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**The Section 355(d) Regulations:  
Narrowing the Scope of an Overly Broad Statute**

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# **THE SECTION 355(d) REGULATIONS: NARROWING THE SCOPE OF AN OVERLY BROAD STATUTE**

By: Mark J. Silverman and Lisa M. Zarlenga<sup>1</sup>

## **I. INTRODUCTION**

Section 355(d) of the Internal Revenue Code<sup>2</sup> imposes limitations on a distributing corporation's ability to distribute the stock of a controlled subsidiary tax free under section 355, when such distributing corporation or controlled subsidiary has been "recently" purchased.

Section 355 generally permits a corporation to distribute to its shareholders appreciated stock of a subsidiary corporation without triggering any gain at either the corporate or the shareholder level. Since the repeal of the General Utilities doctrine in the Tax Reform Act of 1986 (the "1986 Act"),<sup>3</sup> section 355 has provided one of the only ways in which a corporation may distribute stock of a subsidiary to its shareholders without a corporate-level tax.

After the 1986 Act, however, Congress became concerned that taxpayers were using section 355 to "bust up" recently purchased corporations tax free, thereby circumventing

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<sup>2</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

<sup>3</sup> Pub. L. No. 99-514. In General Utilities and Operating Co. v. Helvering, 296 U.S. 200 (1936), the Supreme Court held that corporations could distribute appreciated property to their shareholders tax free. The Tax Reform Act of 1986 repealed the General Utilities doctrine, adding section 311(b) to the Code. Section 311(b) imposes a corporate-level tax on the distribution of appreciated property to shareholders, as if the corporation sold such property for its fair market value.

the repeal of the General Utilities doctrine.<sup>4</sup> Congress responded in 1987 and 1988 by amending section 355(b)(2)(D), which denies application of section 355 where a corporate distributee or a distributing corporation has acquired control of the distributing or controlled corporation within the five-year period before the distribution. However, section 355(b)(2)(D) did not capture all of the bust-up transactions that Congress intended to prevent, so Congress enacted section 355(d) in 1990.

Section 355(d) is an extremely broad provision that goes well beyond the intended purpose of preventing bust-up transactions. It imposes a corporate-level tax on a distribution if, immediately after the distribution, a shareholder holds a 50-percent or greater interest in either the distributing or a spun-off corporation, and that interest is attributable to stock purchased within the five-year period before the distribution. In an apparent attempt to mitigate the breadth of section 355(d), Congress granted the Treasury Department (“Treasury”) authority to issue regulations to exclude from section 355(d) distributions that “do not violate the purposes of this provision.”<sup>5</sup> As a result, on May 3, 1999, almost nine years later, the Internal Revenue Service

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<sup>4</sup> These bust-up transactions are known as “mirror substitute transactions” and are further discussed below. The legislative history of the Revenue Act of 1987 (the “1987 Act”) (amending section 355(b)(2)(D)) and the Omnibus Budget Reconciliation Act of 1990 (“OBRA ‘90”) (amending section 355(d)) suggest that these mirror transactions circumvent the repeal of the General Utilities doctrine. See H.R. Rep. No. 100-391, Part II, at 1082 (1987); H.R. Rep. No. 101-881, at 341 (1990) (hereinafter “House Report”). One can argue, however, that mirror transactions do not present a General Utilities issue -- the gain in the underlying assets has not been eliminated. Rather, the issue that is raised is the asymmetrical treatment of buyers and sellers. See, e.g., Faber Writes that “Mirror” Transactions do not “Undermine the Integrity of the Corporate Income Tax”, 86 Tax Notes Today 178-6 (1986); Faber Responds to Schler Letter on Mirror Structure, 86 Tax Notes Today 188-9 (1986); Shores, Repeal of General Utilities and the Triple Taxation of Corporate Income, 46 Tax Law’r 177 (1992).

<sup>5</sup> H.R. Conf. Rep. No. 101-964, at 1091 (1990) (hereinafter “Conference Report”).

(the “Service”) responded by issuing Proposed Treasury Regulation § 1.355-6.<sup>6</sup> The proposed regulations provided much needed guidance under section 355(d) and were finalized, with some modifications, on December 20, 2000.<sup>7</sup> The regulations adopt a practical approach to section 355(d) and significantly limit the reach of the statute, for which the Service should be congratulated. The regulations are effective for all distributions occurring after December 20, 2000.<sup>8</sup>

This article examines the purpose of section 355(d) and analyzes the regulations under section 355(d). Part II describes the history and purpose of section 355(d); Part III provides an overview of section 355(d); and Part IV analyzes the regulations.

## **II. HISTORY AND PURPOSE OF SECTION 355(d)**

### **A. Mirror Transactions**

Prior to the 1986 Act, corporations could liquidate without recognizing corporate-level gain or loss (except for recapture items).<sup>9</sup> As a result, purchasers of corporations could dispose of unwanted assets without recognizing gain by purchasing the stock of the target corporation, making a section 338 election to treat the stock purchase as a purchase of assets (thereby obtaining a stepped-up basis in the target corporation’s assets) and then selling the

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<sup>6</sup> 64 Fed. Reg. 23,554 (1999). Prior to the issuance of the proposed regulations, the Service issued several private letter rulings that applied a reasonable interpretation of section 355(d). See, e.g., P.L.R. 9620014 (Feb. 14, 1996).

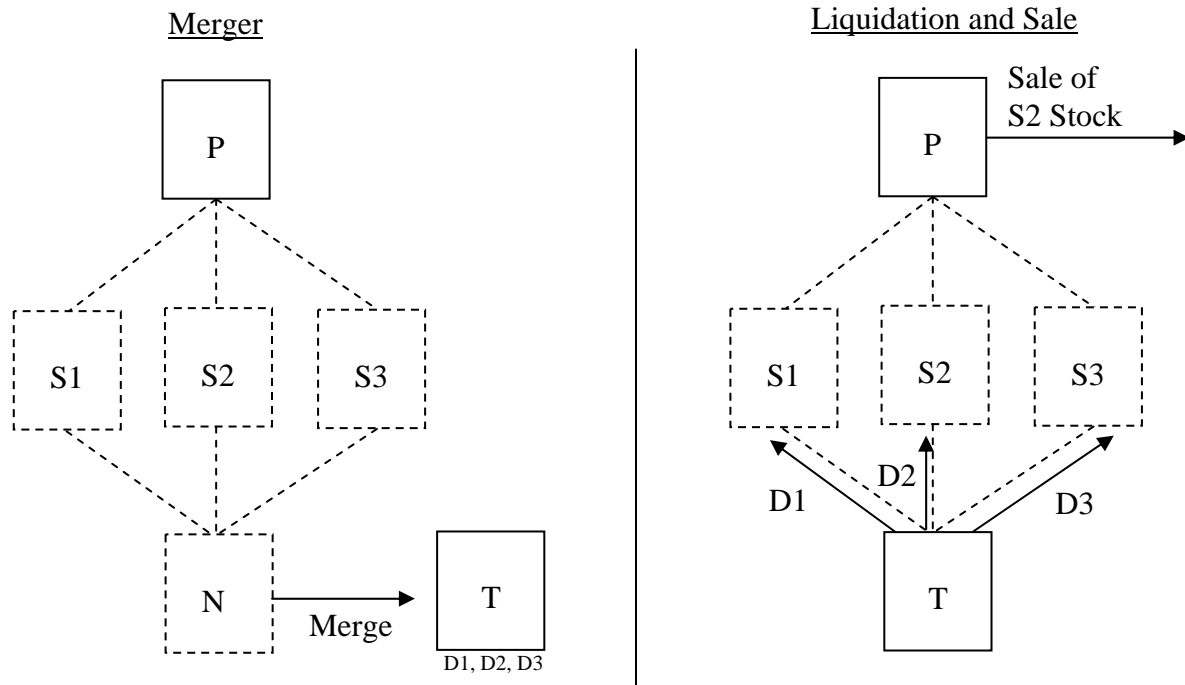
<sup>7</sup> 65 Fed. Reg. 79,719 (2000); T.D. 8913, 2001-1 C.B. 300.

<sup>8</sup> Treas. Reg. § 1.355-6(g). However, the regulations do not apply to distributions occurring pursuant to a binding agreement entered into prior to December 20, 2000. Id.

<sup>9</sup> Sections 336, 337, and 338, prior to amendment by Pub. L. No. 99-514.

unwanted assets for their fair market value. Although the 1986 Act repealed the nonrecognition rule of sections 336, 337, and 338 for less-than-80-percent-owned subsidiaries, taxpayers nonetheless devised a way to sell the stock of a subsidiary without corporate-level tax -- the so-called “mirror subsidiary” transaction.

Example 1 – Mirror Subsidiary Transaction



Facts: T operates through three divisions: D1, D2, and D3. T’s basis in the assets of each division is \$100, and the fair market value of each division is \$200. P wants to acquire all of the stock of T for \$600. P would like to retain D1 and D3, but does not want D2. P forms three wholly owned subsidiaries: S1, S2, and S3, and capitalizes them with \$200 each. Each subsidiary contributes \$200 to a newly formed transitory subsidiary, N, in exchange for 1/3 of its stock. N merges into T in a cash merger, and each subsidiary ends up owning 1/3 of T’s stock. P, T, and the subsidiaries now constitute an affiliated group within the meaning of section 1504(a), and P has a \$200 basis in the stock of each subsidiary. T adopts a plan of complete liquidation. Pursuant to such plan, T distributes the assets of D1, D2, and D3 to S1, S2, and S3, respectively. P sells the stock of S2 for \$200.

As a result of the application of the consolidated return regulations, S1, S2, and S3 are each deemed to own 80 percent of the T stock.<sup>10</sup> Thus, the 80-percent stock ownership requirement for a tax-free liquidation is satisfied, and the liquidation of T is tax free to both T and S1, S2, and S3.<sup>11</sup> In addition, because P has a basis of \$200 in the stock of S2, the sale of S2 generates no gain for P.

The 1987 Act<sup>12</sup> foreclosed the use of the mirror subsidiary transaction by amending section 337(c) to provide that “the determination of whether any corporation is an 80-percent distribute shall be made without regard to any consolidated return regulation.” As a result of the amendment, the liquidation of T in the above example would result in tax to T.<sup>13</sup>

The 1987 Act also foreclosed the use of another mirror-type transaction, which took advantage of section 355 to bust up a purchased corporation. Prior to 1987, section 355(b)(2)(D) provided that control of a corporation that conducted an active trade or business must not have been acquired directly (or through one or more corporations) by “another corporation” within the five-year period before the distribution. In Rev. Rul. 74-5,<sup>14</sup> the Service ruled that where a corporation purchased stock of a distributing corporation (hereinafter “Distributing”), and two years later received stock of a controlled corporation (hereinafter

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<sup>10</sup> Treas. Reg. § 1.1502-34.

<sup>11</sup> Sections 332, 337 (prior to amendment by Pub. L. No. 100-203, § 10223(a)).

<sup>12</sup> Pub. L. No. 100-203, § 10223(a).

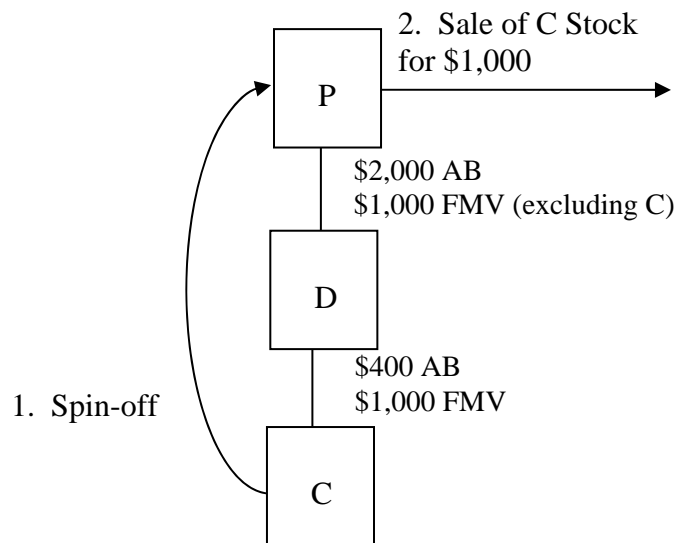
<sup>13</sup> T’s intercompany gain is not taken into account under the consolidated return regulations, but rather is deferred and allocated to S1, S2, and S3 as successors to T. See Treas. Reg. § 1.1502-13(j)(9), Ex.7; see also Prop. Treas. Reg. § 1.1502-13(j)(9)(i), Ex.7.

<sup>14</sup> 1974-1 C.B. 82, obsoleted by, Rev. Rul. 89-37, 1989-1 C.B. 107.

“Controlled”), the transaction could qualify as a section 355 transaction. The Service reasoned that the purpose of section 355(b)(2)(D) was to prevent Distributing from accumulating excess funds to purchase stock of a corporation having an active business and immediately distributing such stock to shareholders. Where the acquiring corporation is merely the shareholder of Distributing, the Service concluded that it is impossible for it to pass accumulated earnings through another corporation to its shareholders.

This ruling set the stage for a transaction that became known as a “mirror substitute” transaction.

Example 2 – Mirror Substitute Transaction



Facts: P purchased all of the stock of D for \$2,000. D’s assets have a basis of \$500 and a fair market value of \$1,000 (excluding its interest in C). D also owns all of the stock of C, with a basis of \$400 and a fair market value of \$1,000. D distributes the stock of C to P in a section 355 transaction, and P subsequently sells the stock of C for \$1,000.

If D were to sell the stock of C, it would recognize a gain equal to \$600. Instead, applying Rev. Rul. 74-5, when D distributes the stock of C to P, the transaction qualifies as a tax-free distribution under section 355. Thus, P allocates its \$2,000 cost basis in its D stock among the D and C stock based on their relative fair market values.<sup>15</sup> P takes a basis in the C stock equal to \$1,000 and a basis in the D stock equal to \$1,000. P then recognizes no gain upon the subsequent sale of the C stock.<sup>16</sup>

In the 1987 Act and the Technical and Miscellaneous Revenue Act of 1988 (the “1988 Act”), Congress attempted to eliminate mirror substitute transactions and obsoleted Rev. Rul. 74-5 by amending section 355(b)(2)(D) to provide that section 355 does not apply if control of the corporation conducting the active trade or business was acquired by Distributing or any distributee corporation (directly or through one or more corporations) within the five-year period before the distribution.<sup>17</sup>

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<sup>15</sup> See section 358(b)(2).

<sup>16</sup> Note that the built-in gain in C’s assets remains. Thus, the corporate-level tax is not avoided, but rather is merely postponed.

<sup>17</sup> The 1987 Act amended section 355(b)(2)(D) to preclude “any distributee corporation” from acquiring control of the corporation conducting the active trade or business. As drafted, the provision opened a new loophole: Distributing could purchase the stock of a corporation and immediately distribute that stock without regard to any five-year holding period. See Benjamin G. Wells, Liberalization of Active Business Requirement in Sec. 355 Not Intended, 38 Tax Notes 743 (1988). The 1988 Act corrected this drafting error to include corporations acquired by Distributing as well as any distributee corporation. In Rev. Rul. 89-37, 1989-1 C.B. 107, the Service formally declared Rev. Rul. 74-5 obsolete in light of the amendment.

B. Section 355(d)

Section 355(b)(2)(D) applies only if a corporation (or two or more members of an affiliated group) acquires control of a corporation conducting an active trade or business. For this purpose, control is determined under section 368(c) (i.e., 80 percent of the voting stock and 80 percent of the total number of shares of all other classes of stock). Thus, while section 355(b)(2)(D) effectively precluded the mirror substitute transaction in Example 2, its technical requirements did not effectively preclude many other transactions in which shareholders obtain a fair market value basis in stock of a subsidiary for any future dispositions without incurring any corporate-level tax. For example, if a corporate shareholder acquires less than 80 percent of the stock of another corporation, section 355(b)(2)(D) is not triggered. Moreover, because section 355(b)(2)(D) applies only to corporate shareholders, the provision is avoided where an individual, partnership, or trust acquires control of another corporation.

As a result of these gaps in the ability of section 355 to police transactions that, in effect, permitted corporate taxpayers to “dispose of subsidiaries in transactions that resemble sales, or to obtain a fair market value basis for any future dispositions, without incurring corporate-level tax,” Congress enacted section 355(d) in OBRA ‘90.<sup>18</sup> Congress was concerned that taxpayers were able to circumvent section 355(b)(2)(D), and it was not clear under what circumstances courts would treat these transactions as taxable sales of the subsidiaries.<sup>19</sup>

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<sup>18</sup> Pub. L. No. 101-508, § 11321(a). See House Report, at 341.

<sup>19</sup> House Report, at 340. Compare Yoc Heating v. Commissioner, 61 T.C. 168 (1973) (holding that a shareholder that recently purchased stock is not treated as a historic shareholder in a tax-free reorganization), with Esmark, Inc. v. Commissioner, 90 T.C. 191 (1988), aff’d. per curiam, 886 F.2d 1318 (7<sup>th</sup> Cir. 1989) (rejecting application of the step-transaction doctrine to recharacterize a distribution of a subsidiary to a new shareholder as a taxable sale of the subsidiary to such shareholder).

