Spin-offs, Leverage and Value Extraction—A Spin by Any Other Name ...

By Deborah L. Paul[*]

Deborah L. Paul discusses the formality of current spin-off rules and practices and analyzes whether, in light of the purposes of the spin-off rules, there should be restrictions on leveraging or value extraction, and if so, what sort of restrictions make sense.

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I. Introduction

On the surface, applying tax rules to the transformation of a single corporation into two might seem to be a simple matter. But, such a transaction raises basic tax policy issues. Tax professionals pride themselves on engaging in a discipline infused with a respect for "substance over form." Yet, tax professionals are also aware that form often plays a significant and even decisive role. The area of spin-offs—the distribution by one corporation ("Distributing") of the stock of a controlled corporation ("Controlled")—presents a case study in the nuances surrounding the relationship between substance and form in the tax law. A foundational case upholding substance over form, *Gregory v. Helvering*,[1] involved a spin-off. Yet, as shall be shown, the spin-off rules in the Internal Revenue Code (the "Code") are replete with formalisms. Spin-offs put to the test the Code's commitment to substance because a host of potential structures can be used to divide a single corporation into two. The Code contains different rules for different structures.

This article addresses primarily a single basic fact pattern. A public company conducts two businesses and wishes to spin one of them off to the public company's shareholders. The article presumes that the transaction has a valid business purpose and that all the other requirements of Code Sec. 355 are satisfied. Furthermore, in the fact pattern, the public company has a certain amount of debt immediately before the spin-off. The debt is debt for tax purposes, and the ostensible borrower could have afforded to borrow the relevant amount on a stand-alone basis. That is, the *Plantation Patterns*[2] doctrine is not at play. The article discusses whether the Code should impose constraints on the respective capital structures of Distributing and Controlled as they emerge from the spin-off.

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Current law does impose constraints, depending on how the spin-off is structured. For example, a basis limit applies if Controlled assumes Distributing debt or if Controlled borrows, distributes funds to Distributing, and then Distributing uses the funds to repay debt of Distributing. No basis limit applies, however, if Controlled issues debt securities to Distributing, which Distributing exchanges for Distributing debt. Logically, since these three structures are economically the same, the Code should impose a basis limit on all three or none at all.

As another example, a basis limit applies if Distributing drops one business, Business A, into Controlled, Controlled borrows, and Controlled *distributes* the borrowed funds to Distributing (which retains the other business, Business B). However, no basis limit would apply if Distributing retained Business A, Distributing dropped Business B into Controlled, Distributing borrowed, and Distributing *contributed* the borrowed funds to Controlled. The Code favors *contributions* of cash over *distributions* of cash.

The current rules lie at the intersection of two fundamental tax policy principles. First, the Code aims to facilitate corporate restructurings by refraining from imposing tax on readjustments of corporate form. Code Secs. 355, providing nonrecognition generally for spin-offs, and 368, providing nonrecognition for corporate reorganizations, embody this principle. Second, as embodied in Code Sec. 1001, the Code aims to impose tax if a taxpayer disposes of property and receives cash in excess of the taxpayer's basis in the property.

The Code never reconciles these two principles in the context of spin-offs that allocate Distributing debt between Distributing and Controlled. Instead, the Code adopts one principle in certain contexts and the other principle in other contexts, with the result that the applicable rules depend on form.

In providing different rules for different paths to the same result, the Code presents a dilemma for tax administrators. One approach would be for the IRS to apply traditional doctrines in a traditional manner. As will be shown, the IRS has not followed this approach. Instead, the IRS has allowed taxpayers to choose the most favorable form. In private ruling after private ruling, the IRS has approved transactions in circumstances where traditional doctrines might have come out differently. The IRS's approach stems from a recognition of the formality inherent in the Code. If the Code provides multiple paths, some of which are taxpayer-favorable and some of which are taxpayer-unfavorable, but all of which are economically the same, the thinking goes, the taxpayer should be entitled to choose. A rigid application of the Code's categories would only increase formality to no particular tax policy end. Thus, the IRS's ruling practice has evolved to find taxpayer-favorable treatment in the context of leverage shifts in spin-offs where it can.

At one level, the system works. Transactions happen, and, in the end, thanks to expansive interpretations by the IRS, taxpayers generally obtain the capital structure they want for Distributing and Controlled. But, these results carry with them significant transaction costs and inefficiencies. For example, many transactions cannot occur without a private ruling from the IRS, because only the IRS can provide comfort that the necessary formalities have been observed. Some of these inefficiencies could be mitigated by the IRS issuing published rulings on key points.

Beyond published rulings, the Code could be made more consistent with a statutory amendment that would impose a basis limitation on securities-for-debt exchanges. Indeed, bills to that effect have been floated numerous times.[3] The principle of consistency could also be served by statutory amendments going in the opposite direction, however, namely, by eliminating basis limitations in the case of liability assumptions and cash distributions used to pay creditors. Indeed, basis limitations are not inevitable. Until 2004, the Code did not impose a basis limitation on cash distributions.[4] While amending the Code to impose a basis limit on securities-for-debt exchanges would make the Code more consistent, the desirability of such an amendment should be analyzed from the perspective of more substantive policy considerations, as discussed below. Such an amendment would not be desirable from the perspective of one who believes that the Code should facilitate leverage shifts in spin-offs. Imposing a basis limit on securities-for-debt exchanges would undercut taxpayers' abilities to obtain the desired capital structures for Distributing and Controlled.

The formalism inherent in the Code's treatment of debt shifts in spin-offs runs deeper than the inconsistency among liability assumptions, cash distributions, and securities-for-debt exchanges, because a taxpayer can choose which business to spin off. The roles of transferor and transferee can be reversed, and, by the same token, a cash contribution can replace a cash distribution. The business that would be the transferor can instead itself be disposed of and be packaged with cash.

All this raises the question whether it is possible to develop a regime that does away with formal distinctions. The goal would be to make the results independent of which business is spun off and independent of the mechanism by which debt is shifted from Distributing to Controlled. The system ideally would determine tax results solely based on economic distinctions. Part VIII of this article presents a heuristic for developing such a system. However, it seems inevitable that, even if the Code eliminates some formalities, others will remain. At a minimum, the spin-off rules presuppose that businesses are conducted in corporate form. Rules governing the separation of businesses conducted in partnership form differ from those applicable to corporations.

Part II of this article discusses arguments for and against currently taxing debt shifts in excess of basis in the context of spin-offs, concluding that both sets of arguments have intuitive appeal. Part III sets forth possible approaches responsive to the arguments discussed in Part II. Under an "Alter Ego Approach," *bona fide* business-motivated debt shifts would never be taxed, even if debt in excess of basis were shifted. Under a "Sale Approach," any debt shift in excess of basis would be taxed. And, under a "Morris Trust Approach," a debt shift in excess of basis would be taxed generally if the leveraged company were acquired as part of the plan. Part IV summarizes current law, and Part V demonstrates how taxpayers have exploited the current law preference for securities-for-debt exchanges and the current law preference for contributions of cash over distributions of cash. Part V also demonstrates the centrality of the IRS ruling process and the leeway the IRS has given taxpayers. Part VI widens the lens to cover spin-offs involving debt shifts where the leveraged entity is meant to be acquired as part of the plan. These transactions exacerbate the concerns of those who would argue that spin-offs with debt shifts are akin to sales. Part VII highlights formalities that apply when Controlled equity, rather than Controlled debt, is the source of the funds. Finally, Part VIII outlines several directions in which the law could head. The system could continue as it has, facilitating transactions yet imposing inefficiencies, or broader reform could be considered, which might serve the prospect of prioritizing substance over form. Any such reform that makes results independent of which business is spun off would upend basic tax principles, such as the realization requirement, and would therefore have far-reaching implications. Such reform would have to grapple with a number of basic questions sketched out in Part VIII.

II. Fundamental Principles

A. Arguments Against Taxing Spin-offs Currently

Strong arguments can be made that spin-offs involving shifts of debt in excess of basis should not be taxed currently. First, by dint of the "business purpose" requirement, spin-offs always have a business purpose.[5] The transactions generally stem from real-world business considerations, not tax planning. Moreover, significant economic and business pressures drive choices about the capital structures for Distributing and Controlled. Those pressures relate to the value of Distributing and Controlled and the cash flows and volatility of their businesses. As Distributing shrinks its asset base, Distributing should, as an economic matter, shed some amount of the corporate group's debt. Thus, under this view, business considerations should drive the amount of debt that is shifted, rather than the Code setting an artificial limit based on a variable—basis—that has no relationship to business considerations. Basis is not a variable that any financier would consider if left to his or her own devices. Thus, imposing a basis limit on the amount of leverage that can be shifted to Controlled interferes with *bona fide* business and economic capital structuring.[6]

Second, one can argue that the Code ought to facilitate corporate restructurings, including spin-offs. Just as Code Sec. 368 and related provisions facilitate acquisitive transactions,[7] the Code should facilitate divisive transactions.[8] When business exigencies motivate an acquisition or division, the Code should not stand in the way. Indeed, one could argue that divisive transactions are particularly sympathetic. In a large industrialized society such as ours, it is beneficial for corporate assets to be able to be disaggregated without significant impediments. Otherwise, businesses may become larger than is optimal from an operational and capital structure standpoint. The Code should not serve as an obstacle to transactions that make businesses smaller, more manageable, and more competitive.

Furthermore, oftentimes, a divisive transaction is intended to allow corporate parties to engage in a second-step acquisitive reorganization.[9] To the extent the Code seeks to facilitate acquisitive transactions, it should do so by similarly facilitating a first-step divisive transaction intended to restructure the relevant businesses such that the acquisitive transaction can occur. Where the target business is separated from another business previously held under the same corporate umbrella in order to facilitate the amalgamation of such target business with the acquiror, and both steps are motivated by an identical, genuine business rationale, it could be argued that the Code should not impose tax on the first step if it would not do so with respect to the second step alone.[10]

Moreover, certain spin-offs resemble acquisitive reorganizations. In a transaction qualifying under both Code Secs. 355 and 368(a)(1)(D) (a "D/355"), Distributing transfers assets to Controlled in exchange for Controlled stock, which Distributing then distributes to Distributing's shareholders. The transaction is similar to a reorganization under Code Sec. 368(a)(1)(C) (a "C Reorganization"), except that Distributing does not transfer substantially all its assets as does the target in a C Reorganization, and the target, Distributing, does not liquidate as does the target in a C Reorganization. Thus, the distinction between acquisitive and divisive reorganizations is not as sharp as it may appear at first blush, and the policies favoring facilitating acquisitive transactions may apply equally to divisive transactions.[11]

Third, all the assets held by Controlled remain in corporate solution. While the repeal of *General Utilities*[12] stands for the proposition that the Code must impose gain recognition when assets leave corporate solution, spin-offs do not present such a situation. The corporate tax base is not depleted. Income from the assets transferred to Controlled, as well as the assets that remain at Distributing, will remain subject to corporate-level tax. Accordingly, there is arguably little point in triggering gain recognition at the time of the extraordinary transaction, the spin-off.[13] Arguably, the Code should prefer spreading income over time rather than bunching income into one period.

Finally, one could argue that the classical system inherent in the Code is fundamentally biased against the corporate form and that the system should mitigate that bias with liberal nonrecognition rules.

B. Arguments for Taxing Spin-offs Currently

To argue the other side of the coin, strong arguments can also be made that spin-offs should be taxed currently where Distributing cashes out, that is, where Distributing receives cash, or the equivalent, in excess of Distributing's basis in the assets or stock disposed of. One could argue that receipt of cash in excess of basis is pervasively in the Code the paradigmatic time to tax. When Distributing shifts debt to Controlled in excess of basis, Distributing monetizes (a portion of) its investment. The transaction is arguably not one that raises subtle questions as to whether there has been a realization event,[14] nor does it involve a property-for-property exchange where the taxpayer has no liquidity to pay tax, each of which might present a sympathetic case for deferral. Rather, the transaction involves a disposition for cash in excess of basis, which, the argument goes, should be a straightforward case for recognizing gain.[15]

In response to the business purpose argument against current taxation, one could argue that the existence of a business purpose and the fact that economic pressures drive capital structure do not mean that tax is not properly imposed. After all, most sale transactions have a business purpose. One would not argue that a sale transaction should not be taxed simply because it stemmed from *bona fide* business exigencies.

In response to the argument that the Code should facilitate corporate restructurings, one could acknowledge that the Code should facilitate divisive corporate restructurings, but this does not mean that such transactions should have a free pass when Distributing cashes out, as the spin-off is the last clear chance to tax Distributing.

