation stock (including under Reg. § 1.1502-30(b)) in a specific manner pursuant to Reg. § 1.358-6 (i.e., under the deemed stock acquisition model or the over-the-top model, as the case may be). Although we are grateful for the Service’s willingness to entertain such ruling requests and closing agreements, we believe the process may be unnecessarily cumbersome and could be streamlined.

It would appear that simply providing for an irrevocable election to determine stock basis would be a much simpler process that would not consume nearly as many valuable government resources as the proposed regulations’ mechanism. See part II.A.4.c., above. Indeed, requiring such an election would seem preferable as a matter of administrative policy.

We recognize that (i) it might be more appropriate to place such an election in Reg. § 1.358-6 (and potentially Reg. § 1.1502-30) than in section 355(d) regulations and (ii) there is no open regulations project under those sections. Nevertheless, we believe that it would be perfectly appropriate to (i) place the election in the section 355(d) regulations or (ii) make a modification to the section 358 regulations in connection with the finalization of the section 355(d) regulations.

Any such election should be required to be filed with the taxpayer’s federal income tax return for the year including the section 355 distribution as opposed to the year of the acquisition. Given the limitations placed on pre-spin-off stock acquisitions by section 355(e),
taxpayers would be in a “Catch-22” situation if they were required to file such an election with their income tax return for the year of the acquisition (because any such election might be used as evidence against the taxpayer for purposes of proving that the taxpayer had a plan that is violative of section 355(e)).

5. Proposed Reg. § 1.355-6(f) – Reliance on Securities Filings

Under Proposed Reg. § 1.355-6(f)(1), in determining whether section 355(d) applies to a distribution, D has a duty to determine whether a “disqualified person” owns stock of D or any distributed C. Under Proposed Reg. § 1.355-6(f)(2), D is deemed to have knowledge of the contents of documents filed with, or under the rules of, the Securities and Exchange Commission (the “SEC”). In addition, absent actual knowledge to the contrary, D may presume, with respect to “reporting stock,” that all persons required to make a filing with, or under the rules of, the SEC as of a given date have made the filing and that the information contained therein is accurate and complete. Proposed Reg. § 1.355-6(f)(3)

The potential problem raised by the proposed regulations is that SEC rules generally require a person that becomes a 5%-or-greater shareholder that could give rise to a section 355(d) violation to file a Schedule 13D or 13G within 10 days after making the stock acquisition, rather than before or on the date of the acquisition. Further, if a Schedule 13D filer has a material change in its stockholdings, it is required to update that Schedule 13D “promptly,” which securities attorneys interpret as providing the filer with a two or three day grace period after the acquisition. In addition, certain shareholders acquiring stock with an investment intent (who are not likely to acquire a sufficient amount of stock to give rise to a section 355(d) violation) may have longer than ten days to file a Schedule 13G. Regulation 13D under the Securities Exchange Act of 1934.

Thus, as of the date of a section 355 distribution, D could have a 5-percent-or-greater shareholder who is not yet required to make an SEC filing about which the company has no knowledge. Read literally, Proposed Reg. § 1.355-6(f)(3) would not protect D. Thus, if the person not yet required to make the filing owned a sufficient amount of disqualified stock, D could unwittingly engage in a section 355(d) transaction.

Although we recognize that a corporation having outstanding reporting stock generally would have actual knowledge of a person acquiring a sufficient amount of stock to give rise to a section 355(d) violation, we believe that the final regulations should protect D in the unlikely event it does not have that actual knowledge, D has made a good faith effort to discover such acquisition, and no SEC filing has been made by the disqualified stockholder.
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