Congress noted that the provisions for tax-free divisive transactions under section 355 were a limited exception to the repeal of the General Utilities doctrine.<sup>20</sup> Section 355 was intended to permit historic shareholders to continue their historic corporate businesses in separate corporations -- not to permit tax-free treatment for divisive transactions that, in effect, result in the disposition of a significant part of the historic shareholders' interests in one or more of the divided corporations.<sup>21</sup> As discussed below, however, Congress launched a missile when a bullet would have sufficed. Section 355(d), as written, not only stops the targeted abuses, but it prevents many legitimate transactions as well.

### **III. OVERVIEW OF SECTION 355(d) AND ITS LEGISLATIVE HISTORY**

Under section 355(d)(1), in the case of a “disqualified distribution,” Distributing must recognize gain as if the Controlled stock were sold to the distributee shareholder(s) at its fair market value.<sup>22</sup> Thus, if a disqualified distribution is made, all gain in respect of the distributed shares will be recognized -- not just that relating to the disqualified stock. Moreover, section 355(d) applies whether the distribution is part of a spin-off, split-off, or split-up. The statute defines a disqualified distribution as any distribution if immediately after the distribution, any person holds “disqualified stock” in Distributing or Controlled, and such disqualified stock constitutes a 50-percent or greater interest (by vote or value) in such corporation.<sup>23</sup>

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<sup>20</sup> House Report, at 341.

<sup>21</sup> Id.

<sup>22</sup> Section 355(d)(1), (c)(2)(A).

<sup>23</sup> Section 355(d)(2), (4).

Disqualified stock is defined as (1) any stock in Distributing or Controlled that was acquired by “purchase” after October 9, 1990 and within the five-year period ending on the date of the distribution, or (2) any stock in Controlled received in a section 355 distribution to the extent attributable to stock of Distributing that was acquired by purchase after October 9, 1990.<sup>24</sup>

The term “purchase” means any acquisition, except (1) acquisitions where the basis of the property is not determined in whole or in part by reference to the transferor’s basis (i.e., carryover basis transactions) or under section 1014, and (2) acquisitions to which sections 351, 354, 355, or 356 apply.<sup>25</sup> However, property acquired in a section 351 transaction in exchange for cash or cash items, marketable securities, or debt of the transferor is treated as acquired by purchase.<sup>26</sup> In addition to stock acquired by purchase directly by the current holder, the statute treats certain other acquisitions as purchases: deemed purchases and carryover basis purchases. First, under the deemed purchase rule, if a person is treated as holding stock or securities held by an entity under the attribution rules of section 318(a)(2), that person is treated as purchasing such stock or securities on the later of the date the person purchased the interest in the entity or the date the entity acquired the stock or securities.<sup>27</sup> Second, under the carryover basis rule, if a person acquires stock in a transaction in which that person’s basis is determined in whole or in part by reference to the adjusted basis of the stock in the hands of the transferor, and

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<sup>24</sup> Section 355(d)(3).

<sup>25</sup> Section 355(d)(5)(A).

<sup>26</sup> Section 355(d)(5)(B).

<sup>27</sup> Section 355(d)(8). The attribution rules of section 318(a)(2) are applied by substituting 10 percent for 50 percent in subparagraph C (attribution from corporations) and by treating any reference to stock as including a reference to securities. Section 355(d)(8)(A).

the transferor acquired the stock by purchase, then such person is treated as acquiring the stock by purchase on the date it was purchased by the transferor.<sup>28</sup>

The five-year holding period is tolled whenever the stock or securities are subject to a substantial diminution of risk by the use of an option, a short sale, any special class of stock, or “any other device or transaction.”<sup>29</sup> The legislative history provides two examples of stock or securities that substantially diminishes the holder’s risk of loss: (1) tracking stock; and (2) stock, securities, or instruments the terms of which provide for the distribution of Controlled or other specified assets to the holder or persons other than the holder.<sup>30</sup>

As noted above, the statute only applies if “a person” holds 50 percent or more disqualified stock. The statute applies aggregation rules to treat related persons and persons acting pursuant to a plan or arrangement in respect to the acquisition of stock in Distributing or Controlled as one person.<sup>31</sup> In addition, because the 50-percent threshold is tested immediately after the distribution, a disqualified distribution may result even though a shareholder purchases disqualified stock representing less than 50 percent of Distributing or Controlled before the distribution. Thus, for example, assume that Individual A purchases 10 percent of the stock of D Corporation, and four years later, D distributes the stock of its controlled subsidiary, C, to A in exchange for A’s D stock in a split-off. In that case, section 355(d) is violated even though A

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<sup>28</sup> Section 355(d)(5)(C).

<sup>29</sup> Section 355(d)(6).

<sup>30</sup> Conference Report, at 1090. See Part IV.F.8., infra.

<sup>31</sup> Section 355(d)(7). For purposes of determining whether persons are related, the rules of section 267(b) or 707(b)(1) apply. Section 355(d)(7)(A).

purchased only a 10-percent interest, because A owns disqualified stock representing a 100-percent interest in C after the distribution.

Section 355(d) as drafted is overbroad and encompasses many legitimate transactions that do not violate the Congressional purpose of the statute. For example, assume that Individual A acquires the stock of T in a taxable transaction. T owns all of the stock of D, which it has held for more than five years, and D owns all of the stock of C, which it has held for more than five years. If D distributes the stock of C to T, section 355(d) as drafted applies, because A is treated as having purchased the D and C stock within the past five years under the deemed purchase rule. However, this transaction does not result in any abusive disguised sale or basis step-up. A's high basis is not pushed down to the D or C stock. Rather, T's historic basis is simply allocated between the D and C stock.

Recognizing the far, and in many instances unintended, reach of section 355(d), Congress specifically authorized the Treasury to issue such regulations "as may be necessary to carry out the purposes of this subsection, including . . . regulations modifying the definition of the term 'purchase.'"<sup>32</sup>

The legislative history further described Treasury's regulatory authority by providing specific issues that should be addressed by any regulations. For example, Congress provided that regulations should treat options to acquire stock as exercised if it would cause the person to have a 50-percent or greater interest acquired by purchase, and the effect of the option

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<sup>32</sup> Section 355(d)(9). In addition, Congress authorized Treasury to issue to regulations to prevent avoidance of section 355(d) through the use of related persons, intermediaries, pass-through entities, options, or other arrangements. Id.

would be to avoid the application of section 355(d).<sup>33</sup> Congress also noted that regulations should consider the effect of related transactions in determining an acquirer's percentage interest.<sup>34</sup> In addition, Congress provided that regulations should address the statute's treatment of certain section 351 exchanges as purchases, providing that (1) regulations should not treat a section 351 exchange as a purchase where the transferor(s) and the transferee are members of the same affiliated group both before and after the section 351 exchange, except where the transaction results in increased ownership or a stepped-up basis inconsistent with the purposes of section 355(d), and (2) regulations should not treat a section 351 exchange as a purchase if the cash, marketable securities, or debt are transferred as part of an active trade or business, and such items do not exceed the reasonable needs of such trade or business.<sup>35</sup> Finally, Congress provided generally that the purposes of section 355(d) are not violated if there is a distribution of Controlled within five years of a purchase, and the effect of the distribution is neither (1) to increase ownership in Distributing or Controlled by persons who have directly or indirectly acquired stock within the five-year period preceding the distribution nor (2) to provide a basis step-up with respect to the stock of Controlled.<sup>36</sup> The legislative history provides a few examples of transactions that do or do not fall within the purpose of the statute, including one that concludes that the intragroup spin-off example above should not be subject to section

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<sup>33</sup> Conference Report, at 1091-92.

<sup>34</sup> Conference Report, at 1092.

<sup>35</sup> Conference Report, at 1092-93.

<sup>36</sup> Conference Report, at 1093.

355(d). Unfortunately, without regulations, taxpayers were left to wonder whether such nonabusive transactions would be subject to section 355(d).

#### **IV. TREASURY REGULATION § 1.355-6**

##### **A. Overview**

The regulations limit the application of section 355(d) to those transactions that Congress intended to curb. The regulations first set forth certain definitions and conventions in Treas. Reg. § 1.355-6(a), and provide a purpose exception to section 355(d) and an anti-avoidance rule in Treas. Reg. § 1.355-6(b). After providing these general rules, the regulations provide detailed rules for determining (1) what constitutes a 50-percent or greater interest in Treas. Reg. § 1.355-6(c), (2) what constitutes a purchase in Treas. Reg. § 1.355-6(d), (3) deemed purchases and the timing of purchases in Treas. Reg. § 1.355-6(e), and (4) Distributing's duty to determine whether a disqualified person holds stock in Distributing or Controlled in Treas. Reg. § 1.355-6(f). We analyze each of these provisions below.

##### **B. Purpose Exception to Section 355(d): Treas. Reg. § 1.355-6(b)(3)**

###### **1. In General**

Following the suggestion of the legislative history, the regulations adopt an approach that limits the reach of section 355(d) to transactions that violate its purposes.<sup>37</sup> Under the regulations, section 355(d) will not apply if a “disqualified person” neither (1) increases its direct or indirect ownership in Distributing or Controlled nor (2) obtains a “purchased basis” in

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<sup>37</sup> Treas. Reg. § 1.355-6(b)(3)(i); see also Preamble to Prop. Treas. Reg. § 1.355-6, 64 Fed. Reg. at 23,555.

Controlled stock (the “two-pronged purpose exception”).<sup>38</sup> A disqualified person is any person that, immediately after a distribution, holds the requisite 50-percent or greater disqualified stock interest in Distributing or Controlled. However, the person must have either directly purchased the disqualified stock or received Controlled stock with respect to Distributing stock directly purchased by such person.<sup>39</sup> Purchased basis is defined as basis in Controlled stock that is disqualified stock, unless the Controlled stock and the Distributing stock on which the Controlled stock is distributed are treated as acquired by purchase solely by reason of the deemed purchase rule of section 355(d)(8).<sup>40</sup>

The regulations do not explain when there is an increase in direct or indirect ownership, except to provide that the payment of cash in lieu of fractional shares is disregarded in making such determination.<sup>41</sup> Does the phrase “direct or indirect ownership” refer to the voting power of the stock? The value? Both? How should an increase in direct or indirect ownership be determined when there is more than one class of stock outstanding with differing voting and distribution rights?

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<sup>38</sup> Treas. Reg. § 1.355-6(b)(3)(i)(A), (B); see also Conference Report, at 1093; House Report, at 345. The focus on Controlled’s stock in the second prong of the purpose exception is consistent with the legislative history under section 355(d). See Conference Report, at 1093.

<sup>39</sup> Treas. Reg. § 1.355-6(b)(3)(ii). The requirement that the person have directly purchased the disqualified stock (or the stock on which the Controlled stock is distributed) was added in the final regulations to prevent persons who did not directly or indirectly purchase stock from being disqualified persons. See Preamble to Treas. Reg. § 1.355-6, 65 Fed. Reg. at 79,720.

<sup>40</sup> Treas. Reg. § 1.355-6(b)(3)(iii).

<sup>41</sup> Treas. Reg. § 1.355-6(b)(3)(iv). This exception was added in the final regulations to ensure that de minimis increases in stock ownership are disregarded. See Preamble to Treas. Reg. § 1.355-6, 65 Fed. Reg. at 79,720.

The proposed regulations provided that a distribution would not be a disqualified distribution if the distribution “and any related transactions” did not violate the purposes of Section 355(d).<sup>42</sup> The final regulations removed the reference to any related transactions.<sup>43</sup> The preamble to the final regulations states the reason for the removal:

Commentators suggested that some “related acquisitions” of stock in Distributing or Controlled prior to or following a distribution should not be taken into account in determining if the purpose rule applies. The IRS and Treasury agree that in many cases a related acquisition that increases a disqualified person’s interest in Distributing or Controlled should not be taken into account. In addition, the IRS and Treasury are concerned that the proposed regulations could be interpreted to allow taxpayers, by relying on certain other related transactions, to avoid section 355(d) inappropriately, where a distribution of stock, if viewed independently, would constitute a disqualified distribution. For example, where a distribution of Controlled stock to a Distributing shareholder constitutes a disqualified distribution, a subsequent but related distribution of that stock should not have the effect of “cleansing” the prior disqualified distribution. Based on these concerns, and a belief that other provisions of the final regulations will adequately address the effect of related transactions (*e.g.*, the anti-avoidance provision, § 1.355-6(b)(4)), the final regulations remove the reference to related transactions in the purpose rule.<sup>44</sup>

As indicated in the preamble, deletion of the phrase “any related transaction” can cut both for and against taxpayers. For example, if a distribution satisfies the two-pronged purpose exception, then a related post-distribution acquisition of additional Distributing or Controlled stock will not cause section 355(d) to apply (assuming, of course, that such acquisition does not violate the anti-avoidance rule of Treas. Reg. § 1.355-6(b)(4)). On the other

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<sup>42</sup> Prop. Treas. Reg. § 1.355-6(b)(3)(i).

<sup>43</sup> Treas. Reg. § 1.355-6(b)(3)(i).

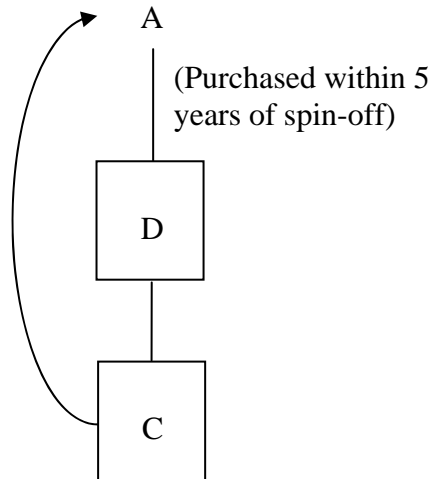
<sup>44</sup> See Preamble to Treas. Reg. § 1.355-6, 65 Fed. Reg. at 79,720.

hand, if a distribution is disqualified, a subsequent, related liquidation of Distributing will not cleanse the tainted basis.

It is important to remember when reading the examples below that the statutory language of section 355(d) applies to all of them. In some of the examples, however, the two-pronged purpose exception of the regulations prevents the application of section 355(d). In some factual situations, section 355(e) may overlap with section 355(d). However, section 355(e) does not apply where section 355(d) applies.<sup>45</sup> For purposes of this article, we have assumed that section 355(e) does not otherwise apply.

## 2. Purchased Basis

### Example 3 – Basic Section 355(d) Transaction



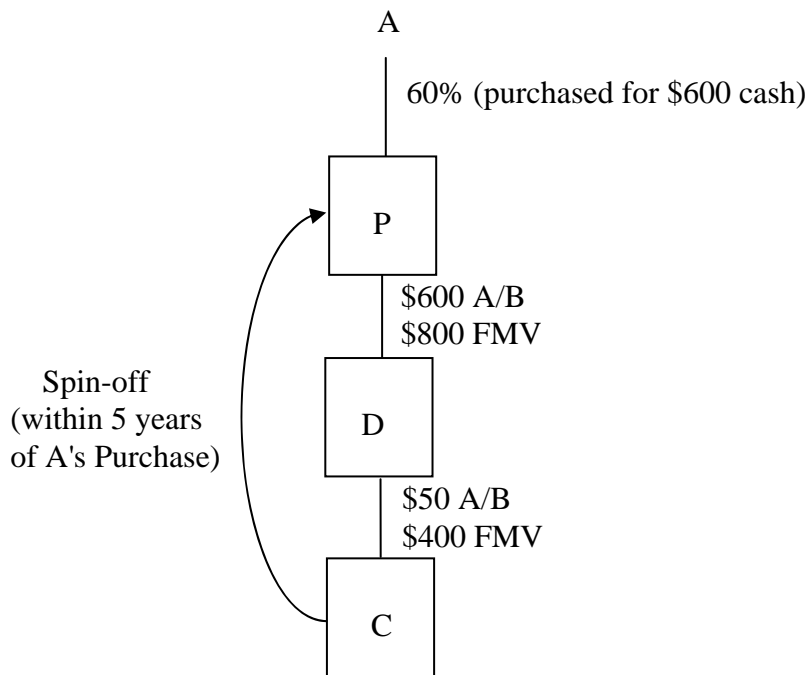
**Facts:** D owns all of the stock of C. Individual A purchases all of the stock of D for cash. Within five years, D distributes the stock of C to A.

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<sup>45</sup> Section 355(e)(2)(D).

This distribution is a straightforward, classic transaction in which section 355(d) applies, but it is helpful in illustrating the application of the regulations. Under the deemed purchase rule of section 355(d)(8), A is treated as having purchased the stock of C on the date A purchased the D stock. The C stock received by A is attributable to a distribution on the purchased D stock. Thus, both the D and C stock constitute disqualified stock, and A is a disqualified person. This distribution violates the purposes of section 355(d) and thus does not meet the two-pronged purpose exception of the regulations. A did not increase direct or indirect ownership in D or C (because A owned 100 percent of C indirectly before the distribution and 100 percent directly after the distribution); however, A's basis in the C stock is a purchased basis. Although the C stock was treated as acquired by purchase solely because of the deemed purchase rule, A's basis in the D stock was not. Thus, section 355(d) applies, and D must recognize gain on its distribution of C stock.

Example 4 – Basic Intragroup Spin-Off



Facts: P owns all of the stock of D. P's basis in the D stock is \$600, and the fair market value of D (including C) is \$800. D owns all of the stock of C. D's basis in the C stock is \$50, and the fair market value of C is \$400. P and D have owned all of the stock of D and C, respectively, for more than five years. Individual A purchases 60 percent of the P stock for \$600 cash. Within five years of A's purchase, D distributes the C stock to P.