In response to the argument that all assets remain in corporate solution, one could argue that this argument as well proves too much. If one corporation simply sells assets to another unrelated corporation, gain is indisputably recognized.[16] If the Code included a concept that protected transactions as long as assets remained in corporate solution, then sale transactions by a corporation to another corporation would not be taxed.[17] But, they are. The Code does not view the corporate tax base as a whole as a single taxpayer such that assets may be moved around within it without triggering tax. Rather, each corporation is a separate taxpayer.[18] Disposals by a single corporation of appreciated assets result in tax, regardless of whether the assets remain in corporate solution.[19] Thus, arguably, the fact that the assets remain in corporate solution should not prevent taxation of a spin-off where Distributing receives cash in excess of basis.[20] Moreover, one could argue that an asset is removed from corporate solution *via* a spin-off, namely, the stock in Controlled.[21]

Finally, as to the argument that the classical system inherently overtaxes, that argument again proves too much as it argues in favor of doing away with the classical system altogether or lowering the rate of tax on corporate income, not in favor of ad hoc mitigations of the classical system.

III. Possible Approaches

Both sets of arguments discussed in Part II above have intuitive appeal. Many people would agree that the Code should facilitate corporate restructurings. At the same time, many would agree that a taxpayer should be taxed if the taxpayer receives cash in excess of basis. These intuitions pull in opposite directions, however. The Code navigates this tension with rules that reflect one intuition in certain contexts and the other intuition in other contexts, resulting in inconsistencies.

Consistent approaches could be adopted, none of which are reflected in current law. First, a believer in the arguments against taxing spin-offs set out in Part II.A above would adopt rules that do not impose tax on a spin-off, regardless of how much cash is received. At a structural level, that approach treats Controlled as an alter ego of Distributing in the sense that, at the time Distributing transfers assets to Controlled, Distributing is viewed as transferring assets to itself (the "Alter Ego Theory").

Second, a believer in the arguments set out in Part II.B (the "Sale Theory") would impose tax if cash exceeds basis. That approach perceives Controlled as a separate taxpayer that bought assets from Distributing to the extent Controlled paid cash, or the equivalent, in excess of Distributing's basis. Under the Sale Theory, the imposition of tax does not depend on the participation of a third-party acquirer. Rather, Controlled is viewed as having purchased the contributed assets from Distributing.[22]

Third, a person might find the Sale Theory to be compelling only if both the amount of cash received by Distributing exceeds basis *and* Controlled is acquired as part of the transaction (the "Morris Trust Theory").[23] The view would be that the transaction seems like a sale to whomever acquires Controlled, as the acquiror is likely to support the debt that Controlled incurred to finance the acquisition of the assets from Distributing. As discussed in greater detail in Part VI below, while the basic version of the Morris Trust Theory would apply regardless of whether the leveraged acquired company was *over*leveraged, some would argue that the Morris Trust Theory should apply only if the leveraged company is acquired and is *over*leveraged in light of the value and nature of its business.

On the surface, all of the above approaches have internal logic, but even they are formal in that they respect the "direction" of the spin. That is, they would lead to different results depending on which of its two businesses Distributing spins off. As we shall see in Parts V.C and VIII below, this issue is a difficult one to tackle.

IV. Current Law

Under current law, while a corporation recognizes gain if it sells assets for cash,[24] "bootstrap" dispositions are not always taxable. A bootstrap disposition is a disposition in which the subsidiary that is disposed of provides a portion of the proceeds to the transferor. In the fully taxable context, *Waterman Steamship*[25] is an example of a bootstrap disposition, namely, a distribution by the target subsidiary followed by a sale of the stock of the subsidiary to a buyer. Spin-offs that involve a shifting of debt from Distributing to Controlled can be viewed as bootstrap dispositions, because the subsidiary, Controlled, provides proceeds to the transferor, Distributing, in the form of cash or relief of liabilities.

As has been well-observed, the Code contains three sets of rules for three economically equivalent but formally different types of spin-offs involving bootstrap dispositions.[26] The three structures are (a) a cash payment from Controlled to Distributing (and a subsequent repayment by Distributing of Distributing debt using such cash), (b) the assumption by Controlled of Distributing liabilities, and (c) the exchange of Controlled debt securities for Distributing debt.

First, if Controlled distributes cash to Distributing and Distributing does not transfer assets to Controlled, such that the transaction qualifies under Code Sec. 355 but is not a D Reorganization (a "355/non-D"), then if the cash exceeds Distributing's basis in the Controlled stock, an excess loss account (ELA) will be created upon the cash distribution[27] and then triggered on the distribution of Controlled to the Distributing shareholders.[28]

If Controlled distributes cash to Distributing in a D/355, Distributing faces a "use of proceeds" requirement and, if the cash is used to repay Distributing debt, a basis limitation. In order to receive the cash tax-free under Code Sec. 361, Distributing must use the cash to pay shareholders or creditors (the "Use of Proceeds Requirement").[29] If the cash is used to pay creditors, under the Code, the cash must not exceed Distributing's basis in the contributed assets (reduced by the amount of any liabilities assumed).[30]

Second, if Controlled assumes liabilities of Distributing, Distributing is taxed on the liabilities assumed in excess of basis.[31] As well, in a D/355, the liability assumption must pass a stringent "principal purpose" test under Code Sec. 357(b). Code Sec. 357(b) provides that if:

> ... taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption ... was a purpose to avoid Federal income tax on the exchange, or ... was not a bona fide business purpose, ...

... then the total amount of the liability assumption (not merely the portion in excess of basis) is treated as boot.[32]

Third, suppose that in a D/355, Controlled issues Controlled debt securities to Distributing in partial exchange for the assets contributed by Distributing, and then Distributing transfers those Controlled debt securities to Distributing debt holders in exchange for Distributing debt (a "Securities-for-Debt Exchange"). In this fact pattern, no basis limitation applies to Distributing's receipt of the Controlled securities.[33] Several bills have been introduced, however, that would impose such a basis limit.[34] Until or unless a basis limit is imposed on Securities-for-Debt Exchanges, such exchanges are the most favorable of the three structures, as they are not subject to a basis limit[35] or a Use of Proceeds Requirement.

Thus, as illustrated in Figure 1, current law seems arbitrary. A basis limit applies to cash distributions used to retire debt and liability assumptions, but, in the case of a D/355, not to Securities-for-Debt Exchanges. A Use of Proceeds Requirement applies to cash distributions in the context of D/355s but not to cash distributions in the context of 355/non-Ds.[36]

V. Recent Structures Exploit Formalities

As discussed above, of the three economically equivalent structures for monetizing an investment in Controlled, the Securities-for-Debt Exchange is generally the most beneficial because it does not involve a basis limitation. Thus, taxpayers often seek to style their transactions as Securities-for Debt Exchanges. In its ruling practice, the IRS has been accommodating, allowing taxpayers to choose the form that suits them best. As shown below, the ruling practice has involved highly context-specific applications of the step transaction doctrine.

A. Securities-for-Newly-Issued Debt

Numerous private rulings have approved a structure under which Distributing issues short-term debt to investment banks only to redeem it two weeks later in exchange for Controlled debt securities. The structure enables Distributing to take advantage of the rules favoring Securities-for-Debt Exchanges without the headaches that would derive from redeeming historic Distributing debt.

A taxpayer wishing to take advantage of the fact that no basis limit applies to a Securities-for-Debt Exchange could, in theory, negotiate with historic debt holders to convince them to receive Controlled securities in exchange for the Distributing debt they hold. Yet, realistically, holders of historic Distributing debt may well not want to own Controlled debt, as it involves a different issuer in a different business and debt with different terms (maturity, interest rate, seniority, *etc.*). Thus, a practice emerged for a "friendly" investment bank to buy up historic Distributing debt from existing holders, and then exchange the Distributing debt with Distributing for Controlled securities.[37] At the same time, the IRS approved Securities-for-Debt Exchanges involving short-term commercial paper of Distributing.[38]

Putting these themes together—the notion that a new owner could qualify as an historic creditor with only a two-week holding period and the notion that the debt itself could be issued shortly before the Securities-for-Debt Exchange—taxpayers proposed, and the IRS approved, scenarios where short-term debt was issued by Distributing to an investment bank. In a typical format, the bank would hold Distributing's newly issued short-term debt for five days and then Distributing and the bank would enter into an "exchange agreement" pursuant to which Distributing and the bank would agree to exchange Controlled securities for the newly issued Distributing debt in another 11 days (the "5/14 Plan").[39]

In approving the structure, the IRS has applied a narrow version of the step transaction doctrine. Under the step transaction doctrine, the newly issued debt might well not be respected as such debt is issued only to be redeemed. And, although the exchange agreement is not entered into until five days after issuance, the redemption of the debt is clearly the end result, and the issuance and redemption of the debt are mutually interdependent, suggesting that, under the step transaction doctrine, the debt would not be respected.[40] Arguably, the step transaction doctrine would respect the debt on the view that the banks do take credit risk for 14 days and there is no binding agreement to exchange at the time the debt is issued, as the exchange agreement is not entered into for five days.[41] One could debate how a traditional step transaction doctrine analysis would come out on the question whether the debt should be respected.[42]

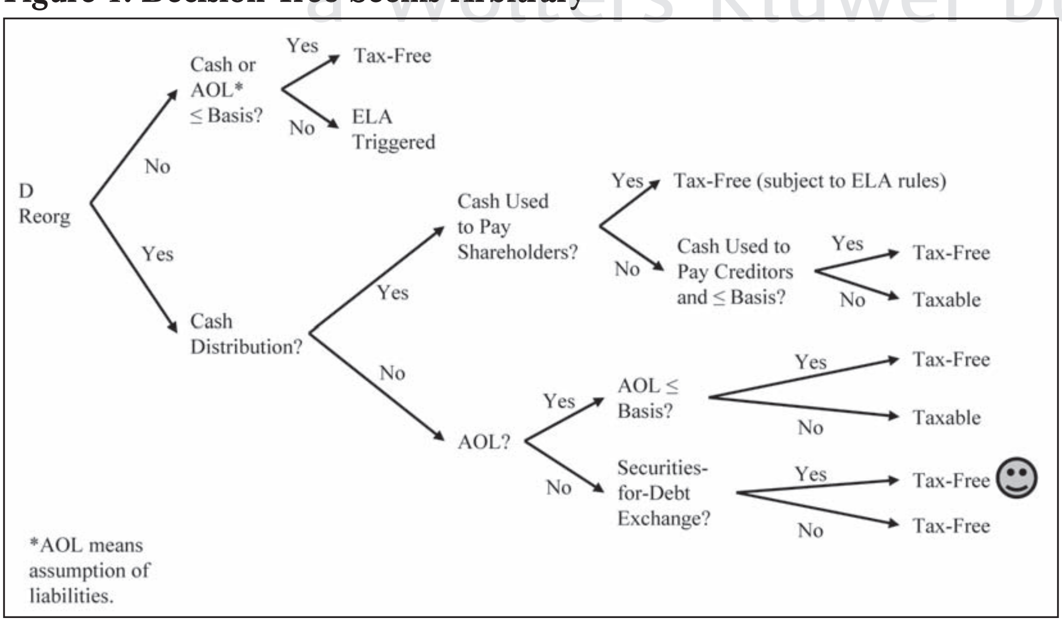
The structure is plainly tax-motivated. The parties would never have had Distributing issue the debt only to have it redeemed 14 days later were it not for tax advisors telling them that this would provide a good tax result.[43] But, arguably, the structure gets to the correct answer. The thinking of the IRS in issuing rulings approving the structure seems to stem from a recognition that the Code embodies two taxpayer-favorable ways to shift debt in a spin-off: contributing cash or doing a Securities-for-Debt Exchange. Other ways to shift debt (distributing cash or assuming liabilities) result in basis limits.[44] But, economically, all these are the same. Thus, it appears that the IRS has concluded that if the taxpayer can facially present a structure that falls within a favored category, here, the Securities-for-Debt Exchange, then the taxpayer should be entitled to the desired treatment.[45] That is, while Congress has provided an irrational framework—taxing economically identical transactions differently[46]—as discussed in Part II.A above, many arguments can be made in support of the Code facilitating spin-offs. Thus, the IRS appears comfortable with a formalistic approach favoring transactions that style themselves in a manner eligible for beneficial tax treatment.