A is treated as having purchased 60 percent of the stock of both D and C on the date A purchases 60 percent of the P stock as a result of the deemed purchase rule.<sup>46</sup> The C stock received by P is attributable to a distribution on the purchased D stock. Thus, both the D and C stock constitute disqualified stock, and A is a disqualified person. However, under the regulations, the distribution is not a disqualified distribution, and thus section 355(d) does not apply, because the purposes of the section are not violated. Because the distribution was a pro-rata spin-off, A did not increase his interest in D or C. In addition, P's basis in the C stock is not a purchased basis, because both the D and C stock are treated as acquired by purchase solely by reason of the deemed purchase rule of section 355(d)(8).<sup>47</sup>

A further distribution of the C stock to A, however, would change this conclusion. For example, if in Example 4, P further distributed the C stock to its shareholders pro rata, the purposes of section 355(d) would be violated. Because the distribution was pro rata, A did not increase his interest in P or C. However, A's basis in the C stock is a purchased basis, so the

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<sup>46</sup> A is also treated as owning the remaining 40 percent of the stock of D and C under the aggregation rules, but, under the facts of Example 4, such stock is not treated as purchased within the five-year period. See section 355(d)(7)(A); see also Part IV.F.7., infra.

<sup>47</sup> Treas. Reg. § 1.355-6(b)(3)(vi), Ex.1; see also Conference Report, at 1093; House Report, at 345.

second prong of the purpose exception is not met. A acquired the P stock directly by purchase -- it is not treated as acquired by purchase solely under the deemed purchase rule. Thus, section 355(d) applies, and P must recognize gain on its distribution of C stock.<sup>48</sup> Presumably, it is only P's gain with respect to C that is recognized -- none of D's gain with respect to C should be recognized, since the intragroup spin-off was not a disqualified distribution.<sup>49</sup> Thus, in this example, although D's built-in gain in its C stock is \$350, none of the gain is recognized because the distribution is not a disqualified distribution. P allocates its \$600 adjusted basis in D between the D and the C stock based on their relative fair market values, or \$300 to each (i.e., because D and C are each worth \$400, P's \$600 basis is divided evenly between D and C). Then, upon P's distribution of the C stock to A, P must recognize \$100 of gain (i.e., the difference between C's \$400 fair market value and P's \$300 adjusted basis in C).

Similarly, if P further distributed the C stock to A in exchange for A's purchased stock in P in a split-off, the purposes of section 355(d) would be violated. Under these facts, both prongs of the purpose exception are violated. A has increased his ownership in C from a 60-percent indirect interest to a 100-percent direct interest. In addition, A's basis in the C stock is a purchased basis, because the P stock is not treated as acquired by purchase solely under the

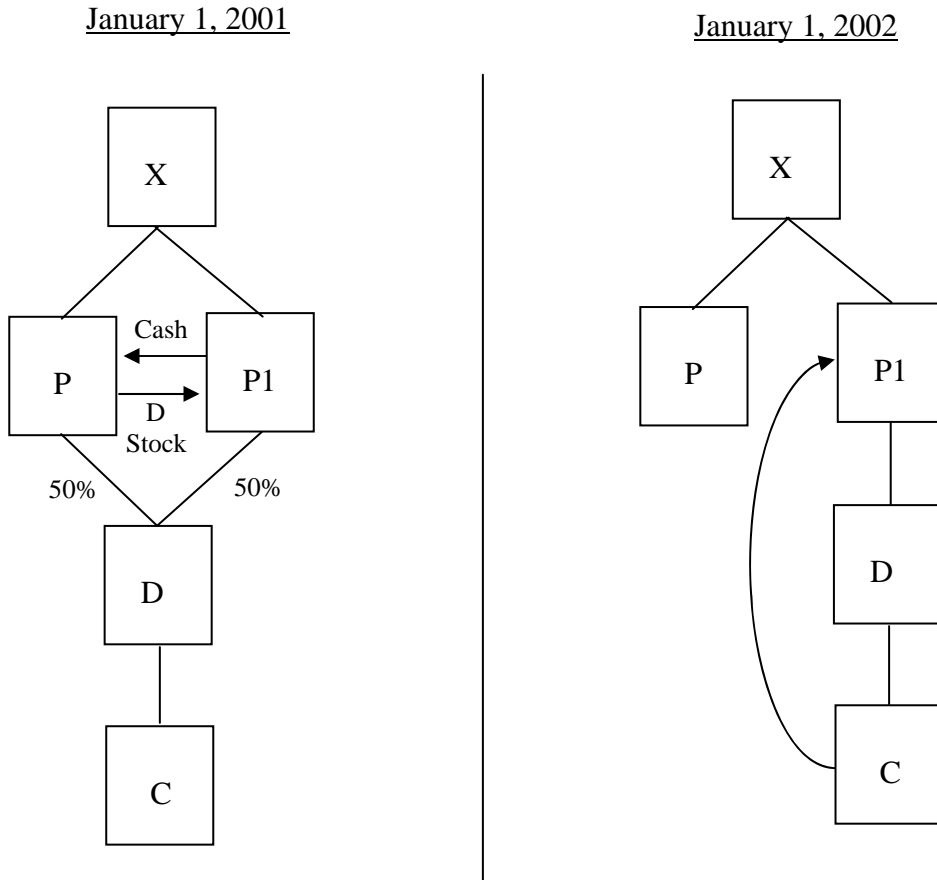
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<sup>48</sup> Treas. Reg. § 1.355-6(b)(3)(vi), Ex.2; see also Conference Report, at 1093; House Report, at 345-46.

<sup>49</sup> The Service reached this result in P.L.R. 199931003 (Apr. 21, 1999). The general facts of P.L.R. 199931003 are as follows: M Corp owned more than 50 percent of the stock of X Corp. X Corp owned some of the stock of D1, D1 owned all the stock of D2, and D2 owned all the stock of C. Y Corp and Z Corp purchased M's stock in X Corp, and within five years of such purchase, D2 distributed the stock of C to D1 in a spin-off, and D1 distributed the stock of C to X in exchange for X's D1 stock in a split-off. The Service ruled the split-off of C to X was a disqualified distribution under section 355(d), but that the spin-off of C to D1 was tax free under section 355.

deemed purchase rule. Thus, section 355(d) applies, and P must recognize gain on its distribution of C stock.<sup>50</sup>

Example 5 – Intercompany Purchase



Facts: Corporation X owns all of the stock of P and P1. P and P1 have each owned 50 percent of the outstanding stock of D for more than five years. D owns all of the stock of C. On January 1, 2001, P sells all of its D shares to P1 for cash. On January 1, 2002, D distributes all of its C stock to P1.

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<sup>50</sup> Treas. Reg. § 1.355-6(b)(3)(vi), Ex. 3; see also Conference Report, at 1093; House Report, at 346. Again, the fact that the split-off results in corporate-level gain should not cause the intragroup distribution of C stock to P to be taxable. See P.L.R. 199931003 (Apr. 21, 1999).

P and P1 are related under section 267(b)(3). Thus, they are treated as one person under the aggregation rules for purposes of section 355(d).<sup>51</sup> Nevertheless, sales and purchases between P and P1 are treated as purchases for purposes of section 355(d).<sup>52</sup> After the distribution, P1 holds disqualified stock in both D and C that represents a 50-percent or greater interest. Thus, P1 is a disqualified person. The purposes of section 355(d) are violated. Although P1 did not increase its interest in D or C, his basis in the C stock is a purchased basis, because the D stock was purchased directly and not solely under the deemed purchase rules.<sup>53</sup>

In this example, P1 has achieved a stepped-up basis only with respect to 50 percent of the stock of C. Thus, since P1 would recognize gain on a subsequent sale of C (albeit less gain) even without the application of section 355(d), P1 cannot avoid corporate-level gain recognition (at least with respect to half of its C stock). However, D's entire gain with respect to the stock of C will be triggered as a result of section 355(d), because neither the statute nor the regulations provide for partial gain recognition when some of the stock is disqualified and some is not.

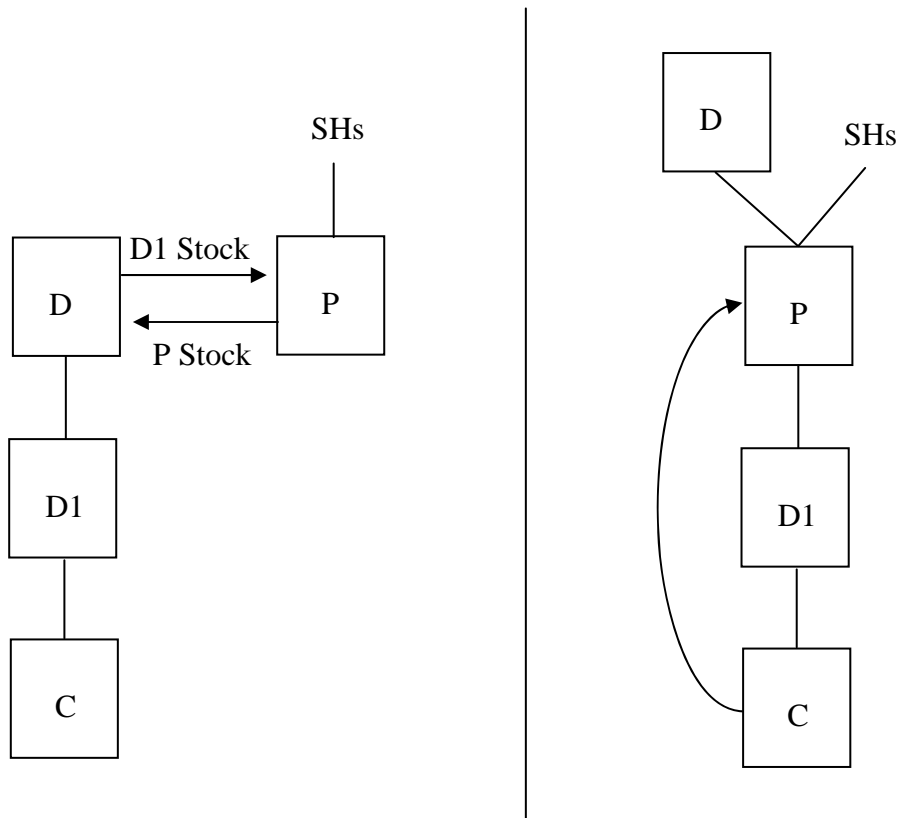
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<sup>51</sup> See section 355(d)(7)(A).

<sup>52</sup> See Treas. Reg. § 1.355-6(e)(1)(iii).

<sup>53</sup> Both D and C remain members of the same affiliated group. Thus, it appears at first glance that this example is like Example 4 (the intragroup spin-off). However, unlike Example 4, P1, the purchaser, ends up holding directly the disqualified stock and thus can utilize the stepped-up basis upon a subsequent sale of C.

Example 6 – Spin-Off Involving Transferred Basis Acquisition



Facts: D1 owns all of the stock of C. D purchases all of the stock of D1 for cash. Within five years of D’s purchase of D1, P acquires all of the stock of D1 from D in a section 368(a)(1)(B) reorganization (which is not also a reverse triangular merger under section 368(a)(1)(A) and (a)(2)(E)), and D1 distributes all of its C stock to P.

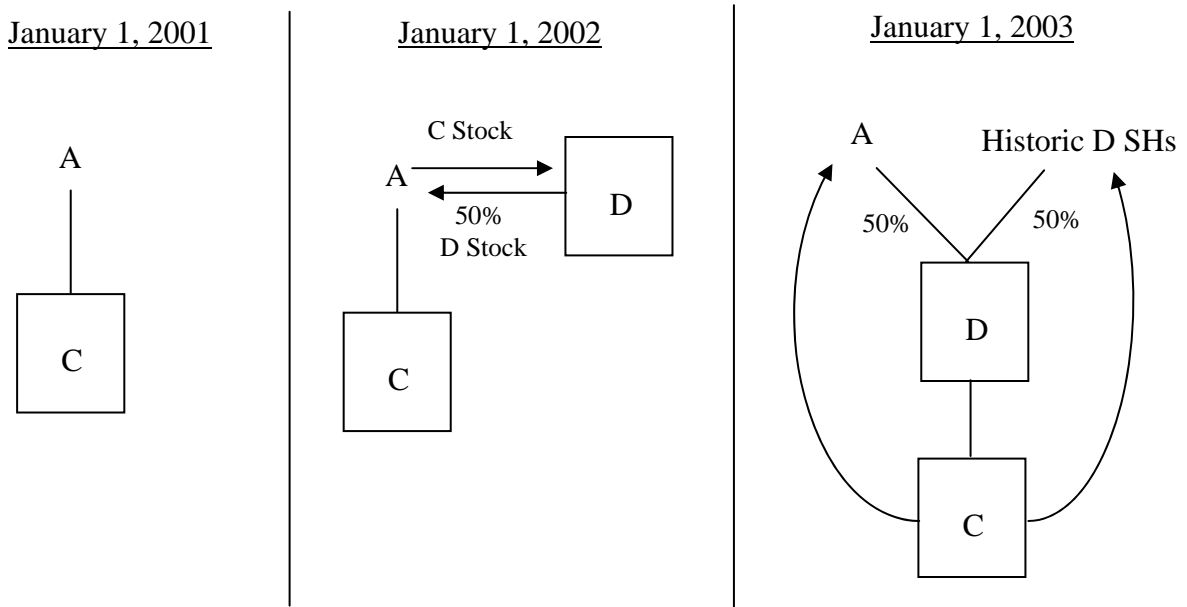
Under the transferred basis rule,<sup>54</sup> P is treated as having acquired the D1 stock by purchase on the date D acquired it. In addition, P is treated as having purchased all of the C stock on the date D purchased the D1 stock under the deemed purchase rule. Because the C

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<sup>54</sup> See Treas. Reg. § 1.355-6(e)(2) (discussed in Part IV.F.3., *infra*); see also section 355(d)(5)(C) (referring to the rule by the term “carryover basis”) (discussed in Part III., *supra*).

stock received by P is attributable to a distribution on purchased D1 stock, both the D1 and C stock constitute disqualified stock, and P is a disqualified person. The purposes of section 355(d) are violated in this example. Although P did not increase its interest in D1 or C, P's basis in the C stock is a purchased basis, because the D1 stock is not treated as acquired by purchase solely under the deemed purchase rule.<sup>55</sup>

Example 7 – Spin-Off Involving Exchanged Basis Acquisition



Facts: Individual A purchases all of the stock of C on January 1, 2001. On January 1, 2002, D acquires the stock of C from A in exchange for 50 percent of D's stock in a B reorganization. On January 1, 2003, D distributes the stock of C pro rata to its shareholders.

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<sup>55</sup> Treas. Reg. § 1.355-6(b)(3)(vi), Ex.4.

Under the exchanged basis rule,<sup>56</sup> A's interest in D is treated as having been purchased on the date his interest in C was purchased. In addition, under the transferred basis rule,<sup>57</sup> D's interest in C is treated as having been purchased on the same date that A purchased his C interest. Because the C stock received by A in the spin-off is attributable to a distribution on purchased D stock, both the D and C stock constitute disqualified stock, and A is a disqualified person. The purposes of section 355(d), as defined in the regulations, are technically violated in this example. Although A did not increase his interest in D or C, A's basis in the C stock is a purchased basis, because the C and D stock are not treated as acquired by purchase solely under the deemed purchase rule.<sup>58</sup>

However, this example does not seem to present the abuse at which section 355(d) was aimed, because A has not been able to utilize his fair market value basis in the C stock to eliminate gain.<sup>59</sup>

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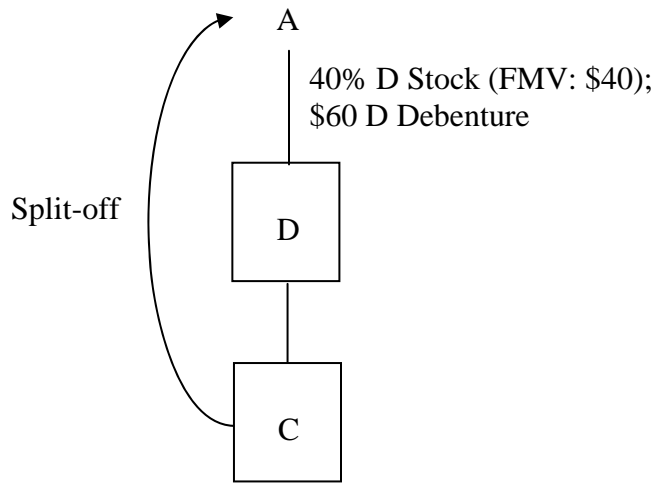
<sup>56</sup> See Treas. Reg. § 1.355-6(e)(3) (discussed in Part IV.F.4., infra).

<sup>57</sup> See Treas. Reg. § 1.355-6(e)(2) (discussed in Part IV.F.3., infra).

<sup>58</sup> See Treas. Reg. § 1.355-6(b)(3)(iii).