B. Travelling Notes

"Travelling notes" also take advantage of the formalism of current law and IRS ruling practice.[47] In this structure, Distributing issues debt to investors that are willing to invest in either Distributing or Controlled debt.[48] The issuance occurs a period of time (*e.g.*, two weeks) before the spin-off and generally before all conditions to the spin-off have been satisfied. The notes provide that they can be exchanged for Controlled securities upon the occurrence of the spin-off. The exchange may be at Distributing's election or it may be mandatory if the spin-off occurs. If the spin-off does not occur, the debt remains at Distributing.[49]

The taxpayer intends to treat the exchange of Controlled securities for the Distributing travelling notes as

Figure 1: Decision Tree Seems Arbitrary



a Securities-for-Debt Exchange, rather than an assumption of liabilities. The IRS adopted the taxpayer's intended approach in LTR 201232014.[50] In that ruling, Distributing issued debt to third parties at least five days before the declaration date of the spin-off and at least 14 days before the spin-off.[51] At least 14 days after the issuance of the travelling notes, in accordance with the terms of the notes, Distributing delivered Controlled securities in satisfaction of the notes.[52]

If the structure were viewed as an assumption of liabilities, then, at best, Code Sec. 357(c) would impose a basis limit on Controlled's assumption of Distributing notes. At worst, Code Sec. 357(b) would apply to treat all the debt assumed in the transaction as boot. Code Sec. 357(b) aims paradigmatically at a transaction where a taxpayer wishes to transfer property in a Code Sec. 351 or D/355 transaction and receive cash from the transferee corporation. Knowing, though, that the receipt of cash would be taxable boot under Code Sec. 351(b) or 361, the taxpayer instead borrows, retains the cash, and has the controlled corporation assume the liability. The IRS has implemented Code Sec. 357(b), as a general matter, in its ruling practice by requiring parties to represent that any "liabilities of the transferor(s) to be assumed by the transferee were incurred in the ordinary course of business and are associated with the assets to be transferred."[53]

On its face, the travelling note structure in LTR 201232014 resembles the transactions at which Code Sec. 357(b) aims. The taxpayer, Distributing, borrowed cash and contributed assets to a transferee corporation, Controlled, in a Code Sec. 361 transaction, while the debt shifted to become an obligation of the transferee corporation. The taxpayer's purpose in structuring the transaction as an incurrence of debt by Distributing, rather than a distribution of cash by Controlled to Distributing, seems tax-motivated. Of course, the overall allocation of liabilities and the decisions made about capital structure are undoubtedly business-motivated. But, had Controlled borrowed in the first instance and distributed cash, Distributing would have had to use the cash to pay shareholders or creditors, in which latter case a basis limit would have applied.[54] Instead, the travelling notes provide cash to Distributing, while the liability winds up at Controlled. Had the IRS required the Code Sec. 357(b) representation—to the effect that the travelling notes were incurred in the ordinary course of business and were associated with the assets being transferred to Controlled—it is difficult to see how the taxpayer could have given the representation. Yet, the IRS accepted the taxpayer's formal styling of the transaction as a Securities-for-Debt Exchange rather than an assumption of a liability, with the result that the representation did not need to be given and no basis limit or Use of Proceeds Requirement applied. The IRS allowed the taxpayer to choose the more favorable form.

C. Reversing Distributing and Controlled

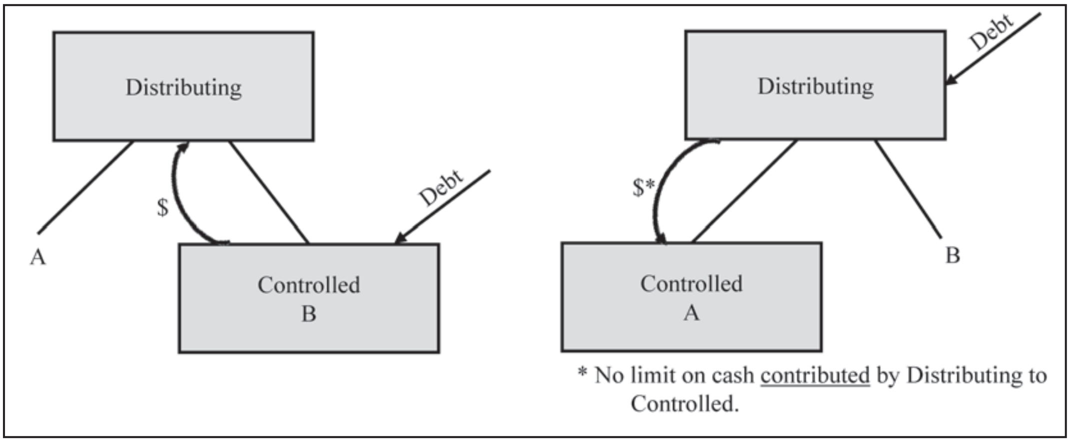
Another approach to avoiding a basis limitation is to reverse the "direction" of the spin-off. That is, suppose that Distributing owns two businesses, A and B. Usually, there is a natural business to spin off, say, Business B, because, for example, Business B is smaller than Business A.[55] Thus, suppose one's first pass at a structure would be for Distributing to drop Business B into Controlled, have Controlled borrow funds and distribute the funds to Distributing, and then spin off Controlled, which holds Business B. The structure, shown on the left side of Figure 2, would limit the amount of cash that Distributing could receive to Distributing's basis in Business B (*i.e.*, Distributing's basis in the assets contributed to Controlled).

As an alternative, and as shown on the right side of Figure 2, Distributing could contribute Business A to Controlled. Then, Distributing could incur debt, contribute the proceeds to Controlled, which holds Business A, and spin off Controlled. The end result is similar to the basic transaction: Businesses A and B are separate, debt burdens Business B, and the cash proceeds of the debt are with Business A. The difference is that the historic top company, Distributing, owns Business B in the alternative, while it held Business A in the basic structure.

As a practical matter, it is not always straightforward to reverse the direction of the spin-off, as there may be nontax reasons to keep Distributing and Business A together. Distributing may be a party to commercial contracts or debt agreements that are meant to stay with Business A.

But, even those constraints may be able to be overcome, as illustrated in LTR 200750009,[56] where the taxpayer used a first-step reorganization pursuant to Code Sec. 368(a)(1)(F) (an "F Reorganization") to keep the historic top company together with the spun business, while contributing cash to Controlled, rather than

Figure 2: Reversing Distributing and Controlled



having Controlled distribute cash to Distributing. In that ruling, an "Historic Parent" (in the ruling, "Old Parent") corporation owned two businesses, A and B, and wished to separate them, burdening Business B with debt, the proceeds of which would go to Business A. The typical way to do this would have been for Historic Parent to drop Business B into a controlled corporation, leverage up the controlled corporation, have the controlled corporation distribute funds to Historic Parent, and then distribute the controlled corporation. But, presumably, doing so would have led to a basis limit on the cash able to be distributed from the controlled corporation to Historic Parent on a tax-free basis. As well, the taxpayer evidently wanted to keep the Historic Parent entity with Business A. Thus, as illustrated in Figure 3, the taxpayer engaged in a first-step F Reorganization in which a new corporation ("Distributing Newco"; in the ruling, "Distributing") acquired Historic Parent, and then Historic Parent converted to a limited liability corporation, disregarded from its owner, Distributing Newco. Historic Parent then distributed Business B to Distributing Newco. Distributing Newco raised funds from an equity investment by an investor in Distributing Newco and a borrowing at Business B (*see* Figure 3). A portion of the funds was used to pay off historic debt owed to Historic Parent, and Distributing Newco contributed Historic Parent, holding Business A, and cash to "Controlled Newco," a wholly owned subsidiary of Distributing Newco. Finally, Distributing Newco distributed Controlled Newco to the Distributing Newco shareholders.

The ability to reverse the direction of the spin-off is arguably the Achilles heel of an argument that the Code has rationality in this area.[57] Because the structure replaces a cash *distribution* with a cash *contribution*, reversing the direction of the spin-off eliminates nearly all the constraints that apply to debt shifts. In effect, instead of Distributing disposing of a business for cash, Distributing retains the business that was supposed to be disposed of and disposes of the business that was supposed to receive the cash, packaging the latter business with cash. If the constraints on distributions are meant to address something important from a tax policy perspective, it is difficult to see why such tax policy concerns should be able to be circumvented by reversing the direction of the spin-off. It would seem that a rational system should treat the two economically equivalent alternatives in the same manner.

D. Ordinary Course Dividends and Stock Buyback Programs

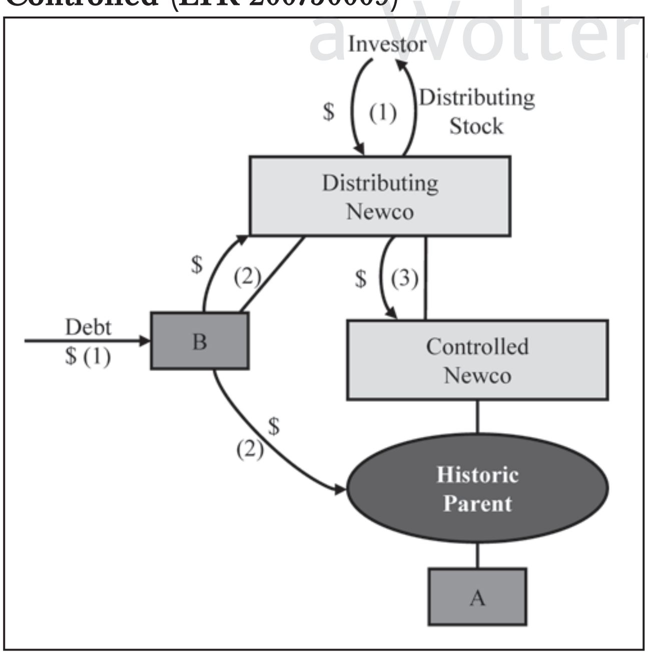
As described in Part V.A, the IRS applies a narrow version of the step transaction doctrine in the context of Securities-for-Debt Exchanges, treating a transaction that involves a transitory issuance of debt in connection with the spin-off in accordance with its form. On the other hand, as discussed below, the IRS has ruled that certain actions that a taxpayer would take regardless of the spin-off are treated as part of the plan that includes the spin-off, a broad interpretation of the step transaction doctrine.

As mentioned, in order for the receipt of cash by Distributing to be tax-free under Code Sec. 361, Distributing must use the cash to pay creditors or shareholders pursuant to the plan of reorganization.[58] Two long-standing questions have been (1) whether payments to shareholders in the form of regular, periodic dividends can qualify, and (2) whether payments to shareholders pursuant to pre-existing stock buyback programs can qualify. Arguably, these payments are not made "in pursuance of the plan of reorganization," because Distributing would have paid such dividends or made such repurchases in any event. However, the IRS has confirmed that these types of payments to shareholders do qualify, provided that they occur within a specified time after the spin-off.[59]

While the step transaction doctrine questions around the concept of what actions are pursuant to the plan of reorganization are arguably different from those surrounding whether debt should be respected as historic debt, the rulings regarding dividends and stock buybacks seem to be in tension with those discussed in Part V.A regarding Securities-for-Debt Exchanges. In permitting newly issued debt to qualify, the IRS rejects the idea that the debt to be repaid must be historic debt existing at the time the plan to undertake the spin-off is adopted. Yet, construing the newly issued debt as "old and cold" would seem to imply that the scope of what is not "old and cold," *i.e.*, the scope of actions that are taken pursuant to the plan of reorganization, is narrow. However, the IRS has also construed the concept of "in pursuance of the plan of reorganization" broadly in holding that the payment of regular dividends and the repurchase of stock pursuant to existing stock buyback programs are actions taken pursuant to the plan that includes the spin-off.

The IRS finds itself in a Catch-22. Ruling as they have done appears inconsistent. On the other hand, taken independently, the rulings seem pragmatic. Approving newly issued debt seems sensible in light of the fact that corporations finance and refinance regularly. And, permitting payments of ordinary dividends and previously announced stock buybacks seems sensible in light of the fungibility of cash. To rule otherwise in each case would have exacerbated the formalism inherent in the tracing approach in the statute. Each of the requirement to repay Distributing debt with Controlled securities and the requirement to pay Distributing creditors or shareholders involves tracing—*i.e.*, Distributing must trace the securities or cash it receives from Controlled to a particular use. Were the IRS to cease to rule in favor of securities-for-newly-issued-debt exchanges or in favor of the use of cash to pay regular dividends or to buy back stock pursuant to existing repurchase programs, taxpayers and the IRS would be in a position of having to draw lines that would quickly become uncertain and feel unmotivated by policy concerns.[60]

Figure 3: Reversing Distributing and Controlled (LTR 200750009)



E. North-South

Another area where the IRS has been generous has been in the "North-South" context. "North-South" generally connotes a scenario where a parent corporation contributes property to a subsidiary corporation, which in turn distributes property to the parent corporation, and the issue is whether those two transfers should be viewed as being in exchange for one another. The IRS has ruled on this issue regularly where the parent corporation is the shareholder receiving a purported distribution of a controlled corporation from the subsidiary distributing corporation in a purported internal Code Sec. 355 distribution.[61]

The IRS went one step further in LTR 201136009.[62] In that ruling, the North-South transaction occurred between Distributing and Controlled, as distinguished from occurring between the shareholder of Distributing and Distributing. Controlled distributed cash to Distributing prior to an internal D/355 (that preceded an external D/355) in which Distributing contributed assets to Controlled.[63] This distribution of cash by Controlled would seem to be a classic Code Sec. 361 distribution, such that Distributing would be required to use the cash to pay creditors or shareholders in order to receive the cash on a tax-free basis. But, the IRS did not require that Distributing so use the cash. Instead, the taxpayer represented that there was "no regulatory, legal, contractual, or economic compulsion or requirement that Distributing 1 make part or all of the Distributing 1 Contribution as a condition to the distribution by Controlled of the Cash Distribution."[64] The IRS held that Code Sec. 301 applied to the cash distribution.[65]

It seems that the North-South transaction could occur on the same day and perhaps pursuant to a single agreement. The North and South legs of the transaction are clearly part of the same plan. And, yet, the IRS is prepared to view the contribution of assets and the distribution of cash as separate because, as represented, there is no compulsion to contribute the assets in order that the distribution can be made.[66] In other words, the taxpayer is effectively representing that the taxpayer would have contributed the assets regardless of the cash distribution and would have distributed the cash regardless of the asset contribution. On that basis, it seems understandable to treat the North and South legs as separate transactions. And, notably, the logic would not apply if Controlled were a new corporation that leveraged up as part of the spin-off, since the lenders would not lend to the new corporation were it not for the assets to be contributed—*i.e.*, a new corporation could not give the representation regarding lack of compulsion. So, the approach of the ruling is limited to assets in an historic Controlled that are desired to be removed as part of the spin-off. Although the ruling appears to come to a sensible result, it would seem that the step transaction doctrine could have been interpreted differently to treat North-South transactions as exchanges.[67] The IRS ruling position, however, has not so applied the step transaction doctrine and, instead, has afforded taxpayers broad latitude to treat contributions and distributions as separate transactions, even where part of the same transaction and overall plan.[68]

VI. Morris Trust Overlay Exacerbates Sale Character

The sale character of a leveraged spin-off may be exacerbated if the leveraged corporation is subsequently acquired by an unrelated party.[69] Indeed, concerns along these lines led to the enactment of Code Sec. 355(e) in 1997.[70] Code Sec. 355(e) imposes tax on Distributing if a spin-off is "part of a plan (or series of related transactions)" pursuant to which one or more persons acquire 50 percent or more of the vote or value of the stock of either Controlled or Distributing.[71] Code Sec. 355(e) was intended to quell spin-offs that resemble corporate level sales, but the statute is overbroad, as it applies regardless of whether any debt was shifted, does not turn on whether the leveraged company or the other company is acquired, and does not depend on whether the acquiror supports or pays off debt incurred by the acquired company.

A transaction involving Viacom and TCI appears to have catalyzed the enactment of Code Sec. 355(e).[72] In that transaction, as explained in greater detail below, a Controlled corporation (Old Sub) that had incurred debt in connection with the transaction and transferred the proceeds indirectly to Distributing was acquired,[73] raising concerns that the transaction resembled a sale of the Controlled corporation. According to the private ruling[74] and the public filings for the Viacom/TCI transaction,[75] a publicly traded Parent (Viacom) owned Old Sub (Viacom International), which borrowed funds (the "New Debt").[76] Old Sub contributed the cash proceeds of the New Debt, along with all of Old Sub's noncable assets, to New Sub (Viacom Services), while New Sub assumed all the debt of Old Sub other than the New Debt and assumed all the noncable liabilities of Old Sub.[77] Old Sub then distributed all the stock of New Sub to Parent in an internal distribution.[78] Old Sub's common stock was recapitalized into a class of common stock that would convert into preferred stock[79] upon the investment by a third party in Old Sub. Then, Parent distributed the Old Sub common stock to some of Parent's public shareholders pursuant to an exchange offer.[80] Immediately after that split-off distribution, a subsidiary of TCI invested cash in Old Sub in exchange for a new class of common stock.[81] The TCI investment caused the common stock in Old Sub owned by the public to convert into preferred stock. Thus, following the transaction, the subsidiary of TCI owned all the voting stock and common stock of Old Sub, while the public shareholders who tendered into the exchange offer owned the Old Sub preferred stock.[82]

Despite the fact that the IRS issued a ruling, it could be argued that the transaction was akin to a sale by Parent of Old Sub (which held the Parent group's historic cable business) in exchange for the cash that Old Sub contributed to New Sub (*i.e.*, the New Debt proceeds). A concern may have been that TCI would support the New Debt or maybe even pay some or all of it off. Indeed, the cash contribution by the TCI subsidiary to Old Sub at the end of the sequence of steps provided funds to Old Sub to service or repay the New Debt. From that point of view, it is as if TCI bought the leveraged cable business from Distributing (Parent) with the debt serving as a mechanic for getting TCI's cash to Distributing. From this perspective, the transaction is a variant of *Waterman Steamship*. In *Waterman Steamship*,[83] an acquirer wished to acquire a subsidiary from a corporate parent. In order to take advantage of rules favoring dividends over sales proceeds, the sales proceeds were restyled as a dividend in the form of debt issued by the target subsidiary to the seller, and the buyer provided the funds to repay the debt. By analogy, here, Controlled (Old Sub) borrowed from third parties, transferred the borrowing proceeds to Distributing, its parent, and then the acquiror of Controlled provided the funds to repay the debt. In both cases, the Code favors Distributing receiving a distribution from Controlled over a payment to Distributing from an acquiror.

The propriety of Code Sec. 355(e) was hotly debated prior to its enactment.[84] Commentators argued that the provision should be tailored to the concern that some spin-offs coupled with acquisitions resembled corporate-level sales. For example, the New York State Bar Association (NYSBA) argued against a general rule imposing gain recognition on all spin-offs coupled with acquisitions and instead advocated targeting scenarios where the merged company was overleveraged.[85] The NYSBA argued that many spin-offs coupled with acquisitions do not resemble sales, as there are often good business reasons to do spin-offs followed by acquisitions.[86] Moreover, the reasonable allocation of pre-existing debt did not strike the NYSBA as abusive.[87] A reasonable allocation would take into account the value and nature of the respective businesses.[88] Some businesses are typically conducted with more leverage than others. The NYSBA distinguished abusive cases in which the acquired company was overleveraged and proposed a standard for determining whether the acquired company was overleveraged.[89]

Indeed, a proposed amendment to Code Sec. 355(e) in 2005 would have followed the NYSBA in limiting the application of Code Sec. 355(e) to scenarios where the merged company was overleveraged. The bill[90] would have applied Code Sec. 355(e) only if the company undergoing the prearranged change in control was "highly leveraged" (*i.e.*, had a debt-to-equity ratio greater than two-to-one) immediately after the distribution and had "excess relative leverage."[91] Under a special rule, if the debt-to-equity ratio of the change in control company were at least six-to-one and there were a prearranged change in control, then the gain realized on the distribution would have been recognized regardless whether the merged company had excess relative leverage.[92]

Thus, spin-offs coupled with acquisitions by a third party of either Distributing or Controlled put the Alter Ego Theory to the test, as the transaction does not merely involve Distributing dividing into Distributing and Controlled but rather a third party acquiring Controlled. Recall that the basic version of the Morris Trust Theory, described in Part III above, would apply if debt were shifted in excess of basis and the leveraged company were acquired. Thus, the basic version of the Morris Trust Theory would split the difference between the theory of the NYSBA and H.R. 4187, on the one hand, and the Sale Theory, on the other hand, in that the basic version of the Morris Trust Theory would not require *over*leveraging. It would apply if debt were shifted in excess of basis, even if the amount of leverage on the acquired company were not excessive. Yet, the Morris Trust Theory, both the basic version and the overleveraging version advanced by the NYSBA and H.R. 4187, limits imposition of tax to scenarios where the leveraged company is acquired, while the Sale Theory would impose tax if debt in excess of basis were shifted even if the leveraged company were not acquired. And, Code Sec. 355(e) itself embodies yet a different theory—that any change of control is sufficient to result in corporate-level gain, regardless of whether any debt was shifted, whether the leveraged company was acquired and whether the leveraged company is excessively leveraged.

VII. Source of Funds Is Controlled Equity, Not Debt

The Code is equally formalistic when the source of funds is Controlled equity, rather than debt, providing different treatment depending on formal structure for economically equivalent transactions.

The simplest way for Distributing to monetize its investment is to sell Controlled equity to a buyer in a secondary sale. If so, Distributing will recognize gain equal to the difference between the amount received and Distributing's basis in the sold shares.[93]

If instead, Distributing causes Controlled to issue shares in a primary offering and then pay the cash to Distributing as a distribution under Code Sec. 361, Distributing may receive the cash tax-free if it satisfies the Use of Proceeds Requirement and, to the extent the cash is used to repay Distributing's creditors, up to Distributing's basis in Controlled.[94] Further, the structure is subject to a 50-percent limitation on the amount of stock issued under Code Sec. 355(e) and a 20-percent limitation by reason of the requirement that Distributing distribute control of Controlled.[95] But, the latter requirement is easily overcome by having the public buy low-vote shares.

In a third alternative, Distributing could monetize its investment through a stock-for-debt exchange, including a stock-for-newly-issued-debt exchange. In this structure, Distributing issues new debt for cash, satisfies the 5/14 Plan, and exchanges Controlled stock for the newly issued Distributing debt. The three structures are illustrated in Figure 4. In the latter structure, no basis limit applies and no Use of Proceeds Requirement applies. The Code Sec. 355(e) 50-percent limit does apply and, although, the 20-percent limit applies, it can be addressed in this structure, just as it can be addressed in the structure that relies on Code Sec. 361, through the use of low-vote stock.[96]

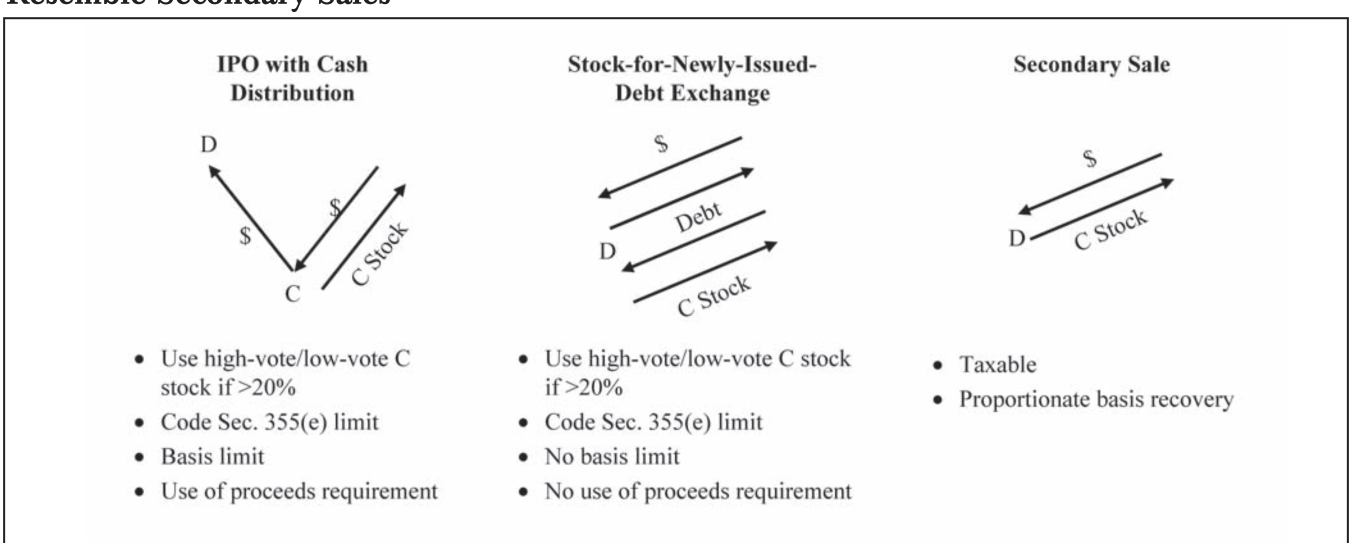
One wonders if a structure could work in which stock is exchanged for newly issued preferred stock. Suppose Distributing issues preferred stock to investors, but the preferred stock is issued as part of a 5/14 Plan. All the parties know that the preferred stock will be exchanged 14 days after issuance for Controlled stock representing, say, 49 percent of Controlled. And, Distributing distributes the remaining 51 percent of Controlled to Distributing's historic shareholders. The only way the distribution qualifies under Code Sec. 355 is if Distributing distributes control of Controlled to Distributing shareholders. Do the preferred stockholders count as shareholders? At first glance, one might think they should not, because the preferred stock is transitory. However, the IRS's willingness to treat newly issued debt as debt for purposes of qualifying an exchange of Controlled stock or securities under Code Sec. 361 suggests that the IRS may also be willing to treat the preferred stock as "old and cold" for purposes of Code Secs. 355(a) and 368(a)(1)(D).

VIII. Where Do We Go from Here?

One could argue that the status quo, while inefficient, is acceptable. Deals do get done on more or less the business terms that are desired. Taxpayers obtain rulings where needed, and often the ruling process does not impede the timing of a transaction as spin-offs take time to plan even apart from the IRS private ruling process.