<sup>59</sup> Assume that, in the example, A purchased the C stock for \$50, so that his basis in the C stock is \$50. D thus takes a \$50 basis in the C stock that it acquires in the B reorganization. Assume further that the C stock appreciates to \$100 before D distributes it. If D had sold 50 percent of the stock of C for \$50 instead of distributing the C stock to its shareholders, D would have recognized gain equal to \$25 (i.e., \$50 amount realized on the sale of one-half of the C stock, less D's \$25 adjusted basis in one-half of its C stock). Similarly, if A sells his 50-percent interest in C received in the spin-off, A will recognize gain equal to \$25 (i.e., \$50 amount realized on the sale of one-half of the stock of C, less A's \$25 adjusted basis in his C stock following the spin-off). Thus, because of the application of the exchanged basis and transferred basis rules, A has not been able to utilize his fair market value basis in the C stock to eliminate gain.

Example 8 – Distribution With Respect to Securities



Facts: D owns all of the stock of C. On January 1, 2001, Individual A purchases 40 percent of D's stock (with a fair market value of \$40) and a \$60 face amount 20-year debenture of D (with a fair market value of \$60). On January 1, 2002, D distributes all of its C stock to A in exchange for A's D stock and debenture.

The proposed regulations provided that any reference to stock of Distributing includes a reference to securities of Distributing.<sup>60</sup> The final regulations adopted a more limited rule, treating securities of Distributing as stock only for purposes of determining if stock of Controlled is disqualified stock.<sup>61</sup> In this example, A is treated as having purchased the stock of C on the date A purchased the D stock and debenture under the deemed purchase rule of section 355(d)(8). The C stock received by A is attributable to a distribution on the purchased D stock and securities. Thus, both the D and C stock constitute disqualified stock, and A is a disqualified

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<sup>60</sup> Prop. Treas. Reg. § 1.355-6(a)(1); see also section 355(d)(3)(B)(ii)(II).

<sup>61</sup> Treas. Reg. § 1.355-6(a)(3). In addition, references to stock in Treas. Reg. § 1.355-6(c)(4), relating to two or more persons acting pursuant to a plan or arrangement, include securities.

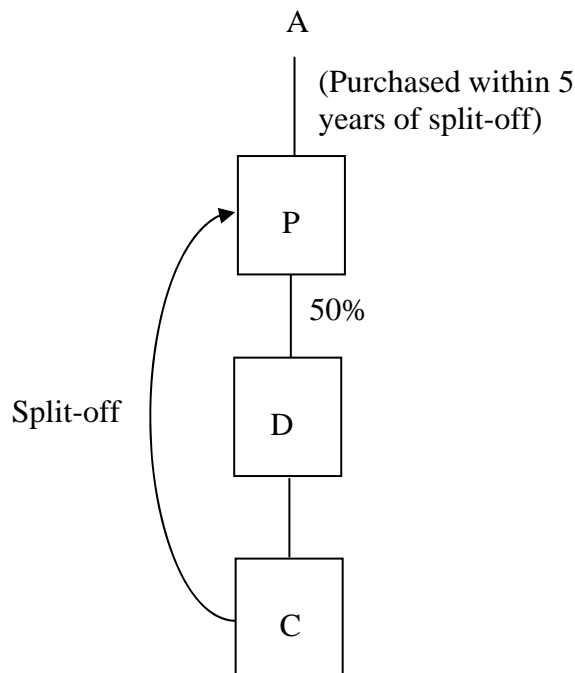
person. This distribution violates the purposes of section 355(d). A increased his interest in C (because A owned 40 percent of C indirectly before the distribution and 100 percent directly after the distribution). Moreover, A's basis in the C stock is a purchased basis, because A's D stock was purchased directly and not solely by reason of the deemed purchase rules. Thus, section 355(d) applies, and D must recognize gain on its distribution of C stock.

Note that the same result occurs if A purchased \$40 of D stock more than five years ago and purchases a \$60 face amount debenture within five years of the distribution. In that case, A still owns a 50-percent or greater interest in C (i.e., 60 percent) that is attributable to purchased D securities.

3. Increase in Direct or Indirect Ownership

Example 9 – Lower-Tier Split-Off Violates the Purposes of Section 355(d)

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Facts: P owns 50 percent of the stock of D, and the remaining stock of D is owned by unrelated persons. D owns all of the stock of C. Individual A purchases all of the P stock from the P shareholders. Within five years of A's purchase, D distributes all of the stock of C to P in exchange for P's D stock in a split-off.

Under the deemed purchase rule, A is treated as having purchased 50 percent of the stock of both D and C on the date that A purchased the P stock. Because the C stock received by P is attributable to a distribution on purchased D stock, both the D and C stock constitute disqualified stock, and A is a disqualified person. The purposes of section 355(d) are violated. Although P's basis in the C stock is not a purchased basis (because both the D and C stock were treated as purchased solely under the deemed purchase rule), A increased his ownership in C from a 50-percent indirect interest to a 100-percent indirect interest.<sup>62</sup>

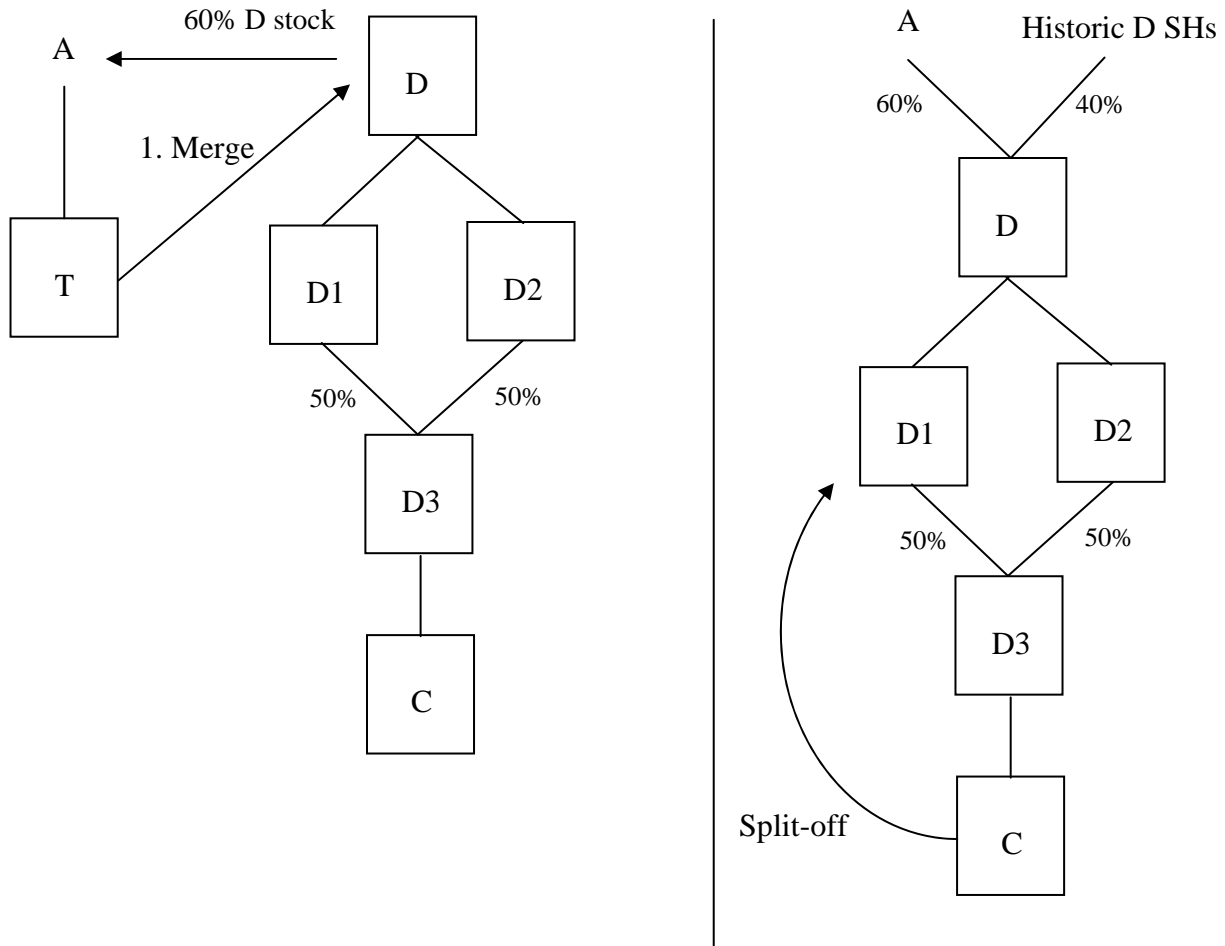
It is not clear why section 355(d) should apply in this example. A cannot take advantage of his purchased basis in the P stock until P subsequently distributes the stock of C to A. Nevertheless, D is taxed currently on its distribution of C. If P were to wait until five years after A purchased the P stock to distribute the C stock to A, the distribution should not be taxed. Nevertheless, under the statute and the regulations, the tax will have already been imposed.

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<sup>62</sup> Treas. Reg. § 1.355-6(b)(3)(vi), Ex.5; see also Conference Report, at 1063; House Report, at 346. In light of the section 355(d) aggregation rules, which treat A and P as one person in this example, it is unclear why the regulations treat A as holding its 100 percent interest in C after the split-off indirectly, as opposed to directly.

Example 10 – Lower-Tier Split-Off Does Not Violate the Purposes of Section 355(d)

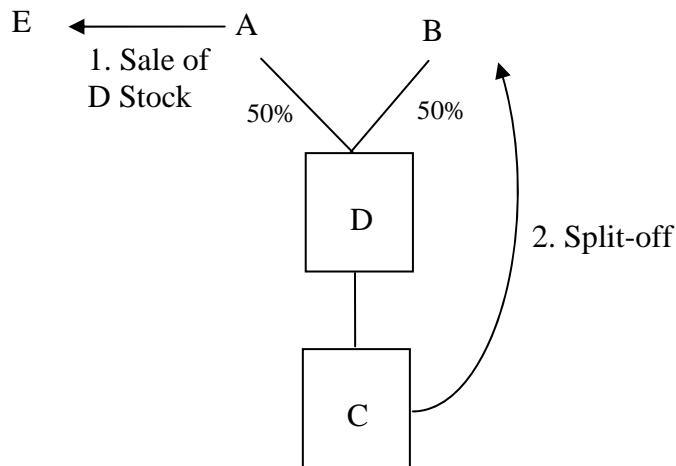
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Facts: Individual A purchases all of the stock of T. T later merges into D in a section 368(a)(1)(A) reorganization, and A exchanges his purchased T stock for 60 percent of the stock of D. D owns all of the stock of D1 and D2. D1 and D2 each owns 50 percent of the stock of D3. D3 owns all of the stock of C. D, D1, D2, and D3 have held their respective stock for more than five years. Within five years of A's purchase of the T stock, D3 distributes the C stock to D1 in exchange for all of D1's D3 stock in a split-off.

Under the exchanged basis rule,<sup>63</sup> A's 60-percent interest in D is treated as having been purchased on the date A purchased the T stock. Under the deemed purchase rule, A is also treated as having purchased 60 percent of the stock of D1, D2, D3, and C on the date A purchased the T stock.<sup>64</sup> Because the C stock received by D1 is attributable to a distribution on purchased D3 stock, both the D3 and C stock constitute disqualified stock, and A is a disqualified person. However, the purposes of section 355(d) are not violated. A's indirect interest in D3 and C remains at 60 percent; thus, A did not increase direct or indirect ownership in D3 or C. Moreover, D1's basis in the C stock is not a purchased basis, because the D3 stock was treated as acquired by purchase solely under the deemed purchase rule.<sup>65</sup>

Example 11 – Split-Off to Historical Shareholder



<sup>63</sup> See Treas. Reg. § 1.355-6(e)(3) (discussed in Part IV.F.4., *infra*).

<sup>64</sup> A is also treated as owning the remaining 40 percent of the stock of D1, D2, D3, and C under the aggregation rules, but, under the facts of Example 10, such stock is not treated as purchased within the five-year period. See section 355(d)(7)(A).

<sup>65</sup> Treas. Reg. § 1.355-6(b)(3)(vi), Ex.6.

Facts: Individuals A and B each own 50 percent of the stock of D. D owns all of the stock of C. A sells all of his D stock to Individual E on January 1, 2001. On January 1, 2002, D distributes all of the stock of C to B in exchange for all of B's D stock in a non-pro rata split-off.

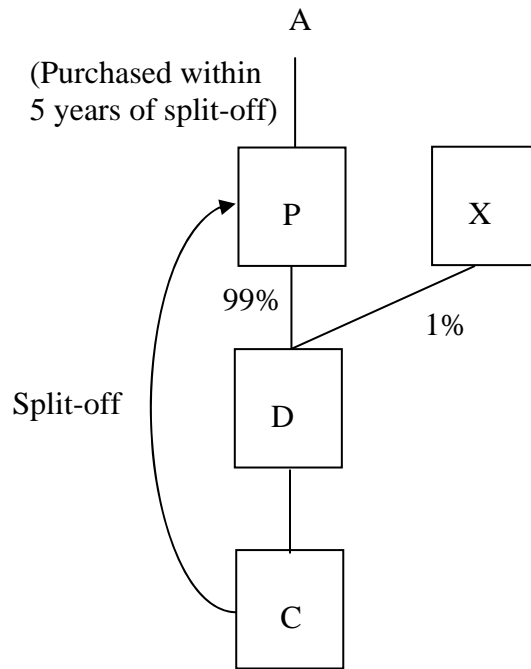
Immediately after the distribution, E owns a 50-percent or greater interest in D that was acquired by purchase within the five-year period ending on the date of the distribution. Thus, the D stock constitutes disqualified stock, and E is a disqualified person. Applying the two-pronged test in the regulations, E does not own any C stock, so the purchased basis prong does not apply. However, E increased his direct ownership in D from 50 percent to 100 percent.<sup>66</sup> Thus, under both the statute and the regulations, this transaction constitutes a disqualified distribution.

This example, however, does not present the mirror substitute problem at which section 355(d) was aimed and, thus, should not constitute a disqualified distribution. As discussed above in Part II.A. and B., section 355(b)(2)(D) and section 355(d) were enacted to prevent disguised sales of controlled corporations or devices to achieve a stepped-up basis in a controlled corporation without incurring a corporate-level tax. In this example, however, the historic shareholder ends up owning all of the C stock, and the basis in the C stock is determined by B's historic basis in D. Although E ends up owning all of the D stock with a fair market value basis, that basis resulted from a taxable purchase -- it was not artificially stepped up. The Service should issue guidance to clarify that this transaction does not result in the application of section 355(d).

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<sup>66</sup> See Treas. Reg. § 1.355-6(b)(3)(i).

Example 12 – De Minimis Increase in Ownership



Facts: P owns 99 percent of the stock of D. The remaining D stock is owned by X, an unrelated corporation. D, in turn, owns all of the stock of C. C is worth considerably less than D. Individual A purchases all of the P stock for cash on January 1, 2001. On January 1, 2002, D distributes all of the stock of C to P in exchange for some of P's D stock in a non-pro rata split-off. P is left owning 95 percent of D and 100 percent of C.

Under the deemed purchase rule, A is treated as having purchased 99 percent of the stock of both D and C on the date that A purchased the P stock. Because the C stock received by P is attributable to a distribution on purchased D stock, both the D and C stock constitute disqualified stock, and A is a disqualified person. The two-pronged purpose exception of the regulations literally does not apply in this example (and thus section 355(d) applies). Although P's basis in the C stock is not a purchased basis (because both the D and C stock were

treated as purchased solely under the deemed purchase rule), A increased his ownership in C from a 99-percent indirect interest to a 100-percent indirect interest.<sup>67</sup>

This transaction does not seem to present the abuse at which section 355(d) was aimed. The increase in the disqualified person's interest is small, and the disqualified person does not directly own the controlled corporation's stock so as to be able to take advantage of the stepped-up basis. There is only a potential for a basis step-up if P distributes D or C to A.<sup>68</sup> The final regulations added an exception for an increase in ownership because of a cash payment in lieu of issuing fractional shares in an effort to disregard de minimis increases in ownership.<sup>69</sup> However, the exception does not apply to this example.

C. Elimination of Purchased Basis: Treas. Reg. § 1.355-6(b)(2)(iii)

The regulations provide that stock of Distributing or Controlled that is acquired by purchase (or deemed purchase) ceases to be acquired by purchase if the basis resulting from the purchase is eliminated.<sup>70</sup> This rule essentially permits a shareholder to purge its tainted stock basis by eliminating it, such as through a liquidation or upstream merger. Because this rule treats the stock as not having been purchased, section 355(d) does not apply, and there is no need to consider the two-pronged purpose exception. Basis in stock is eliminated if and when it would no longer be taken into account by any person in determining gain or loss on a sale or exchange

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<sup>67</sup> See Treas. Reg. § 1.355-6(b)(3)(i).

<sup>68</sup> See Example 9, *supra*.

<sup>69</sup> Treas. Reg. § 1.355-6(b)(3)(iv); see also Preamble to Treas. Reg. § 1.355-6, 65 Fed. Reg. at 79,720.

<sup>70</sup> Treas. Reg. § 1.355-6(b)(2)(iii)(A), (B).

of any stock of such corporation.<sup>71</sup> Basis is not necessarily eliminated, however, if it is allocated between stock of two corporations under Treas. Reg. § 1.358-2(a). In such a case, whether basis has been eliminated is made separately with respect to the stock of each corporation.<sup>72</sup>

Special rules are provided for transferred basis and exchanged basis transactions, split-offs, and split-ups. Basis of purchased stock is eliminated if and when such stock is subsequently transferred to another person in a transferred basis or exchanged basis transaction. The elimination of basis does not, however, affect the deemed purchases that arise under the transferred basis and exchanged basis rules of Treas. Reg. § 1.355-6(e)(2) or (3).<sup>73</sup> Similarly, the basis elimination rule does not apply if purchased Distributing stock is exchanged for Controlled stock in a split-off or split-up, even though it is technically an exchanged basis transaction.<sup>74</sup>

The proposed regulations contained a similar rule that provided that a person who purchases stock in an entity ceases to be treated as purchasing stock owned by the entity under the deemed purchase rule when the person no longer holds the directly purchased stock.<sup>75</sup> Because the proposed regulations only eliminated the purchase taint with respect to stock of lower tier entities deemed purchased, they did not exclude from section 355(d) a direct purchase of Controlled by Distributing followed by a distribution of Controlled. The final regulations fix

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<sup>71</sup> Treas. Reg. § 1.355-6(b)(2)(iii)(C)(1).

<sup>72</sup> Treas. Reg. § 1.355-6(b)(2)(iii)(C)(i), (D).

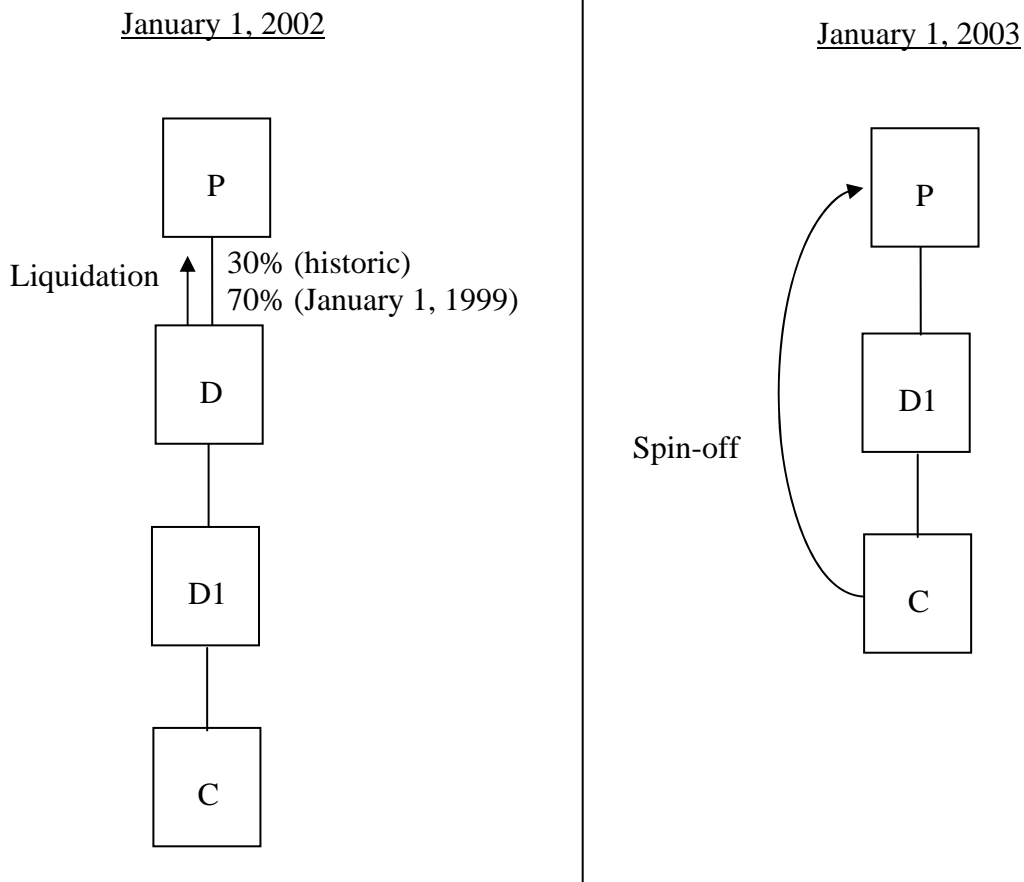
<sup>73</sup> Treas. Reg. § 1.355-6(b)(2)(iii)(2)(C)(2); see Part IV.F.3. & 4, infra, for a discussion of the transferred basis and exchanged basis rules; see also Example 14, infra.

<sup>74</sup> Treas. Reg. § 1.355-6(b)(2)(iii)(2)(C)(3).

<sup>75</sup> Prop. Treas. Reg. § 1.355-6(b)(3)(iv).

this oversight, because the distribution of Controlled eliminates the basis that resulted from Distributing's purchase.<sup>76</sup>

Example 13 – Elimination of Basis Through Liquidation



Facts: P owns 30 percent of the stock of D. D owns all of the stock of D1, and D1 owns all of the stock of C. On January 1, 2001, P purchases the remaining 70 percent of the D stock for cash. On January 1, 2002, P liquidates D in a transaction qualifying under sections 332 and 337(a). On January 1, 2003, D1 distributes the stock of C to P.

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<sup>76</sup> See Preamble to Treas. Reg. § 1.355-6, 65 Fed. Reg. at 79,720.

Under the deemed purchase rule, P is treated as having purchased 70 percent of the stock of D1 and C on the date P purchases the additional 70 percent of D stock. As a result of the section 332 liquidation, P's tainted purchase basis in D disappears. P receives the assets of D (including the D1 stock) with a carryover basis under section 334(b)(1). Accordingly, P is not treated as having acquired the D1 or the C stock by purchase, and neither the D1 nor the C stock is disqualified stock.<sup>77</sup> Note that where the tainted purchase basis is eliminated, section 355(d) does not apply, regardless of whether the two-pronged purpose exception is satisfied. This is significant, because even though the purpose exception would have applied to the distribution in this example, it would not have applied if C were further distributed to P's shareholders, or if C were distributed in a split-off.

What if the liquidation of D had been taxable (because, for example, P did not own the requisite 80 percent of D under section 332 or D was insolvent)? The regulations provide that if the liquidating corporation recognizes gain or loss on the liquidation, any stock received by the transferee corporation is treated as purchased on the date of the liquidation.<sup>78</sup> Thus, if the liquidation were taxable, P would be treated as having purchased the stock of D1 (and thus C under the deemed purchase rule) on the date of the liquidation. Without such an exception, P would be able to purge its tainted basis and, at the same time, receive a fair market value basis in the stock of D1.<sup>79</sup>

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<sup>77</sup> Treas. Reg. § 1.355-6(b)(3)(vi), Ex.7.

<sup>78</sup> Treas. Reg. § 1.355-6(d)(2)(i)(B)(2)(i).

<sup>79</sup> See section 334(a). Note that a taxable liquidation could result in three levels of tax on the same gain. First, when P purchases the stock of D from an unrelated party, the unrelated party recognizes the gain inherent in the D stock (including any gain as a result of appreciation in D1 or C). Second, if the liquidation is taxable, D recognizes the gain inherent in the D1 and C

(Continued ...)

Moreover, the regulations are careful not to apply this rule in cases where an election under section 338 has been made.<sup>80</sup> Assume that in Example 13, P historically owned only 20 percent of D's stock, and it made a qualified stock purchase of the remaining 80 percent from a selling consolidated group for cash within five years of the distribution. If P (jointly with the selling group) makes an election under section 338(h)(10) with respect to D,<sup>81</sup> then D is deemed to sell all of its assets (including the stock of D1) to a new D, and old D is deemed to liquidate. In addition, the seller does not recognize gain or loss on the sale of D.<sup>82</sup> P acquires a stepped-up basis in D's assets (including the D1 stock) but not in D's stock. While the deemed liquidation of D purges any purchased basis in D, it does not purge the purchased basis in D1.<sup>83</sup> Thus, section 355(d) applies.

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stock. Finally, because P received a stepped-up basis in the stock of D1 in the taxable liquidation (section 334(a)), D1 must recognize gain under section 355(d) on the distribution of the C stock.

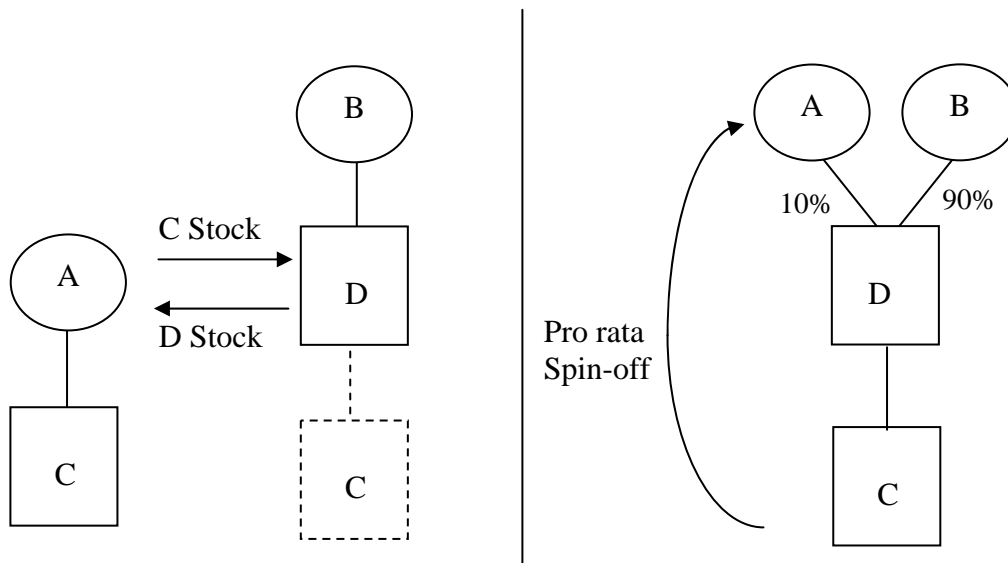
<sup>80</sup> See Treas. Reg. § 1.355-6(d)(2)(iv)(A).

<sup>81</sup> Presumably, P would make the section 338(h)(10) election for D1 and C as well. In that case, section 355(d) would not present a problem.

<sup>82</sup> See Treas. Reg. § 1.338(b)(10)-1(e).

<sup>83</sup> The proposed regulations also treated the D stock acquired by P in the qualified stock purchase as purchased. See Prop. Treas. Reg. § 1.355-6(d)(1)(iii), Ex.2. The final regulations changed this. See Preamble to Treas. Reg. § 1.355-6, 65 Fed. Reg. at 79,721.

Example 14 – Elimination of Basis Through Distribution



Facts: A purchases all of the stock of C on January 1, 2001. D acquires all of the stock of C from A in a B reorganization in exchange for 10 percent of D's stock. The remaining D stock is owned by B. Within five years of A's purchase of the C stock, D distributes all of the C stock pro rata to A and B.

Under the transferred basis rule, D is treated as having purchased all of the C stock on January 1, 2001 (the date A purchased the C stock).<sup>84</sup> Under the exchanged basis rule, A is treated as having purchased 10 percent of the D stock on January 1, 2001.<sup>85</sup> A's purchased basis in C is eliminated when A subsequently exchanges the C stock for the D stock. However, A's purchased basis in the D stock, and D's purchased basis in the C stock as a result of the transferred basis and exchanged basis rules are not eliminated.<sup>86</sup> Upon D's distribution of the C

<sup>84</sup> Treas. Reg. § 1.355-6(e)(2). See Part VI.F.3., *infra*, for a discussion of the transferred basis rule.

<sup>85</sup> Treas. Reg. § 1.355-6(e)(3). See Part VI.F.4., *infra*, for a discussion of the exchanged basis rule.

<sup>86</sup> Treas. Reg. § 1.355-6(b)(2)(iii)(C)(2).

stock to A and B, D's basis in the C stock is eliminated, because it would no longer be taken into account by any person in determining gain or loss on the sale of C stock.<sup>87</sup> Therefore, the C stock distributed to A and B is not disqualified stock as a result of D's purchase of C. However, A's 10-percent interest in D is disqualified stock, because that stock basis was not eliminated, and A's 10-percent interest in C is disqualified stock, because it is attributable to A's purchased D stock. Nonetheless, because A does not hold disqualified stock that constitutes a 50-percent or greater interest in D or C, the distribution is not a disqualified distribution subject to section 355(d).<sup>88</sup>

D. Anti-Avoidance Rule: Treas. Reg. § 1.355-6(b)(4)

The regulations contain an anti-avoidance rule, which permits the Service to treat any distribution as disqualified if the distribution or another transaction is engaged in or structured with a principal purpose to avoid the purposes of section 355(d). For example, the Commissioner may determine that the existence of a related person, intermediary, or pass-through entity should be disregarded, in whole or in part, if the intermediary is formed or availed of with a principal purpose to avoid the purposes of section 355(d).<sup>89</sup> The regulations contain only two examples illustrating how this rule may be applied.

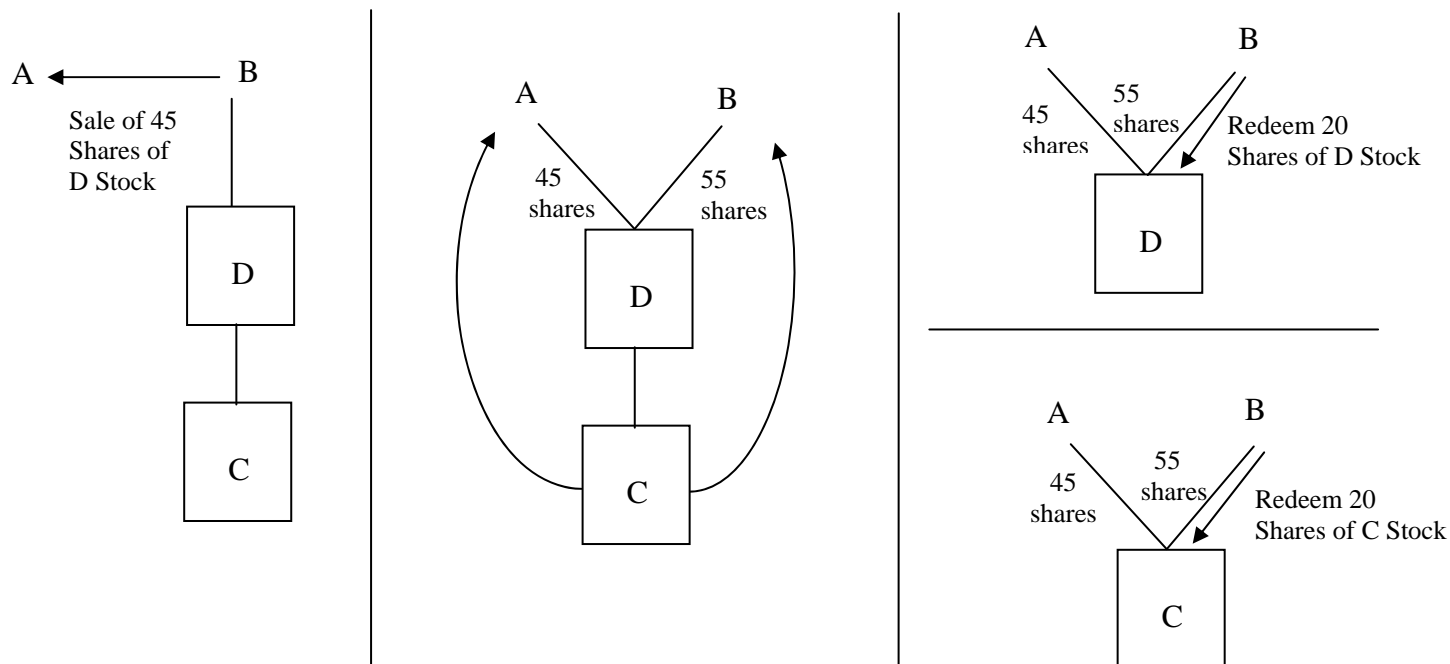
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<sup>87</sup> Treas. Reg. § 1.355-6(b)(2)(iii)(C)(1).

<sup>88</sup> Treas. Reg. § 1.355-6(b)(3)(vi), Ex.9.

<sup>89</sup> Treas. Reg. § 1.355-6(b)(4).

Example 15 – Post-Distribution Redemption



Facts: Individual B owns all of the stock of D, which owns all of the stock of C. D and C each has 100 shares of a single class of stock outstanding. With a principal purpose to avoid the purposes of section 355(d), Individuals A and B and Corporations D and C engage in the following transactions. A purchases 45 shares of D stock. Within five years after A's purchase, D distributes all of its C stock to A and B pro rata. D then redeems 20 shares of B's D stock, and C redeems 20 shares of B's C stock, so that A is left with 45 shares and B with 35 shares in each of D and C.