But, the system is inefficient, uncertain, and idiosyncratic, because many of the rules are inherent in IRS ruling practice. Taxpayers must incur the time and expense of seeking rulings for many transactions, because advisors applying traditional doctrine and analyses would not be able to provide the level of comfort that parties seek. Further, parties must incorporate transaction steps—such as newly issued debt or reversing the direction of the spin—that they would not have taken apart from tax considerations, not a salutary condition for a system based on voluntary compliance. Finally, the status quo arguably lodges too much power in the IRS, as the issuance of private rulings is discretionary.

Figure 4: IPO with Cash Distribution and Stock-for-Newly-Issued-Debt Exchange Resemble Secondary Sales



The system places a premium on the IRS's ability to apply its ruling standards even-handedly and objectively. While the IRS has largely succeeded in this dimension to date, the system's dependency on IRS decision-making protocols makes the system fragile.

One potential improvement would be for the IRS to issue published rulings confirming certain of the standards the IRS applies to private rulings. Each of the structures discussed in Part V above would be a candidate for a published ruling. The approach would be reminiscent of the IRS's approach to the business purpose requirement under Code Sec. 355. Historically, the IRS ruled on business purpose, but in 2003, the IRS announced that it would no longer rule on business purpose and would instead provide published guidance.[97] If the IRS does choose to issue published rulings, however, it would be desirable, at least for a period of time, for the IRS to continue to privately rule so that taxpayers may develop experience with the published rulings and an appreciation of their scope.

Another arguable improvement would be for Congress to amend the statute to treat liability assumptions, cash distributions and Securities-for-Debt Exchanges consistently in respect of basis limitations. In one direction, Congress could improve the consistency of the Code by imposing a basis limit on Securities-for-Debt Exchanges.[98] Alternatively, Congress could repeal the basis limits applicable to liability assumptions[99] and cash distributions. This would mean reversing the basis limit Congress imposed in 2004 on cash distributions with the enactment of the last sentence of Code Sec. 361(b)(3).[100]

None of those approaches addresses the anomaly that reversing the direction of the spin eliminates all the constraints on shifting debt. One could argue that the ability to avoid such constraints by reversing the direction of the spin is not a significant problem, because it is often very difficult to reverse the direction of the spin. For example, if a large public company wishes to spin off a relatively small business, it would often be impractical to spin off the businesses that would otherwise be retained. The taxpayer would not want the businesses that would normally be retained to be inconvenienced by the dislocation and conveyancing issues that often come with being spun off. However, depending on the facts, these issues may be smaller or larger impediments. Given that many businesses are conducted in subsidiaries, it may be that individual assets and contracts need not be transferred regardless of which business is retained and which is spun off, thus mitigating conveyancing concerns.

Ideally, the rules applicable to debt shifts in spin-offs would apply independent of form—meaning that the rules would not hinge on which business is spun off, on the mechanic for shifting debt from Distributing to Controlled, or on whether Controlled is old and cold. The following example, set forth in Figure 5, raises a fundamental question for any regime, namely, whether leaving one corporation with debt in excess of basis should result in current tax. In the example, pre–spin-off Distributing has positive net asset basis,[101] while after the spin-off, one resulting corporation, X, has positive net asset basis, while the other resulting corporation, Y, has negative net asset basis. Suppose, as set forth in Figure 5, pre–spin-off Distributing has 1,000 of asset basis and 300 of liabilities for a net asset basis of 700. Suppose that in the spin-off, Distributing divides into two, resulting in Corporation X, with 900 of asset basis and no liabilities, and Corporation Y, with 100 of asset basis and 300 of liabilities. Thus, X has 900 of net asset basis, and Y has negative 200 of net asset basis. Under current law, if X were Controlled, then Distributing, Y, would not recognize gain, as Y disposed of a business with 900 of basis and no liabilities were shifted to that business.

If Y were Controlled, however, then the answer would depend. If the 300 of liabilities were assumed or if Y had borrowed 300 and distributed the proceeds to Distributing (and Distributing had not further distributed the proceeds to its shareholders), then Distributing would recognize gain of 200, whereas if the debt shift occurred *via* a Securities-for-Debt Exchange, Distributing would not recognize gain on the transaction. In any event, under current law, no basis step-up would result.

Intuitions may vary as to whether the example presents an appropriate occasion to tax. A believer in the Alter Ego Theory would argue that no tax should be triggered on the spin-off despite Y having asset basis less than liabilities. The outcome under the other theories might depend on which of X and Y were Distributing. Assuming X were Distributing, a believer in the Sale Theory would argue that 200 of gain should be recognized by X with a corresponding 200 basis step-up to Y. An adherent of the basic version of the Morris Trust Theory may argue that the 200 of gain should be recognized only if the spin-off is part of a plan pursuant to which Y would be acquired. Under the overleveraging version of the Morris Trust Theory, the 200 of gain should be recognized only if the spin-off is part of such a plan and Y is overleveraged taking into account the industry it is in.

Suppose that Y, the resulting company with negative net asset basis, were Distributing. Thus, mechanically, Y disposed of X. The liabilities in excess of asset basis were retained, not shifted. To be consistent, the Sale Theory ought to result in 200 of gain recognition, and the Morris Trust Theory ought to apply in the same manner as if X were Distributing.[102] In effect, this approach would cause gain recognition if liabilities exceed basis in *either* of the resulting companies (the "Greater Of Rule"). This approach would be a far cry from current law, which generally respects a transferor as transferor and does not impose tax on retained assets.

Moreover, the approach would have to be considered as it related to taxable distributions by a corporation. Suppose the Greater Of Rule applied to Code Sec. 355 transactions, but not to spin-offs that failed to satisfy Code Sec. 355. It may be that a corporate taxpayer conducting two businesses would rather separate the two businesses outside Code Sec. 355, since the taxpayer could then choose which business would give rise to gain recognition. In the above example, a distribution of X outside of Code Sec. 355 would result in gain recognition equal to the value of X less, generally, the 900 basis in X, which gain might be less than the 200 gain that would be recognized under the Greater Of Rule.

Even more fundamentally, the Greater Of Rule would need to be considered relative to a scenario where a corporation borrows and distributes the cash proceeds of the borrowing to its shareholders, a transaction colloquially known as a "leveraged recapitalization." Under current law, such a transaction does not give rise to corporate level gain, because the corporation does not distribute an appreciated asset. It makes no difference under current law that the corporation might have negative net asset basis after the distribution. If the Greater Of Rule applied to Code Sec. 355 distributions and not to leveraged recapitalizations, taxpayers would have yet another incentive to avoid Code Sec. 355.

Another example serves to clarify intuitions around the significance of historic debt for the Alter Ego Theory and the Sale Theory. Suppose, as set forth in Figure 6, that the facts are the same as in Figure 5, except that post–spin-off X has asset basis of 1200 and liabilities of 300. In other words, X may have received 300 of cash from Y, but instead of using the 300 to repay liabilities of 300, X retained the cash. Current law would generally treat the 300 received by X as taxable boot.[103] Arguably, the transaction looks more like a sale than the example in Figure 5, because the transaction does not merely allocate the 300 of pre–spin-off liabilities, but rather provides X with cash on its balance sheet. Indeed, even more to the point, one could consider an example where pre–spin-off Distributing had no debt, Controlled borrowed funds, Controlled distributed the funds to Distributing and Distributing retained the funds for its own corporate purposes. These examples raise the question whether the Alter Ego Theory depends on Distributing having had historic debt that is economically allocated in the spin-off.[104] It could be difficult to sustain an Alter Ego Theory that depended on historic debt being allocated, however, since many companies without debt likely could have borrowed, and thus, distinguishing between those that did and did not borrow seems somewhat arbitrary.

Figure 5: Can We Do This Without Reference to Form?

	Pre-Spin D	Post-Spin X	Post-Spin Y
Asset Basis	1000	900	100
Liabilities	(300)	0	(300)
Net Asset Basis	700	900	(200)

An advocate of applying the Sale Theory or the Morris Trust Theory without regard to form would also have to come to grips with a scenario where pre–spin-off Distributing had negative net asset basis. Suppose, as shown in Figure 7 below, before the spin-off, Distributing has 300 of asset basis and 1,000 of liabilities, *i.e.*, a 700 negative net asset basis. Suppose that after the spin-off, X has asset basis of 300 and zero liabilities, while Y has zero asset basis and 1,000 of liabilities. As shown in Figure 7 below, after the spin-off, X has 300 of net asset basis and Y has 1,000 of negative net asset basis. For a Sale Theory adherent, the intuition may be that 1,000 of gain should be recognized, because it is as if X sold the zero basis Y assets for 1,000 of liability assumption. Under the Greater Of Rule, that would appear to be the result, since looking at the transaction the other way—as if Y had sold X—there would appear to be zero gain recognized since liabilities are zero and basis is 300. Alternatively, however, a Sale Theory advocate might conclude that 700 of gain should be recognized, because the spin-off is the time to recapture the 700 of pre–spin-off negative net asset basis but no more than that. Or, perhaps 300 of gain should be recognized because the spin-off has exacerbated negative net asset basis by only 300.

Indeed, the source of the negative net asset basis may bolster the conclusion that only 300 of gain should

Figure 6: Do Gross Liabilities Matter?

	Pre-Spin D	Post-Spin X	Post-Spin Y
Asset Basis	1000	1200	100
Liabilities	(300)	(300)	(300)
Net Asset Basis	700	900	(200)

Figure 7: Starting with Negative Net Asset Basis

	Pre-Spin D	Post-Spin X	Post-Spin Y
Asset Basis	300	300	0
Liabilities	(1000)	0	(1000)
Net Asset Basis	(700)	300	(1000)

be recognized in this example. Suppose that the 700 of pre–spin-off negative net asset basis corresponds to 700 of net operating loss in Distributing, as could well have occurred if Distributing depreciated or amortized assets resulting in the low asset basis. If so, then arguably the net operating loss should be taken into account like basis, as both basis and net operating losses are tax attributes. Thus, if the net operating loss stays with Y in the spin-off, then under the Greater Of Rule, arguably, the measure based on Y should be the 1,000 liability assumption less the sum of the zero asset basis and 700 of net operating loss of Y, for gain of 300.

An approach that seeks to tax spin-offs independent of form would need to address many unanswered questions. While the above discussion raises a number of basic questions, it does not even begin to address any of the complexities that would arise in the case of internal spin-offs, inside/outside basis differentials, and the existence of assets held in subsidiaries and liabilities owed by subsidiaries. While the formality of current law is vexing, true reform would involve up-ending basic tax law concepts like the identity of the transferor and the realization requirement. Accordingly, it appears that in this area, form will continue to drive results. That said, putting aside the formality that derives from the ability to reverse the direction of the spin-off, the area could be made more consistent and predictable through the issuance of published rulings or statutory amendments that provided consistent rules for economically equivalent transactions. Furthermore, consideration should be given to the basic version of the Morris Trust Theory under which cash in excess of basis is taxed if the leveraged company is acquired, regardless of whether the leveraged company is overleveraged, as this variant does not appear to have previously been developed.

Note from the Author: On January 2, 2013, after this article was submitted for publication, the IRS announced significant limitations to its ruling policy with respect to spin-offs.[1†] The new limitations stem from the concerns discussed in this article and raised by commentators over the years. These long-standing questions led the IRS and the Treasury to review the policies and, consistent with the recommendation of the article, seek to issue published guidance. Specifically, under the new policy, until it resolves each issue by publishing a revenue ruling, a revenue procedure, or otherwise, the IRS will not rule on whether (1) Code Sec. 355 or 361 applies to a securities-for-newly-issued-debt exchange, (2) the two legs of a "north-south" transaction will be respected as separate, or (3) a corporation qualifies as a "controlled corporation" under Code Sec. 355(a)(1)(A) where such corporation is recapitalized into high-vote/low-vote shares or where there is a pre-spin-off public offering of low-vote shares of such corporation.[2††] Parts V.A and V.B of this article discuss the IRS's recent ruling practice with respect to securities-for-newly-issued-debt exchanges, and Part V.E discusses the recent ruling practice with respect to "north-south" transactions. Part VII of this article discusses recent structures where a distributing corporation receives cash from a public offering of (oftentimes, low-vote) shares of a controlled corporation. Part VIII of this article suggests that the IRS should consider enhancing its ruling practice in these and other areas relevant to leveraged spin-off transactions by issuing published guidance, but that it should continue to rule privately, at least until taxpayers become familiar with the published standards. In light of the recent curtailments to the ruling policy and the resulting uncertainty among taxpayers, the author believes it is especially desirable for the IRS to issue published guidance expeditiously in these areas.

Endnotes

[1†] *See* Rev. Proc. 2013-3, IRB 2013-1, 113.

[2††] *Id.*, at 123–24 (§§5.01(9)–(10), 5.02(2)).