The regulations conclude that in the above example, the Service may treat A as owning disqualified stock in D and C that constitutes a 50-percent or greater interest in D and C immediately after the distribution.<sup>90</sup> This example incorporates a suggestion in the legislative history that any regulations ought to consider the effect of related transactions in determining an

<sup>90</sup> Treas. Reg. § 1.355-6(b)(4)(ii).

acquirer's percentage interest (citing as an example a subsequent redemption).<sup>91</sup> It is interesting that the Service decided to incorporate step-transaction principles as part of the anti-avoidance rule (where "a principal purpose" must be shown) instead of as a separate, and less stringent, rule providing that related transactions are taken into account in determining whether a shareholder holds the requisite 50-percent disqualified interest.<sup>92</sup>

Another example of the application of the anti-avoidance rules is given in the context of section 351 transactions. Assume that P Corporation contributes cash to its wholly owned subsidiary, S Corporation, with principal purpose to increase its stock basis in S. Sixty percent of the value of P's stock is attributable to the cash contribution. Notwithstanding the exception in the regulations that treats a transfer of cash, marketable stock, or debt in a section 351 transaction as not being a purchase if the transferor, transferee, and controlled corporation of the transferee are members of the same affiliated group both before and after the transfer, the example concludes that 60 percent of the S stock will be treated as purchased.<sup>93</sup>

Given the broad language in the anti-avoidance rule, it may be difficult to avoid the application of section 355(d) in legitimate transactions. For example, assume Individual A purchased 50 percent of the stock of D Corporation four years ago, and, for valid business

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<sup>91</sup> Conference Report, at 1092.

<sup>92</sup> Note that the final regulations removed the reference to "any related transactions" in the two-pronged purpose exception. The proposed regulations stated that "a distribution is not a disqualified distribution if the distribution and any related transactions do not violate the purposes of section 355(d) . . . ." Prop. Treas. Reg. § 1.355-6(b)(3)(i) (emphasis added). The Service thought that taxpayers could rely on related transactions to avoid section 355(d) and believed that the anti-avoidance provision would adequately address the effect of related transactions. See Preamble to Treas. Reg. § 1.355-6, 65 Fed. Reg. at 79,720.

<sup>93</sup> Treas. Reg. § 1.355-6(d)(3)(v)(B), Ex.2.

purposes, D now proposes to distribute the stock of C Corporation pro rata to its shareholders. Just prior to the spin-off, A sells five percent of his D stock to a third party in a bona fide, arm's-length transaction. Does the anti-avoidance rule apply? Even if the anti-avoidance rule does not apply, it is possible that section 355(d)(7)(B) may apply to treat A and the third party as one person as a result of a plan or arrangement between A and the third party to acquire the C stock.

E. 50-Percent or Greater Interest: Treas. Reg. § 1.355-6(c)

1. In General

As noted above, section 355(d) will only apply if there is a “disqualified distribution.” A disqualified distribution occurs if, immediately after the section 355 distribution, any person holds disqualified stock in Distributing or Controlled that constitutes a 50-percent or greater interest in such corporation.<sup>94</sup> Section 355(d)(4) states that “50-percent or greater interest” means stock possessing “at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock.”<sup>95</sup> For purposes of this calculation, the regulations provide that all shares within a single class are considered to have the same value.<sup>96</sup>

2. Aggregation

To be a disqualified distribution, a person must hold the tainted 50-percent or greater interest in Distributing or Controlled. Thus, if Individual A and Individual B each

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<sup>94</sup> Section 355(d)(2).

<sup>95</sup> Section 355(d)(4); Treas. Reg. § 1.355-6(c)(1).

<sup>96</sup> Treas. Reg. § 1.355-6(c)(2).

purchase 30 percent of Distributing within five years of the distribution of Controlled, section 355(d) will not apply absent rules that aggregate A and B.

Section 355(d)(7) aggregates persons related under section 267(b) or 707(b)(1), or persons acting pursuant to a “plan or arrangement with respect to acquisitions of stock or securities in the distributing corporation or controlled corporation . . . .”<sup>97</sup> Persons aggregated under section 355(d)(7) are treated as one person for purposes of section 355(d). Thus, if Individual A and Individual B above are family members, or they act pursuant to a plan or arrangement to purchase the Distributing stock, they will be treated as one person who acquired 60 percent of the stock of Distributing.<sup>98</sup>

What constitutes a “plan or arrangement” for purposes of section 355(d) is far from clear in the statute. Fortunately, the regulations provide rules for determining whether there is a plan or arrangement under section 355(d)(7).<sup>99</sup> Under these new rules, two or more persons will be treated as acting pursuant to a plan or arrangement “only if they have a formal or

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<sup>97</sup> Section 355(d)(7). Persons related under section 267(b) and 707(b)(1) generally include: (1) members of a family (siblings, spouses, ancestors, lineal descendants); (2) an individual and a 50-percent-or-more owned (directly or indirectly) corporation or partnership; (3) two corporations that are members of the same controlled group (using a 50-percent control test); (4) a fiduciary and beneficiary of a trust; and (5) a corporation and a partnership, or a partnership and a partnership, if the same person owns more than 50 percent of both entities.

<sup>98</sup> See Part IV.F.7., *infra*, for a discussion of when A and B would be treated as acquiring their interest by purchase.

<sup>99</sup> The Preamble to the proposed regulations states that the rules do “not apply for purposes of any other section of the Internal Revenue Code.” See Preamble to Prop. Treas. Reg. § 1.355-6, 64 Fed. Reg. at 23,556. Presumably, the Service wanted to make clear that taxpayers could not use the new section 355(d) “plan or arrangement” regulations in interpreting section 355(e)(2)(A) (plan or series of related transactions). The Service has issued regulations under section 355(e) defining plan or series of related transactions. Treas. Reg. § 1.355-7.

informal understanding among themselves to make a coordinated acquisition of stock.”<sup>100</sup> The regulations further provide that in determining whether an understanding exists, a principal element “is whether the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders.”<sup>101</sup> Thus, a public offering is generally not treated as a plan or arrangement if each investor makes its own investment decision.<sup>102</sup> This definition of plan or arrangement is based on the entity rule in Treas. Reg. § 1.382-3(a)(1), and the Service “intend[s] that the two provisions be administered in a similar manner.”<sup>103</sup>

The regulations provide several examples illustrating when two or more persons have a formal or informal understanding. In the first example, 20 unrelated individuals who own no stock in Distributing agree among themselves to acquire 50 percent or more of Distributing’s stock and subsequently acquire such stock.<sup>104</sup> The example states that the 20 individuals have a formal or informal understanding and thus their interests are aggregated.<sup>105</sup>

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<sup>100</sup> Treas. Reg. § 1.355-6(c)(4)(ii).

<sup>101</sup> Id. The participation by creditors in formulating a plan for an insolvency workout or reorganization in a title 11 or similar case is not treated as acting pursuant to a plan or arrangement under the regulations. Treas. Reg. § 1.355-6(c)(4)(ii).

<sup>102</sup> See Preamble to Prop. Treas. Reg. § 1.355-6, 64 Fed. Reg. at 23,556.

<sup>103</sup> Id. Under Treas. Reg. § 1.382-3(a)(1), an entity includes a group of persons “who have a formal or informal understanding among themselves to make a coordinated acquisition of stock.” Furthermore, a principal element in determining whether a formal or informal understanding exists is “whether the investment decision of each member of a group is based upon the investment decision of one or more other members.” Treas. Reg. § 1.382-3(a)(1).

<sup>104</sup> Treas. Reg. § 1.355-6(c)(4)(iii), Ex.1.

<sup>105</sup> Id.

In the second example, Distributing's management -- concerned that Distributing may become subject to a takeover bid -- meets with potential investors (who are not current shareholders and who are friendly to management) to convince them to acquire Distributing's stock, "based on an understanding that [Distributing] will assemble a group that in the aggregate will acquire more than 50 percent of [Distributing's] stock."<sup>106</sup> Subsequently, 15 of these investors each purchase four percent of Distributing's stock (for a total of 60 percent). The example states that the 15 investors have a formal or informal understanding and thus their interests are aggregated.<sup>107</sup>

In the third example in the regulations, an investment adviser recommends to his clients that they purchase Distributing stock, because such stock is undervalued.<sup>108</sup> Acting on this recommendation, 20 unrelated individuals purchase three percent of Distributing's stock (for a total of 60 percent). No client's decision to purchase Distributing stock is based on the investment decisions made by other clients. The example states that the 20 individuals' interests are not aggregated, because there is no formal or informal understanding.<sup>109</sup> Moreover, the interests would not be aggregated even if the investment advisor were the underwriter for a primary or secondary offering of Distributing's stock.<sup>110</sup>

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<sup>106</sup> Treas. Reg. § 1.355-6(c)(4)(iii), Ex.2.

<sup>107</sup> Id.

<sup>108</sup> Treas. Reg. § 1.355-6(c)(4)(iii), Ex.3(i).

<sup>109</sup> Id.

<sup>110</sup> Treas. Reg. § 1.355-6(c)(4)(iii), Ex.3(ii). Similarly, if a trustee of several qualifying trusts sponsored by unrelated corporations causes each trust to purchase Distributing's stock, the interests would also not be aggregated, "provided that the trustee's investment decision made on behalf of each trust was not based on the investment decision made on behalf of one or more of the other trusts." Treas. Reg. § 1.355-6(c)(4)(iii), Ex.3(iii).

The final regulations added an exception to a plan or arrangement for subsequent exchanged basis transactions. If two or more persons do not act pursuant to a plan or arrangement with respect to an acquisition of stock in a corporation, a subsequent exchanged basis acquisition will not result in such persons being treated as one person, even if the second acquisition is pursuant to a plan or arrangement.<sup>111</sup>

3. Options, Warrants, Convertible Obligations, and Other Similar Interests

a. In General

In enacting section 355(d), Congress directed the Secretary of the Treasury to promulgate regulations as may be necessary to carry out the statute's purposes, including regulations to prevent the avoidance of section 355(d) through the use of options or other arrangements.<sup>112</sup> In the legislative history of section 355(d), Congress stated that it intended that Treasury use its regulatory authority to treat options, warrants, convertible obligations, and other similar interests as exercised "if that would cause the person to have a 50-percent or greater interest acquired by purchase and where, under all the facts and circumstances . . . the effect of the option would be to avoid the application" of section 355(d).<sup>113</sup>

In response to Congress' mandate, the Service has promulgated rules in Treas. Reg. 1.355-6(c)(3), which treat an option<sup>114</sup> that has not been exercised on the date of a

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<sup>111</sup> Treas. Reg. § 1.355-6(c)(4)(iv)(A).

<sup>112</sup> See section 355(d)(9).

<sup>113</sup> Conference Report, at 1091-92.

<sup>114</sup> For purposes of these rules, the term "option" is broadly defined to include the following: a call option, warrant, convertible obligation, the conversion feature of convertible stock, put option, redemption agreement, notional principal contract that provides for the payment of amounts in stock, stock purchase agreement or similar arrangement, or any other

(Continued ...)

distribution as exercised for purposes of section 355(d) if: (1) its exercise would cause a person to become a disqualified person (alone or in conjunction with the deemed exercise of other options), and (2) immediately after the distribution, it is “reasonably certain” that the option will be exercised.<sup>115</sup> If either requirement is not satisfied, an unexercised option will not be treated as exercised.<sup>116</sup>

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instrument that provides for the right to purchase, issue, redeem, or transfer stock (including an option on an option). Treas. Reg. § 1.355-6(c)(3)(v). The proposed regulations also included cash settlement options, phantom stock, stock appreciation rights, notional principal contracts that provide for payment based on the price of stock, or any other similar interest (except for stock). See Prop. Treas. Reg. § 1.355-6(c)(3)(v)(B). However, to the extent such instruments are exercisable into stock, they would be treated as an “other instrument that provides for the right to purchase issue, redeem or transfer stock” and thus would be treated as an option under the final regulations. See Preamble to Treas. Reg. § 1.355-6, 65 Fed. Reg. at 79,722.

An “option” does not include certain instruments that are not normally abusive. These instruments include: (1) an option that is part of a security arrangement in a typical lending transaction, if the arrangement is subject to customary commercial conditions (i.e., an escrow, pledge, or other security agreement); (2) an option with customary terms provided to an employee, director, or independent contractor in connection with the performance of services for a corporation (and that is not excessive in relation to the services performed), which is nontransferable (and does not become transferable) and does not have a readily ascertainable fair market value; (3) the conversion feature of convertible stock if the stock is not convertible for at least five years after issuance or transfer, and the terms of the conversion feature do not require the tender of any consideration other than the stock being converted; (4) an option entered into between stockholders of a corporation, or between a stockholder and a corporation, that is exercisable only upon the death, disability, or mental incompetency of a stockholder, or is exercisable only upon the stockholder’s separation from service (if the option is in connection with the performance of services for the corporation); and (5) any other instruments specified in regulations, a revenue ruling, or a revenue procedure. Treas. Reg. § 1.355-6(c)(3)(vi). However, these instruments will be treated as options if they are issued, transferred, or listed with a principal purpose to avoid the application of section 355(d) or the regulations thereunder. Id.

<sup>115</sup> Treas. Reg. § 1.355-6(c)(3)(i) and (ii). Thus, it is irrelevant whether the option is in or out-of-the-money at the time of the issuance of the option. The regulations do not address whether instruments are options or stock. That issue must be determined under general principles of tax law, such as substance over form. Treas. Reg. § 1.355-6(c)(3)(i).

<sup>116</sup> See Treas. Reg. § 1.355-6(c)(3)(ii).

b. Timing and Effect of Deemed Exercise

If an option is treated as exercised under the regulations, it is treated as exercised on the date it was issued or most recently transferred.<sup>117</sup> For purposes of this rule, the following are treated as a new issuance or transfer of an existing option only if it “materially increases” the likelihood that an option will be exercised: (1) an exchange of an option for another option or options, (2) an adjustment to the terms of an option, (3) an adjustment to the terms of the underlying stock, (4) a change to the capital structure of the issuing corporation, and (5) an alteration to the fair market value of issuing corporation stock through an asset transfer (other than regular, ordinary dividends) or through any other means.<sup>118</sup> The final regulations added a rule for substituted options. If an existing option is exchanged for another option, and such exchange is not treated as a new issuance or transfer, then the substituted option will be treated as issued on the date the existing option was issued or most recently transferred.<sup>119</sup>

If an option is treated as exercised under the regulations, it is treated as exercised for purposes of determining both the 50-percent “vote” test and the 50-percent “value” test.<sup>120</sup> If a stock purchase agreement or similar arrangement is deemed exercised under the regulations, the purchaser is treated as purchasing stock under the agreement as if all covenants and contingencies in the agreement are satisfied.<sup>121</sup>

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<sup>117</sup> Id. Treas. Reg. § 1.355-6(c)(3)(iii)(A).

<sup>118</sup> Id. In addition, a compensatory option that becomes transferable is treated as issued on the date it becomes transferable. Treas. Reg. § 1.355-6(c)(3)(iii)(B).

<sup>119</sup> Treas. Reg. § 1.355-6(c)(3)(iii)(C).

<sup>120</sup> Treas. Reg. § 1.355-6(c)(3)(iv)(A).

<sup>121</sup> Treas. Reg. § 1.355-6(c)(3)(iv)(B). The agreement or arrangement is treated as being exercised as of the date it is entered into or most recently assigned. Id.

c. Reasonably Certain Standard

As noted above, an option will not be treated as exercised unless, immediately after the distribution, it is reasonably certain that the option will be exercised. Treasury and the Service rejected comments to replace the reasonably certain standard with a “principal purpose to avoid section 355(d)” standard, viewing the more objective reasonably certain standard as more appropriate.<sup>122</sup> Whether an option is reasonably certain to be exercised is based on all the facts and circumstances.<sup>123</sup> In applying the reasonably certain test, the fair market value of the stock underlying the option is determined by taking into account control premiums and minority and blockage discounts.<sup>124</sup> In addition, a stock purchase agreement or similar arrangement “is treated as reasonably certain to be exercised if the parties’ obligations to complete the transaction are subject only to reasonable closing conditions.”<sup>125</sup>

The regulations do not define what constitutes reasonably certain, except by providing two examples. Presumably, an option that is deep-in-the-money immediately after the distribution would meet the reasonably certain standard, and an option whose strike price is equal to the fair market value immediately after the distribution would not meet such standard. However, there is considerable uncertainty in between these two alternatives.

In the first example provided in the regulations, Individual A purchases 40 percent of Distributing’s only class of stock and an option to purchase an additional 20 percent

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<sup>122</sup> Preamble to Treas. Reg. § 1.355-6, 65 Fed. Reg. at 79,722.

<sup>123</sup> Treas. Reg. § 1.355-6(c)(3)(vii)(A).

<sup>124</sup> Id.

<sup>125</sup> Treas. Reg. § 1.355-6(c)(3)(vii)(B).

for \$30/share (exercisable within five years of issuance).<sup>126</sup> Within five years of A's purchase, Distributing distributes the stock of its wholly owned corporation, Controlled, to its shareholders pro rata. Immediately after the distribution, Distributing's stock is trading at \$30/share (it was trading at \$27/per share on the date of issuance), and Controlled's stock is trading at \$15/share. Thus, as a result of the distribution, A receives 40 percent of the Controlled stock, and exchanges his option to purchase 20 percent of Distributing's stock for \$30/share for two options: one to purchase 20 percent of Distributing's stock for \$20/share and one to purchase 20 percent of Controlled's stock for \$10/share. The example in the regulations states that, under these facts, it is reasonably certain that A will exercise his options.<sup>127</sup> Thus, A is treated as owning 60 percent of both Distributing and Controlled on the date the original option was issued, and the distribution is a disqualified distribution. This example seems to indicate that if an option may be exercised at a 33.3 percent discount (i.e., a \$20/share exercise price for the \$30/share fair market value Distributing stock, and a \$10/share exercise price for the \$15/share fair market value Controlled stock), the option will be reasonably certain to be exercised.