Endnotes

* The author would like to thank Rachel B. Reisberg for superb assistance on all aspects of this article.

1 *Gregory v. Helvering*, SCt, 35-1 USTC ¶9043, 293 US 465 (1935).

2 *Plantation Patterns, Inc.*, CA-5, 72-2 USTC ¶9494, 462 F2d 712 (treating notes issued by a corporation and guaranteed by the sole shareholder's spouse as equity where the notes were subordinated, the corporation had a high debt-to-equity ratio, and the corporation's assets were insufficient to support the debt).

3 *See, e.g.*, H.R. 6152, 112th Cong. §4 (2012) (restricting the type of property that the transferor in a D reorganization in connection with a spin-off may receive tax-free under Code Sec. 361(a) to "stock other than nonqualified preferred stock (as defined in section 351(g)(2))" rather than "stock or securities"); H.R. 14, 112th Cong. §40307 (2012) (same); S. 1813, 112th Cong. §40307 (as passed by Senate, Mar. 14, 2012) (same); S. 2132, 112th Cong. §308 (2012) (same); H.R. 2604, 112th Cong. §1 (2011) (same).

4 The last sentence of Code Sec. 361(b)(3), imposing a basis limitation in the context of a D reorganization in connection with a spin-off on cash distributions received by the transferor and used to pay creditors, was enacted in 2004 pursuant to Act Sec. 898(a) of the American Jobs Creation Act of 2004 (P.L. 108-357). Prior to that enactment, some believed that the consolidated return regulations effectively imposed a basis limitation. *See infra* note 30.

5 Reg. §1.355-2(b).

6 *See, e.g.*, Amy S. Elliott, *Practitioners Wary of Transportation Bill's Anti-Reverse Morris Trust Provision*, 134 TAX NOTES 1371, 1372 (2012) (describing one practitioner's view that because Distributing "must divide its debt," leveraging Controlled should not be viewed as "a cashing out"); *cf.* Robert A. Rizzi, *Debt to Creditors: The Ongoing Debate over Nonstock Payoffs in Spinoffs*, J. CORP. TAX'N, Mar./Apr. 2011, at 18, 23 [hereinafter Rizzi, *Debt to Creditors*] (explaining that, in enacting Code Sec. 355(e), Congress "avoided second-guessing allocations of indebtedness between and among parties to spinoff transactions").

7 *See* Code Sec. 361(a).

8 *See, e.g.*, Candace A. Ridgway, *Myths and Legends of "RMT" Spin-offs*, 53 TAX MGM'T MEMO. 179, 180 (2012) (arguing that even spin-offs coupled with mergers represent readjustments in structure that generally should be entitled to tax deferral); Neil J. Barr, *Uncertainty Regarding the Tax Treatment of Liabilities in Divisive Reorgs Survives the AJCA*, 105 TAX NOTES 1125, 1130 (2004) (arguing that where the distributing corporation exchanges securities of the controlled corporation for its own debt, the holders retain "a continuing economic interest in a historic Distributing business, which, under general principles, is not the occasion for a recognition event"); Melissa C. McCann, *Section 355 in a Post-*General Utilities *World: The Victim of an Overreaction?* 23 J. CORP. TAX'N 137, 139 (1996) (noting that a similarity between corporate "divorces" and "marriages," namely, that both change the form but not the nature of the shareholders' investment, seems to have led to tax-free treatment); Karla W. Simon & Daniel L. Simmons, *The Future of Section 355*, 40 TAX NOTES 291, 293 (1988) (arguing that "the logic supporting nonrecognition treatment in acquisitive reorganizations should apply with equal force to divisive transactions").

9 *See, e.g.*, Robert A. Rizzi, *The Fuss About* Morris Trust*: Spin-Off Transactions As Acquisition Techniques*, 23 J. CORP. TAX'N 303, 303 (1997) [hereinafter Rizzi, *Fuss About* Morris Trust] (highlighting spin-offs as "integral parts of acquisitive reorganizations").

10 *See, e.g.*, Jeffery T. Sheffield & Herwig J. Schlunk, *Reconciling Spin-Offs With General Utilities Repeal*, 74 TAXES 941, 952 (1996) (arguing that *General Utilities* repeal does not support imposing tax on a spin-off followed by an acquisitive reorganization because of the absence of any basis step-up).

11 The Code has long permitted the assumption of liabilities in an acquisitive reorganization without reference to a basis limitation. In *L.M. Hendler*, SCt, 38-1 USTC ¶9215, 303 US 564, the Supreme Court treated the assumption and payment of the target's liability as boot, citing *Minnesota Tea Co. v. Helvering*, SCt, 38-1 USTC ¶9050, 302 US 609, which held that cash received by the target, distributed to shareholders and then used to pay the target's creditors, constituted boot. Congress retroactively overturned *Hendler* in 1939 when it enacted the predecessor to Code Secs. 357(a) and (b) providing the general rule that, in a reorganization, the assumption of liabilities does not constitute boot unless there is no business purpose for the assumption. Code Sec. 357(c) did, however, apply a basis limitation to acquisitive reorganizations under Code Sec. 368(a)(1)(D) until 2004. *See infra* note 99.

12 *Gen. Utils. & Operating Co. v. Helvering*, SCt, 36-1 USTC ¶9012, 296 US 200 (1935) (repealed by the Tax Reform Act of 1986).

13 *See, e.g.*, Ridgway, *supra* note 8, at 180 ("Because [spin-offs] keep shareholders' interests in corporate assets in 'corporate solution'—albeit in modified form—the policy has been to regard them as not proper occasions for income recognition."); Jodi J. Schwartz, *Can You Ever Be Too [cash] Rich or Too [active business] Thin? Corporate Basis Shifting and the Cash-Rich Split-Off*, M&A J., Jan. 1, 2005, at 15, 18 (noting that *General Utilities* concerns in connection with spin-offs can be overstated as assets remain in corporate solution); Peter C. Canellos, *The Section 355 Edifice: Spinoffs Past, Present, and Future*, 104 TAX NOTES 419, 420 (2004) (noting that Congress repealed "mirror liquidations" in 1987 despite the argument that *General Utilities* repeal was not offended because assets remained in corporate solution); Rizzi, *Fuss About* Morris Trust, *supra* note 9, at 306 (describing the view that the repeal of *General Utilities* "only means that gain should be recognized when corporate assets leave 'corporate solution,'" because when assets remain in corporate solution, basis is preserved); Sheffield & Schlunk, *supra* note 10, at 943 (arguing that corporate-level tax should not be imposed on a spin-off because the distribution does not remove any assets from corporate solution); McCann, *supra* note 8, at 158–59 (arguing that Code Sec. 355 is not an exemption from taxation because assets remain in corporate solution with a carryover basis and arguing that the intent of *General Utilities* repeal was to foreclose the opportunity for permanent exemption from corporate taxation *via* the extraction of assets from corporate solution); *see also* Robert A. Jacobs, *Jacobs Opposes Corporate Spinoff Provisions in President's 1997 Budget*, 71 TAX NOTES 299 (1996) (stating that *Morris Trust* transactions do not violate principles underlying tax-free treatment of corporate divisions because the unwanted assets remain in corporate solution without a basis step-up).

14 *See Cottage Sav. Ass'n*, SCt, 91-1 USTC ¶50,187, 499 US 554.

15 *See, e.g.*, Rizzi, *Debt to Creditors*, *supra* note 6, at 18 (where Distributing repays its debt with Controlled securities, Distributing improves its balance sheet on a pretax basis: "[Distributing] is able indirectly to use assets with built-in gain, translated through the medium of [Controlled] debt securities, to monetize its investment without triggering tax").

16 Code Sec. 1001.

17 *Cf.* THE AM. LAW INST., FEDERAL INCOME TAX PROJECT, SUBCHAPTER C: PROPOSALS OF THE AMERICAN LAW INSTITUTE ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS 40–41, 48–49 (1982) (advocating an elective regime pursuant to which asset sales between corporations could be taxable with an asset basis step-up to the buyer or, if the parties jointly elected, tax-free with a carryover basis to the buyer).

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[18] Code Sec. 11(a).

[19] Code Sec. 1001.

[20] *See, e.g.*, Rizzi, *Fuss About* Morris Trust, *supra* note 9, at 305–06 (describing the view of many commentators and individuals in the IRS and Treasury that "any movement of assets from the corporate owner, unless such movement falls within a specific statutory scheme, should trigger corporate-level gain" even if the assets do not leave corporate solution); McCann, *supra* note 8, at 158 (acknowledging that deferral is a tax benefit that should be available only in special circumstances); Lee A. Sheppard, *Treasury Proposes to End Shopping With Spinoffs*, 71 TAX NOTES 17, 20 (1996) (arguing against any "escape hatch" from corporate recognition of gain on a distribution of appreciated property even if assets remain in corporate solution).

[21] *See* Rizzi, *Fuss About* Morris Trust, *supra* note 9, at 304 (referring to Code Sec. 355 as "virtually the sole remaining mechanism in the Code for removing assets from corporate solution without a prohibitive tax burden").

[22] *See* George White, *The Legacy of Mary Archer Morris*, 135 TAX NOTES 213, 215 (2012) (suggesting that it is not the *Morris Trust* feature of spin-offs (*i.e.*, the subsequent merger of Controlled into a third party) that is problematic, but rather the ability for Distributing "to monetize the gain in the assets of an unwanted business without recognizing the gain").

[23] *See, e.g.*, Sheffield & Schlunk, *supra* note 10, at 943 (acknowledging the argument for imposing corporate-level tax where the spin-off is associated with the acquisition of either Distributing or Controlled in a transaction that would be a sale if done prior to the spin-off). A stricter version of the Morris Trust Theory might impose tax if the acquiror's shareholders control the combined entity subsequent to the acquisition of Controlled, regardless of whether Distributing receives cash in excess of basis. *See, e.g.*, Rizzi, *Fuss About* Morris Trust, *supra* note 9, at 305 (describing the justification for Code Sec. 355(e) as the belief that where shareholders of the distributing corporation lose control of the controlled corporation, the transaction is effectively a sale).

[24] Code Sec. 1001.

[25] *Waterman S.S. Corp.*, CA-5, 70-2 USTC ¶9514, 430 F2d 1185.

[26] *See generally* Debra J. Bennett, *Obtaining Value from an Investment in a Controlled Corporation*, TAXES, Dec. 2011, at 9 (discussing the technical requirements for each structure); J. William Dantzler Jr., *Spinoffs: Still Remarkably Tax Friendly*, 129 TAX NOTES 683, 690 (2010) (describing the incongruent tax treatment of monetizing strategies that achieve the same economic result); Barr, *supra* note 8 (arguing that the American Jobs Creation Act of 2004 created symmetry between two of the structures, but introduced ambiguities); Michael L. Schler, *Simplifying and Rationalizing the Spinoff Rules*, 56 SMU L. REV. 239, 275 (2003) (arguing that the existing rules are "illogical in certain respects"); Jeffery T. Sheffield & Steven E. Clemens, *Monetization Strategies in Corporate Spin-offs*, TAXES, March 2003, at 288 (arguing that "tax consequences to [Distributing] vary considerably based solely on the form" of the spin-off); Jodi J. Schwartz, *When You Assume ... Rearranging Liabilities in Corporate Reorganizations*, Tax Club (2001) (on file with the author) (analyzing doctrinal development of and inconsistencies among rules governing rearrangement of liabilities in a spin-off).

[27] Reg. §§1.1502-19(a)(2), -32(a)(3)(ii), -32(b)(2)(iv), -32(b)(3)(v).

[28] Reg. §1.1502-19(b), -19(g), Example (3)(c).

[29] Code Sec. 361(b).

[30] Code Sec. 361(b)(3), last sentence, enacted in 2004.

Some would argue that under the Treasury Regulations, Distributing faces a basis limitation even if Distributing uses the cash to pay shareholders. Under this view, although Code Sec. 361 does not result in tax, the consolidated return regulations do, because the receipt of the cash results in an ELA in the Controlled stock (*see* Reg. §§1.1502-19(a)(2), -32(b)(3)(v)), which is triggered upon the spin-off. *See* Reg. §1.1502-19(b).

That result is not clear, however. First, under Reg. §1.1502-32(b)(3)(v), an ELA is created if the cash received by Distributing is treated as a distribution under Code Sec. 301 or otherwise treated as a dividend, for example, under Code Sec. 356(a)(2). The cash received by Distributing from Controlled is not, however, treated as a dividend. Instead, under Code Sec. 361(b), it is viewed as consideration in exchange for the assets contributed by Distributing to Controlled. One could seek to argue that Reg. §1.1502-13(f)(3) treats the cash received by Distributing from Controlled as a Code Sec. 301 distribution, but this is not the better reading of that Regulation. Reg. §1.1502-13(f)(3)(ii) treats the receipt of boot (*e.g.*, cash) in an intercompany transaction to which Code Sec. 356 would otherwise apply as a separate transaction governed by Code Secs. 302 and 311, rather than Code Secs. 356 and 361. But, Reg. §1.1502-13(f)(3)(ii) does not appear to apply. To begin with, it refers to transactions to which Code Sec. 356 would otherwise apply, but Code Sec. 356 does not apply to Distributing's receipt of cash from Controlled. Code Sec. 361 applies. Furthermore, Reg. §1.1502-13(f)(3) does not apply if as part of the transaction, a member leaves the group, as would be the case because of the spin-off of Controlled. Reg. §1.1502-13(f)(3)(i).

Another argument one could make to the effect that a basis limit applies if cash is used to pay shareholders is that Code Sec. 358(a)(1)(A)(ii) reduces basis in the Controlled stock by the amount of cash received by Distributing and that such basis reduction can create an ELA because Reg. §1.1502-19(a)(2)(i) states that a subsidiary's stock basis may be adjusted under "rules of law" outside the consolidated return regulations and that negative adjustments may result in an ELA. It is not clear, however, whether Reg. §1.1502-19(a)(2)(i) means that basis adjustments under Code Sec. 358 can cause an ELA where Controlled leaves the Distributing consolidated group.

Finally, the enactment of Code Sec. 361(b)(3), which imposes a basis limit if cash is used to pay creditors, implies that Congress did not intend a basis limit to apply if cash is used to pay shareholders. *See* S. REP. NO. 108-192, at 184–85 (2003) (stating that Congress sought to change present law by imposing a basis limit on cash distributions where the cash is used by Distributing to pay creditors). For a discussion of the ambiguities surrounding the tax treatment of liability shifts in the consolidated group context, *see* Barr, *supra* note 8, at 1126; Sheffield & Clemens, *supra* note 26, at 292.

[31] In a D/355, this results from the application of Code Sec. 357(c). In a 355/non-D, this results from the ELA that is created by reason of the assumption and then triggered by reason of the spin-off. *See supra* notes 27–28.

[32] Code Sec. 357(b)(1).

[33] Code Sec. 361(a). If the Distributing debt is a security and holders receive no "excess principal amount," then the exchange is also tax-free to the Distributing security holders. Code Sec. 355(a)(1).

[34] *See supra* note 3. Each of these legislative proposals would have subjected Securities-for-Debt Exchanges to the basis limitation that Code Sec. 357(c) currently imposes on direct assumptions of liabilities in D/355s. However, practitioners have argued that Code Sec. 357(c) was enacted to prevent negative basis, and that its application to spin-offs may be inappropriate because Distributing's basis in Controlled stock disappears upon the spin-off. *See* Amy S. Elliott, *Extenders Proposal Targets Debt Securities Issues in Spinoffs*, 129 TAX NOTES 174, 174–75 (2010). Further, the application of the theory underlying Code Sec. 357(c) to *pro rata* spin-offs may be difficult to rationalize, because such spin-offs involve a continuing interest by the same group

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of shareholders in both the assets and liabilities of Distributing albeit in different corporate form, much like an acquisitive reorganization involving an assumption of the transferor's liabilities. Barr, *supra* note 8, at 1127–28.

35 Neither the Code nor the Treasury Regulations impose a basis limit on Securities-for-Debt Exchanges. The ELA concern that is arguably raised in the context of a cash distribution to Distributing does not apply in the case of a distribution of Controlled securities, because Controlled securities are not "nonqualifying property" under Reg. §1.1502-13(f)(3).

36 Practitioners have recommended eliminating the distinction between D/355s and 355/non-Ds. *See, e.g.*, Sheffield & Clemens, *supra* note 26, at 298.

37 *See, e.g.*, LTR 200832001 (Apr. 30, 2008) (step 5); LTR 200747012 (Aug. 28, 2007) (step (6)); LTR 200732002 (May 11, 2007); LTR 200702033 (Sept. 25, 2006) (step (xiii)); LTR 200629001 (Apr. 7, 2006) (step (iv)), *supplemented by* LTR 200644010 (July 12, 2006); LTR 200629007 (Apr. 21, 2006) (step (iv)). The IRS permitted these transactions by reference to a practice that had evolved years earlier in the area of stock-for-debt exchanges under Code Sec. 108. Until the enactment of Code Sec. 108(e)(10) pursuant to the Deficit Reduction Act of 1984, P.L. 98-369, §59, 98 Stat. 494 (1984), the issuance by a corporation of stock in exchange for its own debt generally did not result in cancellation of debt income. Corporations seeking to take advantage of this rule would issue stock to a friendly investment bank that had recently purchased the corporation's debt from third-party debtholders. The IRS required the investment banks to hold the debt for a period of time in order to demonstrate that they were true creditors. *See* TAM 8738003 (May 22, 1987); TAM 8735007 (May 18, 1987); TAM 8735006 (May 18, 1987) (the bank's acquisition of debt preceeded execution of the exchange agreement by anywhere from three days to over four months); *see also* Dantzler Jr., *supra* note 26, at 689 (noting that the technique of the early 1980s, whereby a banker purchased the outstanding debt prior to any binding obligation to consummate the exchange, has been applied to spin-offs).

38 *See, e.g.*, LTR 201032017 (Feb. 5, 2010) (exchange of Controlled securities for commercial paper or other debt of Distributing); LTR 200832001 (Apr. 30, 2008) (exchange of Controlled securities for debt of Distributing, possibly including commercial paper); LTR 200802009 (Oct. 5, 2007) (exchange of Controlled securities for commercial paper of Distributing); LTR 200708017 (Nov. 15, 2006) (exchange of Controlled securities for commercial paper and notes of Distributing); LTR 200701010 (Sept. 1, 2006) (same); LTR 200644010 (July 12, 2006) (same); LTR 200629007 (Apr. 21, 2006) (same); LTR 200629001 (Apr. 7, 2006) (same); *see also* LTR 201129006 (Apr. 13, 2011) (stock-for-debt exchange in which shares of Controlled exchanged for commercial paper of Distributing or other short-term debt with a maturity of 30 days or longer); LTR 201129005 (Apr. 13, 2011) (same); LTR 201123030 (Nov. 15, 2010) (same).

39 LTR 201228033 (Apr. 11, 2012) (steps (iv) and (xi)); LTR 201216023 (Jan. 19, 2012) (steps 5 and 6); LTR 200802009 (Oct. 5, 2007) (step (x)); *see also* LTR 200936022 (Sept. 10, 2008) (steps (xxi) and (xxx); number of days redacted), *supplemented by* LTR 201029007 (Mar. 12, 2010). In some transactions, the day count is different. *See* LTR 201132009 (May 9, 2011) (debt-for-equity exchange; steps (xiv)–(xvi)); *cf.* Amy S. Elliott, *IRS Official Explains 'No-Compulsion' Requirement*, 135 TAX NOTES 157, 157 (2012) [hereinafter Elliott, *'No-Compulsion' Requirement*] (noting that an IRS official has said the IRS would need a lot of time to consider terms other than those in the 5/14 Plan).

40 Under the "end result test," the step transaction doctrine is generally applied where steps are "component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." *King Enters., Inc.*, CtCls, 69-2 USTC ¶9720, 418 F2d 511, 516 (quoting David R. Herwitz, BUSINESS PLANNING 804 (1966)); *see also Kanawha Gas & Utils. Co.*, CA-5, 54-2 USTC ¶9508, 214 F2d 685, 691 (noting the step transaction doctrine will integrate a series of steps that are "designed and executed as parts of a unitary plan to achieve an intended result").

Under the "interdependence test," the step transaction doctrine applies if "on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." *Associated Wholesale Grocers, Inc.*, CA-10, 91-1 USTC ¶50,165, 927 F2d 1517, 1523 (quoting Randolph Paul & Philip Zimet, *Step Transaction*, SELECTED STUDIES IN FEDERAL TAXATION (2d series, 1938)); *see also Kuper*, CA-5, 76-1 USTC ¶9467 533 F2d 152, 156 (noting that application of the step transaction doctrine is "especially proper where ... it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts").

See, e.g., Amy S. Elliott, *IRS Rethinking Repayments of Distributed Debt in Spinoff*, 133 TAX NOTES 144, 144 (2011) [hereinafter Elliott, *IRS Rethinking Repayments*] (explaining that at least one IRS representative has raised a step transaction concern if the Distributing debt exchanged for Controlled securities "was recently incurred"); Dantzler Jr., *supra* note 26, at 690 (noting the step transaction issue); *see also* Amy S. Elliott, *Memo Will Be Only Guidance on Built-In Loss Carrybacks*, 133 TAX NOTES 556, 557 (2011) [hereinafter Elliott, *Built-In Loss Carrybacks*] (calling securities-for-newly-issued-debt exchanges an "anomaly in the IRS's ruling practice").

41 *See, e.g., I. Gordon*, SCt, 68-1 USTC ¶9383, 391 US 83, 96 (in order for there to be a "first step" in a step transaction, "there must be a binding commitment to take the later steps").

42 *See* Robert Willens, *Ralcorp's Plans for Its Retained Post Shares Revealed in Ruling*, 134 TAX NOTES 1273, 1275–76 (2012). Willens compares the IRS's approval of a 5/14 Plan securities-for-newly-issued-debt exchange in LTR 201216023 (Jan. 19, 2012) to the IRS's position in Rev. Rul. 80-221, 1980-2 CB 107 (which became obsolete, Rev. Rul. 95-71, 1995-2 CB 323). In Rev. Rul. 80-221, instead of purchasing property from X for $10,000, Y purchased for $10,000 one share of preferred stock of X. In just over a year, X redeemed the share in exchange for the property. In contrast with its approach in the 5/14 Plan rulings, the IRS applied the step transaction doctrine and required X to recognize gain on the sale of property.

43 For a discussion of the 5/14 Plan and the background of the day-counting rules, *see* Robert Rizzi, *IRS Opens the Gates: Sara Lee's Spinoff Ruling*, J. CORP. TAX'N, Jan.–Feb. 2013 [hereinafter, Rizzi, *IRS Opens the Gates*].

44 Under a traditional step-transaction analysis, a direct assumption of newly-incurred Distributing debt by Controlled might fare better than the repayment of such debt using cash or securities received from Controlled. *See* Dantzler Jr., *supra* note 26, at 691 (describing the Kraft/Post split-off, in which Kraft (Distributing) received $300 million in cash proceeds from new indebtedness and Post (Controlled) assumed the newly-incurred debt in the D/355).

45 *See, e.g.*, Elliott, *IRS Rethinking Repayments*, *supra* note 40, at 144 (describing the IRS's current ruling practice as "very generous," according to one practitioner).

46 *See generally* Schler, *supra* note 26.

47 For a discussion of the IRS's general thinking with respect to travelling notes before the issuance of LTR 201232014 (Feb. 16, 2012), see Elliott, *Built-In Loss Carrybacks*, *supra* note 46, at 557 (stating that the IRS was figuring out the appropriate levels of event and credit risk and considering the relevance

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of an instrument's contingencies in the event that the spin-off did not occur).

[48] *See* LTR 201232014 (Feb. 16, 2012); Amy S. Elliott, *Sara Lee's Leveraged Spinoff Ruling Breaks New Ground,* 136 TAX NOTES 1542, 1542 (2012) [hereinafter, Elliott, *Sara Lee's Ruling*] (describing one practitioner's explanation of travelling notes as debt of the distributing corporation "that, at the sole option of the distributing corporation (Sara Lee) and in accordance with the terms of the debt instrument, may be—and is expected to be—exchanged for debt of the controlled subsidiary").

[49] *See* LTR 201232014 (Feb. 16, 2012); Rizzi, *IRS Opens the Gates, supra* note 43; Elliott, *Sara Lee's Ruling, supra* note 48.

[50] LTR 201232014 (Feb. 16, 2012).

[51] *Id.* (step 3).

[52] *Id.* (step 9).

[53] Rev. Proc. 83-59, 1983-2 CB 575, §4.03(3)(b)(2) (also requiring, if the liabilities to be assumed were not incurred in the ordinary course of business, a statement of "the business reason or purpose for the assumption of these liabilities").

[54] Code Sec. 361(b)(3).

[55] Business A might also be subject to certain other nontax constraints, such as covenants in debt or other third-party agreements, which could impede Distributing's ability to reverse the direction of the spin-off.

[56] LTR 200750009 (Sept. 12, 2007).

[57] *See, e.g.,* Dantzler Jr., *supra* note 26, at 693 (surmising that the IRS's approach to monitoring spin-offs may be shaped by a recognition that current law cannot police monetization techniques that reverse the direction of the spin-off); Schler, *supra* note 26, at 276 (arguing that the taxpayer's ability to choose which business to spin off means that transactions with the same economic result can have "very different tax results"); Sheffield & Clemens, *supra* note 26, at 293 (arguing that a basic tax policy challenge is how to address the ability to alter tax results by reversing the direction of the spin-off); Sheffield & Schlunk, *supra* note 10, at 943 (arguing that where Distributing has two businesses, either business could be spun off and, ideally, the two scenarios should be taxed in the same manner).