The second example illustrates that if a shareholder in the position of the option holder would pay more per share because of a control premium (i.e., the additional shares would allow the option holder to be in control of the corporation), that control premium is taken into account in determining whether it is reasonably certain that the option holder will exercise his options.<sup>128</sup> Thus, assume that within five years of a distribution of Distributing's wholly owned

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<sup>126</sup> Treas. Reg. § 1.355-6(c)(3)(viii), Ex.1.

<sup>127</sup> Id.

<sup>128</sup> See Treas. Reg. § 1.355-6(c)(3)(viii), Ex.2.

subsidiary, Controlled, Individual A purchases 37 percent of Distributing's stock and an option to purchase an additional 14 percent of Distributing's stock for \$50/share. As a result of the distribution, A receives 37 percent of the stock of Controlled, and exchanges his option for two options: one to purchase 14 percent of Distributing's stock for \$25/share and one to purchase 14 percent of Controlled's stock for \$25/share. Assume further that immediately after the distribution, a shareholder in A's position would pay \$30/share for the 14 percent of Distributing's or Controlled's stock, but a shareholder that owned no Distributing or Controlled stock would pay only \$20/share. Under these facts, the example in the regulations states that it is reasonably certain that A will exercise his option, because the control premium must be taken into account (i.e., A has an option to purchase shares at \$25/share for which A would pay \$30/share).<sup>129</sup> This example seems to indicate that if the option may be exercised at a 16.67 percent discount (i.e., a \$25/share exercise price for the \$30/share value of Distributing stock), the option will be reasonably certain to be exercised -- at least where the exercise would give the holder control.

F. Purchase: Treas. Reg. § 1.355-6(d)

1. In General

In general, section 355(d) will not apply unless stock in Distributing or Controlled is acquired by "purchase" during the five-year period.<sup>130</sup> Section 355(d)(5)(A) defines "purchase" as any acquisition, but only if (1) the basis of the property acquired in the hands of the acquirer is not determined by reference to the basis of the property in the hands of the

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<sup>129</sup> Id.

<sup>130</sup> Section 355(d)(3).

transferor (or under section 1014(a)<sup>131</sup>), and (2) the property is not acquired in an exchange to which section 351, 354, 355, or 356 applies.<sup>132</sup>

Even if an acquisition is structured as a direct purchase for cash, if an acquisition is treated as a carryover basis transaction under another section of the Code, the acquisition will not be a purchase under section 355(d).<sup>133</sup> Thus, for example, assume Individual A owns all the stock of P and T, and A sells all of his T stock to P for cash. Section 304 treats this transaction as if A had transferred the T stock to P in exchange for stock of P in a section 351 transaction, and then P redeemed the P stock issued in the transaction. Under section 362(a), P's basis in the T stock is determined by reference to A's basis in the T stock. Thus, P's purchase of the T stock from A for cash is not treated as a purchase under section 355(d).<sup>134</sup>

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<sup>131</sup> Section 1014(a) provides for a fair market value basis when receiving property from decedents.

<sup>132</sup> Section 355(d)(5)(A); Treas. Reg. § 1.355-6(d)(1)(i). In a section 351 transaction, the “property” referred to in section 355(d)(5)(A) appears to be the property transferred by the shareholder to the corporation. But see section 355(d)(5)(B), discussed in Part IV.F.5., infra, in which the “property” referred to appears to be the stock transferred by the corporation to the shareholder.

<sup>133</sup> Treas. Reg. § 1.355-6(d)(1)(iii).

<sup>134</sup> Id.

2. Receipt of Boot

a. Treatment of Transferor

Under the regulations, the fact that a shareholder receives boot in a section 351 transaction or a corporate transferor receives boot in a reorganization (the shareholder and the corporate transferor collectively referred to in this section as “transferor”) will generally not affect whether the acquisition is a purchase under section 355(d), as long as section 358(a)(1) applies to determine the transferor’s basis in the stock received.<sup>135</sup> The Service included this rule despite legislative history that suggested that transferors should be treated as purchasing stock if they receive boot in a reorganization.<sup>136</sup> The legislative history indicated that purchase treatment was necessary because the basis in the acquiring corporation stock received by the transferor is increased by the gain the shareholder recognizes.<sup>137</sup> However, the Service correctly noted in the Preamble to the proposed regulations that the basis in the stock received by the transferor is also reduced by the amount of boot received.<sup>138</sup>

Thus, if in a section 351 transaction or a reorganization, a transferor receives boot in addition to stock of the transferee corporation, the acquisition of transferee stock will generally not be a purchase -- even though the transferor recognizes gain under section 351(b) or 356.<sup>139</sup> However, if the transferor receives nonqualified preferred stock or stock in a third

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<sup>135</sup> Treas. Reg. § 1.355-6(d)(2)(i).

<sup>136</sup> See Conference Report, at 1092.

<sup>137</sup> Id.

<sup>138</sup> Preamble to Prop. Treas. Reg. § 1.355-6, Fed. Reg. at 23,556; see section 358(a)(1).

<sup>139</sup> But see Part IV.F.5., infra (discussing certain section 351 exchanges treated as purchases).

corporation as boot in a section 351 transaction or a reorganization, the transferor is treated as purchasing such stock on the date of the section 351 exchange or reorganization (because the transferor receives a fair market value basis in such stock).<sup>140</sup>

b. Treatment of Transferee

Similar to the treatment of transferors, transferee corporations in section 351 transactions and reorganizations are generally not treated as purchasing stock received to the extent section 362(a) or (b) (or section 334(b)) applies to determine the transferee's basis in the stock received.<sup>141</sup> Thus, if a transferor contributes stock of D Corporation to P Corporation in exchange for P stock in a section 351 transaction, P will not be treated as purchasing the D stock, because P's basis in the D stock is determined under section 362(a).<sup>142</sup> However, to the extent the transferee's basis in the stock received is increased through the recognition of gain by the transferor, the stock is treated as purchased on the date of the stock acquisition.<sup>143</sup> Thus, if the transferor in the previous example contributes the stock of D to P in exchange for P stock (worth \$90) and \$10 cash in a transaction qualifying under section 351, P will be treated as having purchased 10 percent of the D stock on the date of the section 351 exchange and the remaining 90 percent of the D stock when the transferor purchased such stock.<sup>144</sup>

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<sup>140</sup> Treas. Reg. § 1.355-6(d)(2)(i)(A)(2), (C), Ex.1(ii); see sections 351(g) and 356(e).

<sup>141</sup> Treas. Reg. § 1.355-6(d)(2)(i)(B)(1).

<sup>142</sup> But see Part IV.F.5., infra (discussing certain section 351 exchanges treated as purchases).

<sup>143</sup> Treas. Reg. § 1.355-6(d)(2)(i)(B)(2). The same rule applies if a liquidating corporation recognizes gain or loss under section 334(b)(1). Id.

<sup>144</sup> Treas. Reg. § 1.355-6(d)(2)(i)(C), Ex.2.

3. Stock Received in Certain Transactions

a. Section 355 Distributions

In general, stock received in a section 355 transaction, whether a spin-off, split-off, or split-up, is not treated as purchased.<sup>145</sup> However, if Distributing distributes Controlled stock with respect to “recently purchased” Distributing stock in a section 355 transaction, the Controlled stock is deemed to be purchased by the distributee on the date the distributee acquired the recently purchased Distributing stock.<sup>146</sup> Distributing stock is recently purchased if it was purchased by the distributee during the five-year period with respect to that distribution.<sup>147</sup>

b. Section 305 Distributions

In general, stock received in a section 305 distribution (i.e., distributions received by a corporation’s shareholders from such corporation with respect to such corporation’s stock) is not treated as a purchase to the extent section 307(a) applies to determine the recipient’s basis.<sup>148</sup> However, the stock received by the shareholder in the section 305 distribution will be treated as purchased on the date the shareholder purchased the stock with respect to which the distribution was made.<sup>149</sup>

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<sup>145</sup> Treas. Reg. § 1.355-6(d)(1)(ii).

<sup>146</sup> Treas. Reg. § 1.355-6(e)(4)(i).

<sup>147</sup> Id. For purposes of this definition, stock acquired solely by reason of the deemed purchase rule is not treated as recently purchased stock. Id.

<sup>148</sup> Treas. Reg. § 1.355-6(d)(2)(ii).

<sup>149</sup> Treas. Reg. § 1.355-6(e)(4)(ii).

c. Section 1036 Exchanges

An exchange of common stock for common stock, or preferred stock for preferred stock, under section 1036(a) is not treated as a purchase by either party to the exchange to the extent the basis of the property acquired equals that of the property exchanged under section 1031(d).<sup>150</sup>

d. Section 338 Elections

Stock acquired in a qualified stock purchase with respect to which a section 338 or 338(h)(10) election is made is not treated as a purchase.<sup>151</sup> However, any stock held by the old target that is deemed purchased by the new target by reason of section 338 is treated as purchased for purposes of section 355(d), unless a section 338 or 338(h)(10) election is also made for that stock.<sup>152</sup>

4. Transferred Basis Rule

If a person acquires property from another person who purchased such property (without regard to the attribution or aggregation rules discussed in Part IV.F.7. below), and the acquirer's basis in the acquired property is determined by reference to the transferor's basis in such property, the acquirer is treated under the regulations as having purchased the property on the date the transferor originally purchased such property.<sup>153</sup> Thus, if Individual A purchases

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<sup>150</sup> Treas. Reg. § 1.355-6(d)(2)(iii).

<sup>151</sup> Treas. Reg. § 1.355-6(d)(2)(iv). This represents a change from the proposed regulations. See Prop. Treas. Reg. § 1.355-6(d)(1)(iii), Ex.2.

<sup>152</sup> Treas. Reg. § 1.355-6(d)(2)(iv).

<sup>153</sup> Treas. Reg. § 1.355-6(e)(2). However, to the extent the basis of the stock is increased through the recognition of gain by the transferor under section 362(a) or (b), the stock is treated

(Continued ...)

stock of D Corporation on January 1, 2001 and contributes such stock to P Corporation in a section 351 transaction on January 1, 2002, P will be treated as having purchased the D stock on January 1, 2001.

5. Exchanged Basis Rule

If a person acquires an interest in an entity by purchase (without regard to the attribution or aggregation rules discussed in Part IV.F.7. below), and such interest is exchanged for an interest in a second entity where the adjusted basis of the second interest is determined in whole or in part by reference to the adjusted basis of the first interest, then the second interest is treated under the regulations as having been purchased on the date the first interest was purchased.<sup>154</sup> Thus, if Individual A purchases stock of D Corporation on January 1, 2001, and contributes such stock to P Corporation in exchange for P stock in a section 351 transaction on January 1, 2002, A will be treated as having purchased the P stock on January 1, 2001.

6. Certain Section 351 Exchanges Treated as Purchases

a. In General

Notwithstanding the general rule that the term “purchase” does not include property acquired in a section 351 transaction, the Code and regulations provide that the term “purchase” does include property (i.e., stock) acquired by the transferor in a section 351 transaction to the extent such stock is acquired in exchange for any cash or cash item, any

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as purchased by the acquirer on the date of the stock acquisition. Id.; see Treas. Reg. § 1.355-6(d)(2)(i)(B)(2).

<sup>154</sup> Treas. Reg. § 1.355-6(e)(3). However, to the extent nonqualified preferred stock or stock in a third corporation is received as boot, such stock is treated as purchased on the date of the exchange. Id.; see Treas. Reg. § 1.355-6(d)(2)(i)(A)(2), discussed in Part IV.F.2.a., supra.

marketable stock, or any debt of the transferor (the “Cash/Stock/Debt Rule”).<sup>155</sup> Thus, if Individual A contributes \$60 cash, \$30 worth of real estate, and \$10 worth of equipment to P in exchange for 100 percent of P’s stock, A is treated as purchasing 60 percent of P’s stock on the date of the exchange (i.e., the amount of P stock attributable to the cash), but is not treated as purchasing the remaining 40 percent of P’s stock.<sup>156</sup>

b. Exceptions

Under the regulations, there are three exceptions to the Cash/Stock/Debt Rule:

(1) transfers to holding companies; (2) transfers of assets as part of an active trade or business; and (3) transfers between members of the same affiliated group.

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<sup>155</sup> Treas. Reg. § 1.355-6(d)(3)(i); see section 355(d)(5)(B). The terms “cash item” and “marketable stock” include actively traded personal property under section 1092(d)(1) and Treas. Reg. § 1.1092-1 (without regard to section 1092(d)(3)). Treas. Reg. § 1.355-6(d)(3)(ii).

As discussed in note 131, supra, in a section 351 transaction, the “property” referred to in the general rule of section 355(d)(5)(A) (general definition of purchase) appears to be the property transferred by the shareholder to the corporation. However, the “property” referred to in section 355(d)(5)(B) (section 351 transaction treated as a purchase) appears to be the stock transferred by the corporation to the shareholder. There is no explanation for this inconsistency. Query whether the term “property” in section 355(d)(5)(B) can also refer to the property transferred by the shareholder to the corporation. Although it does not appear that Congress intended this result, technically the provision could apply to a corporation that receives stock from its shareholder in exchange for such corporation’s stock plus cash, marketable stock, or debt. However, all of the examples in the regulations that illustrate the application of section 355(d)(5)(B) and Treas. Reg. § 1.355-6(d)(3) treat the term “property” as referring to the stock transferred by the corporation to the shareholder. See Treas. Reg. §§ 1.355-6(d)(3)(iii)(B); -6(d)(3)(v)(B), Ex.1 and 2; -6(d)(4)(iii); -6(d)(5)(iii); -6(d)(6)(iii).

<sup>156</sup> If A had received both P stock and P securities in the exchange, the amount of stock or securities purchased would be allocated based on their relative fair market values consistent with the section 358 regulations. Treas. Reg. § 1.355-6(d)(3)(i)(B); see Treas. Reg. § 1.358-2(b).

(i) Transfers to Holding Companies

Under the regulations, if the transferor transfers marketable stock of a corporation in an amount that meets the requirements of section 1504(a)(2), the transferor will not be treated as purchasing the stock of the transferee.<sup>157</sup> Thus, if the public shareholders of P Corporation, acting pursuant to a plan or arrangement, transfer all the stock of P to D Corporation in exchange for all of the stock of D, the public shareholders of P will not be treated as purchasing the D stock, because they have transferred at least 80 percent (by vote and value) of the D stock.<sup>158</sup>

(ii) Transfers of Assets as Part of an Active Trade or Business

Under the regulations, the Cash/Stock/Debt Rule does not apply if: (1) the transferor is engaged in the active conduct of a trade or business, and the transferred items (i.e., the cash, marketable stock, or debt) are used in such trade or business; (2) the transferred items do not exceed the reasonable needs of the trade or business; (3) the transferor transfers the items as part of the trade or business; and (4) the transferee continues the active conduct of the trade or business.<sup>159</sup> In general, whether this exception applies depends on the facts and

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<sup>157</sup> Treas. Reg. § 1.355-6(d)(3)(iii). The section 1504(a)(2) requirement is met if the transferor possesses at least 80 percent of the total voting power of the stock of the corporation, and has a value equal to at least 80 percent of the total value of the stock of such corporation. Note that to qualify as a section 351 transaction, section 368(c) applies to determine control (i.e., 80 percent of the voting power and 80 percent of each class of nonvoting stock).

<sup>158</sup> See Treas. Reg. §§ 1.355-6(d)(3)(iii)(B); -6(c)(4). But see Part IV.F.4., supra, discussing Treas. Reg. § 1.355-6(e)(3) (exchanged basis rule). The American Bar Association had suggested that stock transfers to holding companies be excepted from the Cash/Stock/Debt Rule by providing a rule that tested marketability after the transaction.

<sup>159</sup> Treas. Reg. § 1.355-6(d)(3)(iv)(A); see also Conference Report, at 1093 (stating that regulations should not treat stock as purchased if items are transferred as part of an active trade or business, and such items do not exceed the reasonable needs of the trade or business). This exception only applies if the exception in Part IV.F.5.b.i., supra (transfers to holding companies) does not apply. Treas. Reg. § 1.355-6(d)(3)(iv)(A).

circumstances.<sup>160</sup>

Whether the transferor is engaged in the active conduct of a trade or business is determined under the section 355(b) regulations, with some modifications.<sup>161</sup> Whether the transferred items exceed the reasonable needs of the trade or business is tested at the time of transfer. The reasonable needs of a trade or business:

include only the amount of cash or cash items, marketable stock, or debt of the transferor that a prudent business person apprised of all relevant facts would consider necessary for the present and reasonably anticipated future needs of the business. Transferred items may be considered necessary for reasonably anticipated future needs only if the transferor and the transferee have specific, definite, and feasible plans for their use. Those plans must require that items intended for anticipated future needs rather than present needs be used as expeditiously as possible consistent with the business purpose for retention of the items. Future needs are not

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<sup>160</sup> Treas. Reg. § 1.355-6(d)(3)(iv)(D).

<sup>161</sup> Treas. Reg. § 1.355-6(d)(3)(iv)(B); see Treas. Reg. § 1.355-3(b)(2) and (3). The regulations modify the section 355(b) regulations, stating that for purposes of section 355(d): (1) conduct is to be tested before the transfer with respect to the transferor, and after the transfer with respect to the transferee; and (2) the trade or business need not be conducted for five years prior to the transfer (but it “must have been conducted for a sufficient period of time to establish that it is a viable and ongoing trade or business”). Treas. Reg. § 1.355-6(d)(3)(iv)(B)(1) and (2).