[58] Code Sec. 361(b).

[59] *See, e.g.,* LTR 201132009 (May 9, 2011) (step (xi); noting that Distributing would possibly use cash received from Controlled "to pay quarterly dividends to shareholders ... within approximately 12 months after" the spin-off); LTR 200803012 (Oct. 17, 2007) (step (vi); Distributing will use cash received from Controlled to repurchase stock pursuant to its "continuing authorization" in connection with its share repurchase programs); *cf.* LTR 200841020 (July 8, 2008) (step (vi); Distributing will use cash received from Controlled to repurchase stock pursuant to an existing stock repurchase program, but its board will authorize an increase in the repurchase program and will commit itself to undertake certain repurchases in connection with the spin-off). *But see* LTR 201032017 (Feb. 5, 2010) (representation (uuuuu); if Distributing used the cash received from Controlled to buy back shares or pay dividends, any such repurchases would be authorized by a special action of Distributing's board and would be in addition to any repurchases occurring in the ordinary course, and any such dividends would be special dividends declared by Distributing's board and would be in addition to any regularly occurring dividends).

[60] Recently, one IRS official stated that the IRS might reconsider its ruling policy respecting securities-for-newly-issued-debt exchanges, and instead require the retired debt to be "old and cold." That approach "would impose logistical burdens." Elliott, *IRS Rethinking Repayments, supra* note 40, at 145 (noting one practitioner's view that allowing Distributing to incur new debt, but requiring Distributing "to take additional steps" to redeem only its old debt would not further any policy objective).

[61] *See, e.g.,* LTR 201202007 (Sept. 30, 2011) (steps (v), (1), and (2)); LTR 201149012 (Sept. 9, 2011) (steps (xxxiii) and (xl)); LTR 201123022 (Mar. 14, 2011) (steps (ii) and (viii)); LTR 201033007 (May 21, 2010) (steps (xxv) and (xxx)); LTR 201030005 (Apr. 28, 2010) (steps (iv) and (v)); LTR 201007050 (Nov. 13, 2009) (steps (i) and (v)); *see also* Thomas F. Wessel, et al., CORPORATE DISTRIBUTIONS UNDER SECTION 355 507–16 (2012); Wayne T. Murray, *The* Gregory *Rules of Section 355 Business Purpose Active Trade or Business Device (with Additional Thoughts on Control, Continuity, and Other Section 355 Miscellany), in* 16 PRACTISING LAW INST., THE CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 207-1, 207-603–12 (Louis Freeman, ed., 2010).

[62] LTR 201136009 (May 23, 2011).

[63] *Id.* (steps (a) and (b)).

[64] *Id.* (representation (y)).

[65] *Id.* (ruling (1)). For a discussion of LTR 201136009, *see* Bennett, *supra* note 26, at 14 (noting that a Code Sec. 301 distribution appears to be a method for Distributing to receive value from Controlled prior to a spin-off); Amy S. Elliott, *IRS May Extend 'North-South' Ruling Position,* 133 TAX NOTES 548, 548 (2011) [hereinafter Elliott, *Extend 'North-South' Ruling*] (quoting William Alexander, IRS Associate Chief Counsel (Corporate) as stating that if a taxpayer does not document its transaction as an exchange, the IRS "would not as a default" characterize the transaction as an exchange because taxpayers are "free to contribute or extract—up to a limit" to and from wholly owned subsidiaries); Elliott, *IRS Rethinking Repayments, supra* note 40, at 145 (noting "there is a fair amount of electivity" in the IRS's ruling practice).

[66] An IRS official has indicated that if the contribution of assets in the South leg were intended to "replenish" the entity making the distribution of assets in the North leg, the steps might be integrated and viewed as an exchange. *See* Elliott, *IRS Rethinking Repayments, supra* note 40, at 145 (quoting Steve Fattman, counsel, IRS Office of Associate Chief Counsel (Corporate)). Further, an IRS official has said that the type of economic compulsion relevant to the North-South analysis "is not [S]ection 355 tax related and probably not federal income tax related," but is rather about Controlled needing "to satisfy a capital requirement," suggesting that contributions made in order to satisfy the active trade or business requirement of Code Sec. 355 would not be made under economic compulsion. *See* Elliott, *'No-Compulsion' Requirement, supra* note 39, at 157 (quoting Fattman).

[67] *See, e.g.,* Dantzler Jr., *supra* note 26, at 692 (arguing that under the step-transaction doctrine, if the cash is a dividend distribution and contemporaneous with a transfer of assets from Distributing to Controlled, the transaction could be viewed as an exchange of the cash for the assets); N.Y. STATE BAR ASS'N, TAX REPORT 1162: FORMAL GUIDANCE FOR STOCK BUY-BACKS AND "NORTH AND SOUTH" TRANSACTIONS 10–13 (Aug. 18, 2008) (recommending that the IRS issue guidance viewing North-South transactions as separate steps rather than exchanges).

[68] *See* Elliott, *Extend 'North-South' Ruling, supra* note 65, at 548 (quoting Alexander as saying that the North and South legs may be treated separately even if they occur "at the same time ... and they further the same plan").

[69] *See, e.g.,* Thomas W. Avent, Jr. & John F. Simon, *The Evolution of the Plan Under Code Sec. 355(e),* 7 CORP. BUS. TAX'N MONTHLY 17, 17 (2006) (noting that the separation of liabilities from proceeds in a leveraged spin-off is arguably abusive); Sheffield & Schlunk, *supra* note 10, at 942 (stating that the question whether a contemporaneous acquisition of Distributing or Controlled should turn a spin-off into a sale is unresolved).

[70] *See, e.g.,* Robert Willens, *Reforming 'Anti-Morris Trust' Rule: Bill Would Rein in*

Endnotes

Coverage of § 355(e), 24 Tax Mgm't Wkly. Rep. 1788, 1789 (2005) [hereinafter Willens, *Reforming 'Anti-Morris Trust'*] (noting that the spin-off rules were not intended to cover disguised sales to an unrelated acquiror); Lee A. Sheppard & Sheryl Stratton, *Proposed Business Tax Changes in Administration's 1997 Budget*, 70 Tax Notes 1714, 1716 (1996) (quoting a senior Treasury official as saying that the goal of Code Sec. 355(e) was to "prevent spin-off transactions that are substitutes for disguised sales").

71 Code Sec. 355(e)(1)–(2).

72 *See, e.g.,* Robert A. Rizzi, *Section 355(e) Redux: Anti-Morris Trust Reform Legislation Proposed*, Corp. Tax'n, July/Aug. 2006, at 31, 31 [hereinafter Rizzi, *Section 355(e) Redux*] (stating that Code Sec. 355(e) was a "direct response" to the Viacom/TCI transaction); Avent, Jr. & Simon, *supra* note 69, at 18.

73 Viacom Int'l Inc., Registration Statement (Form S-4/A) i–iii (June 24, 1996) [hereinafter Viacom S-4].

74 LTR 9637043 (June 17, 1996); *see also IRS Approved Two Distributions in Viacom Ruling*, 96 TNT 125-17, June 26, 1996; Lee Sheppard, *Aliens Kidnap IRS Lawyers: Inexplicable Viacom Ruling*, 72 Tax Notes 13, 14–15 (1996) (arguing that TCI's acquisition of control of Old Sub distinguishes this transaction from others where the public acquires stock in Controlled).

75 Viacom S-4.

76 *Id.,* at i–ii. The borrowing was \$1.7 billion. *Id.*

77 *Id.*

78 *Id.*, at ii–iii.

79 The preferred stock had no voting rights and had a fixed dividend rate, payable in cash or stock in TCI, at the option of Old Sub. After five years, a holder had the option to convert into stock in TCI at a fixed rate. Also, after five years, Old Sub was permitted to redeem the shares for cash or stock in TCI. After ten years, Old Sub was required to redeem the preferred shares for either cash or TCI common stock. *Id.*; *see also* LTR 9637043 (June 17, 1996).

80 Viacom S-4, at iii.

81 *Id.,* at iii–iv. The amount of TCI's investment was \$350 million. *Id.*

82 *Id.,* at ii–iv.

83 *Waterman S.S. Corp.*, CA-5, 70-2 ustc ¶9514, 430 F2d 1185.

84 *See, e.g.,* Rizzi, *Section 355(e) Redux*, *supra* note 74, at 31 (noting that when Code Sec. 355(e) was proposed, commentators warned that the "change in control" focus of Code Sec. 355(e) would have unintended adverse effects, would not eliminate the perceived abuse and would raise technical problems); N.Y. State Bar Ass'n, Tax Report on Section 355 (July 2, 1997) [hereinafter NYSBA 355 Report] (arguing that Morris Trust transactions are normally not abusive); Rizzi, *Fuss About* Morris Trust, *supra* note 9, at 305–06 (describing the debate over Code Sec. 355(e) in the context of *General Utilities* repeal); Jacobs, *supra* note 17 (arguing that Morris Trust transactions "are not evil").

85 *See* NYSBA 355 Report, *supra* note 84, at pt. III.B.

86 *Id.,* at pt. III.A.

87 *Id.,* at pt. III.B.

88 *Id.*

89 *Id.,* at pt. III.B, app. I.

90 H.R. 4187, 109th Cong. (2005).

91 *Id.* Excess relative leverage would mean an excess of actual debt over the greater of (i) the amount of debt that would result in such company having a debt-to-equity ratio of two-to-one, and (ii) the amount of debt that would result in such company having a debt-to-equity ratio that equaled the other corporation's debt-to-equity ratio plus 0.25. *Id.,* at §1(a), Code Sec. 355(e)(5).

92 *Id.,* at §1, Code Sec. 355(e)(4)(H); *see, e.g.*, Willens, *Reforming 'Anti-Morris Trust'*, *supra* note 70, at 1789 (stating that H.R. 4187 would facilitate *Morris Trust* transactions "not involving an 'anticipatory' borrowing such that the transaction, in substance, resembles a sale"). However, others have noted the perils of Congress legislating how much debt a merged company may have. *See* Rizzi, *Debt to Creditors*, *supra* note 6, at 18, 23.

93 Code Sec. 1001.

94 Code Sec. 361(b)(3).

95 Code Sec. 355(a)(3)(D)(ii), (e).

96 Indeed, in Lucent's spin-off of Agere in 2002, the stock-for-debt exchange occurred using low-vote stock. *See* Agere Sys. Inc., Registration Statement (Form S-1/A) (Mar. 26, 2001) (describing Class A common stock as having one vote per share and Class B common stock as having four votes per share and stating that "Lucent and Morgan Stanley expect to enter into an exchange agreement dated the date of this prospectus in which Morgan Stanley would have an option to exchange, as a principal for its own account, debt obligations of Lucent then held by Morgan Stanley for shares of [Agere] Class A common stock held by Lucent").

97 Rev. Proc. 2003-48, 2003-2 CB 86; *see also* Rev. Rul. 2003-74, 2003-2 CB 77 (holding that a spin-off undertaken to enable a high-growth and a low-growth business each to concentrate on its own needs satisfied the business purpose requirement despite the existence of a five-percent shareholder and overlapping directors); Rev. Rul. 2003-75, 2003-2 CB 79 (holding that a spin-off undertaken to resolve a competition for capital satisfied the business purpose requirement despite the existence of a five-percent shareholder and a post–spin-off working capital loan).

98 *See supra* note 34 and accompanying text.

99 Historically, the basis limit of Code Sec. 357(c) applied to acquisitive reorganizations under Code Sec. 368(a)(1)(D). But, that limit was repealed in the American Jobs Creation Act of 2004 (P.L. 108-357).

100 *See supra* note 4 and accompanying text.

101 Net asset basis means tax basis less liabilities.

102 That is, in the basic version of the Morris Trust Theory, gain ought to be triggered if Y is acquired as part of the plan, and in the overleveraging version of the Morris Trust Theory, gain ought to be triggered if Y is acquired as part of the plan and the 300 of debt on Y is excessive in light of the business that Y is in.

103 Code Sec. 361(b)(1)(B).

104 The IRS generally requires a representation that the amount of Distributing debt assumed, repaid, or exchanged in a spin-off does not exceed the average level of Distributing's outstanding third-party indebtedness over the 12-month period preceding the date on which Distributing decided to undertake the spin-off. *See, e.g.*, LTR 201232014 (Feb. 16, 2012) (representation (cc)); LTR 201228033 (Apr. 11, 2012) (representation (6z)); LTR 201228030 (Mar. 29, 2012) (representation (yyyyyy)); LTR 201220011 (Feb. 3, 2012) (representation (aa)); LTR 201216023 (Jan. 19, 2012) (representation (cc)). Concerns along the lines described in the text may lie behind that requirement.