In general, under the section 355(b) regulations, a corporation is treated as engaged in a trade or business if a specific group of activities is being carried out for the purpose of earning income or profit, and the activities include every operation that forms a part of, or a step in, the process of earning income or profit. Treas. Reg. § 1.355-3(b)(2)(ii). This group of activities “ordinarily must include the collection of income and the payment of expenses.” Id. In addition, under the section 355(b) regulations, the determination of whether a business is actively conducted is based on the facts and circumstances, but the corporation is generally required to perform active and substantial management and operational functions. Treas. Reg. § 1.355-3(b)(2)(iii). The Service has ruled that one managerial employee and one operating employee are sufficient. Rev. Rul. 73-234, 1973-1 C.B. 180, distinguished Rev. Rul. 86-126, 1986-2 C.B. 58; see also Rev. Rul. 92-17, 1992-1 C.B. 142 (providing rules for conducting active businesses through partnerships).

reasonably anticipated if they are uncertain or vague or where the execution of the plan for their use is substantially postponed.<sup>162</sup>

Although the anticipated future reasonable needs of the business are generally tested at the time of the transfer, events and conditions after the transfer and through the date immediately after the distribution may be considered.<sup>163</sup> Thus, to a certain extent, taxpayers may use 20/20 hindsight to prove that at the time of the transfer, the transferred items were necessary for the present and reasonably anticipated future needs of the business, and the Service may use 20/20 hindsight to prove that such items were not necessary.

Commentators had expressed concern that the requirement that the transferee continue the active conduct of the trade or business would prevent a transfer of the assets to a lower tier member within the same affiliated group.<sup>164</sup> To address this concern, the final regulations added a rule providing that the transfer of the business assets to another member of the transferee's affiliated group will not preclude the use of the active trade or business exception, as long as the requirements for the exception would have been met if the transferor had transferred the assets directly to the final transferee.<sup>165</sup>

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<sup>162</sup> Treas. Reg. § 1.355-6(d)(3)(iv)(C). These standards for determining whether transferred items exceed the reasonable needs of the trade or business are similar to standards set forth in the accumulated earnings tax ("AET") regulations. See Treas. Reg. § 1.537-1. Presumably, the Service will use AET standards in determining whether transferred items exceed the reasonable needs of the trade or business under section 355(d).

<sup>163</sup> Treas. Reg. § 1.355-6(d)(3)(iv)(C).

<sup>164</sup> Preamble to Treas. Reg. § 1.355-6, 65 Fed. Reg. at 79,721.

<sup>165</sup> Treas. Reg. § 1.355-6(d)(3)(iv)(E).

(iii) Transfers Between Members of the Same Affiliated Group

Under the regulations, the Cash/Stock/Debt Rule does not apply if (1) the transferor(s) and transferee are members of the same affiliated group<sup>166</sup> before the section 351 transaction (if the transferee is in existence prior to the transaction), (2) the cash, marketable stock, or debt was not acquired by the transferor (or another member of the transferor's affiliated group) from a nonmember in a related transaction in which section 362(a) or (b) applies to determine the basis in the acquired assets, and (3) the transferor(s), transferee, and any distributed controlled corporation do not cease to be members of such affiliated group in any transaction pursuant to a plan that includes the section 351 transaction (including any distribution of Controlled).<sup>167</sup>

Thus, assume P Corporation owns all the stock of D Corporation and contributes cash to D equal to 60 percent of the value of D in a section 351 transaction. Assume further that within five years after the cash contribution, D contributes assets to a newly formed controlled corporation, C Corporation, and distributes its C stock to its sole shareholder, P in a section 355(a) transaction. Under these facts, the regulations conclude that P's cash contribution to D is

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<sup>166</sup> Corporations are members of the same affiliated group if they are members of the same affiliated group under section 1504(a). See Treas. Reg. § 1.355-6(d)(3)(v)(A)(1).

<sup>167</sup> Treas. Reg. § 1.355-6(d)(3)(v)(A). But see Part IV.F.4., supra, discussing Treas. Reg. § 1.355-6(e)(3) (exchanged basis rule). This exception only applies if the exceptions in Parts IV.F.5.b.i., supra (transfers to holding companies) and IV.F.5.b.ii., supra (transfers of assets as part of an active trade or business) do not apply. Id. In addition, this exception does not apply if the section 351 transaction has a principal purpose to avoid the purposes of section 355(d). Treas. Reg. § 1.355-6(d)(3)(v)(A), (B), Ex.2; see Preamble to Prop. Treas. Reg. § 1.355-6, 64 Fed. Reg. at 23,557; see also Part IV.D., supra.

not treated as a purchase of D stock, because P, D, and C do not cease to be members of the affiliated group at any time.<sup>168</sup>

7. Triangular Reorganizations and Group Structure Changes

a. Triangular Asset Reorganizations

The regulations provide special purchase rules for “triangular asset reorganizations.”<sup>169</sup> A triangular asset reorganization is defined as: (1) a forward subsidiary merger under section 368(a)(2)(D); (2) a reverse subsidiary merger under section 368(a)(2)(E), unless the transaction also qualifies as either a section 351 transfer or a B reorganization; or (3) a C reorganization, if stock of the parent corporation rather than the acquiring subsidiary corporation is exchanged for the target corporation’s properties.<sup>170</sup>

For purposes of section 355(d), the regulations generally treat a triangular asset reorganization as if the parent corporation (1) acquired the assets and assumed the liabilities of the target corporation in a transaction in which the parent corporation’s basis in the assets of the

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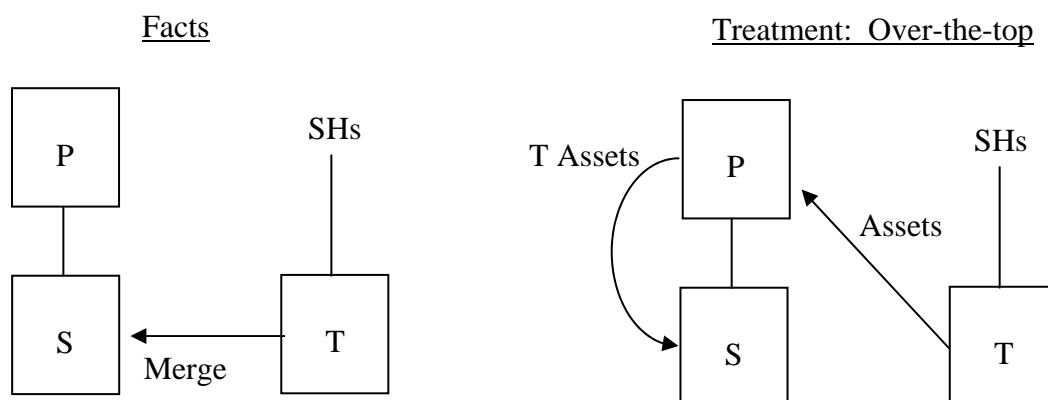
<sup>168</sup> See Treas. Reg. § 1.355-6(d)(3)(v)(B), Ex.1. This example highlighted a technical problem with the proposed regulations. The proposed regulations stated that the transferor(s), the transferee, and the distributed controlled corporation had to be members of the same affiliated group before the section 351 transaction. See Prop. Treas. Reg. § 1.355-6(d)(3)(v)(A). In the example, P, D, and C are not members of the same affiliated group before the section 351 transaction because C was not in existence. Nevertheless, the example in the proposed regulations reached the appropriate result. The final regulations deleted the reference to the distributed controlled corporation, thus clarifying that C need not be in existence prior to the section 351 transaction.

<sup>169</sup> Treas. Reg. § 1.355-6(d)(4).

<sup>170</sup> Treas. Reg. § 1.355-6(d)(4)(i).

target corporation is determined under section 362(b), and (2) transferred the acquired assets and liabilities to the subsidiary in a section 351 transfer.<sup>171</sup>

Example 16: Triangular Asset Reorganizations



Facts: P owns all the stock of S. Unrelated T merges with and into S in a section 368(a)(2)(D) forward subsidiary merger, with T's shareholders receiving P stock in exchange for their T stock.

The regulations treat this transaction as if T transferred its assets to P in a transaction in which P's basis in the T assets are determined under section 362(b), and P transferred such assets to S in a section 351 transaction.<sup>172</sup> The general rules and exceptions discussed in Part IV.F.5. above apply to determine whether P will be treated as purchasing any of the stock of S as a result of the section 351 transaction.

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<sup>171</sup> Treas. Reg. § 1.355-6(d)(4)(ii).

<sup>172</sup> See Treas. Reg. § 1.355-6(d)(4)(iii). The same treatment applies if S merges into T in a reverse subsidiary merger under section 368(a)(2)(E), if such reverse subsidiary merger does not also qualify as a B reorganization (e.g., if T's shareholders receive a small amount of cash in addition to P stock) or a section 351 transaction (e.g., if T's shareholders do not control P after the transaction).

b. Reverse Subsidiary Mergers That Also Qualify As B Reorganizations or Section 351 Transactions

(i) In General

The regulations also provide a special rule for reverse subsidiary mergers under section 368(a)(2)(E) that also qualify as B reorganizations or section 351 transactions.<sup>173</sup> Under this special rule, if a reverse subsidiary merger under section 368(a)(2)(E) also qualifies as a B reorganization or section 351 transfer, then the total amount of stock treated as purchased by the parent corporation will be the higher of: (1) the amount of stock that would be treated as purchased under the triangular asset reorganization rule described in Part IV.F.6.a. above;<sup>174</sup> or (2) the amount of stock that would be treated as purchased under the transferred basis rule described in Part IV.F.3. above.<sup>175</sup>

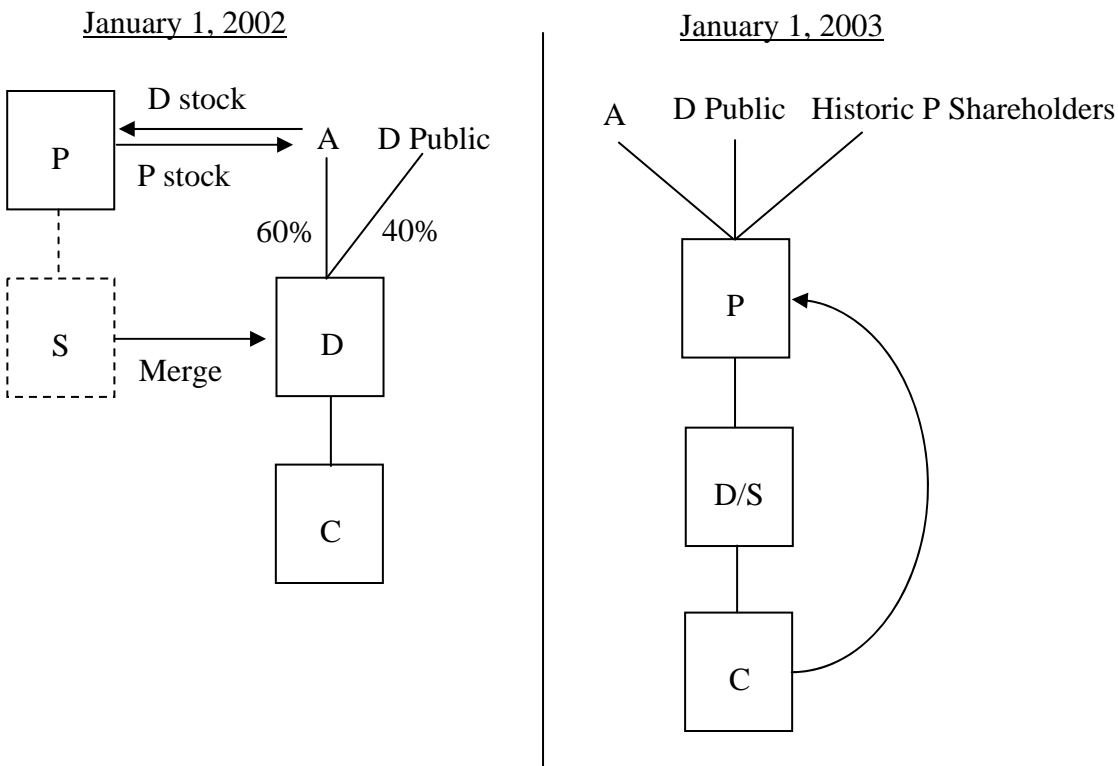
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<sup>173</sup> Treas. Reg. § 1.355-6(d)(5). This special rule is necessary because under the section 358 and consolidated return regulations, a controlling corporation may choose from two alternative methods in determining its basis in triangular reorganizations, but need not choose such method until a basis determination is relevant. Preamble to Prop. Treas. Reg. § 1.355-6, 64 Fed. Reg. at 23,557; see Treas. Reg. §§ 1.358-6(c)(2)(ii); 1.1502-30(b).

<sup>174</sup> Under the triangular asset reorganization rule, as modified by Treas. Reg. § 1.355-6(d)(5)(i)(A), the reorganization is treated as if the parent corporation acquired the target corporation's assets in a transaction in which the parent's basis in the target's assets is determined under section 362(b), and then transferred the target's assets to the surviving corporation in a section 351 transaction.

<sup>175</sup> Under the transferred basis rule, the parent corporation is treated as purchasing the stock of the target corporation at the time the target shareholders purchased their target stock. Treas. Reg. § 1.355-6(e)(2).

Example 17: Reverse Subsidiary Merger



Facts: Individual A purchases 60 percent of the stock of D on January 1, 2001. The remaining 40 percent of the stock of D has been held by public shareholders for over five years. D, which owns no marketable stock or debt, holds cash that represents 20 percent of its value that is not used in its trade or business. On January 1, 2002, P forms S, and S merges into D in a section 368(a)(2)(E) reverse subsidiary merger that also qualifies as a B reorganization. In the reorganization, P receives all of D's stock in exchange solely for P stock. On January 1, 2003, D distributes its wholly owned subsidiary, C, to P.<sup>176</sup>

Because the reverse subsidiary merger in this example also qualifies as a B reorganization, P will be treated as purchasing the stock of D in an amount equal to the higher of:

(1) the amount of D stock that would be treated as purchased under the triangular asset

<sup>176</sup> See Treas. Reg. § 1.355-6(d)(5)(iii), Example (i).

reorganization rule; or (2) the amount of D stock that would be treated as purchased under the transferred basis rule.

Under the triangular asset reorganization rule, P is treated as if it acquired D's assets in a transaction in which its basis in D's assets is determined under section 362(b), and then transferred such assets to D in a section 351 transaction. Under the section 351 rules discussed above, P would be treated as acquiring 20 percent of the D stock by purchase on January 1, 2002, because that is the portion attributable to D's cash. (The remaining 80 percent is not treated as purchased because it is not received in exchange for cash, marketable stock, or debt of the transferor under Treas. Reg. § 1.355-6(d)(3).)<sup>177</sup> Under the transferred basis rule, P is treated as acquiring 60 percent of the D stock by purchase on January 1, 2001, because P acquired 60 percent of the D stock from A, who purchased such stock on January 1, 2001. Thus, under the special rule for reverse subsidiary mergers that also qualify as B reorganizations or section 351 transactions, P will be treated as purchasing 60 percent of the D stock on January 1, 2001 -- the higher of the 20 percent treated as purchased under the triangular asset reorganization rule, and the 60 percent treated as purchased under the transferred basis rule.<sup>178</sup>

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<sup>177</sup> In this example in the regulations, the Service cites Treas. Reg. § 1.355-6(d)(3)(iv) (the active trade or business exception) in arriving at the conclusion that P is treated as having purchased 20 percent of the D stock under the triangular asset reorganization rule. See Treas. Reg. § 1.355-6(d)(5)(iii), Example (i). It is unclear why the Service cites the active trade or business exception, since such exception does not apply to the remaining 80 percent of D stock received by P in exchange for D's non-cash assets (since such assets are not cash, marketable stock, or debt). The Service should clarify the reason for its reference to the active trade or business exception.

<sup>178</sup> *Id.* This "higher of" rule may be to a taxpayer's advantage. For example, assume that Individual A in the above example purchases its 60 percent interest in D on December 31, 1995, and D holds cash not used in its trade or business that represents 55 percent of its value. Under the Service's analysis, P will be treated as purchasing the higher of 55 percent of the stock of D on January 1, 2002 under the triangular asset reorganization rule, or 60 percent of the stock of D

(Continued ...)

(ii) Exception

Notwithstanding the general rule that the amount treated as purchased is the greater of the amount determined under the triangular asset reorganization rule and the amount determined under the transferred basis rule, if the parent corporation obtains a letter ruling from the Service and enters into a closing agreement under section 7121 in which the parent corporation agrees to determine its basis using the over-the-top method in Treas. Reg. § 1.358-6(c)(2)(ii)(A) (i.e., an asset acquisition followed by a drop of such assets to a subsidiary), then the parent corporation will be treated as purchasing the amount of stock that would be treated as purchased under the triangular asset reorganization rule.<sup>179</sup> Thus, in Example 17 above, if P

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on December 31, 1995 under the transferred basis rule. Thus, when C is distributed on January 1, 2003, section 355(d) apparently would not apply, as the distribution is not within five years of the December 31, 1995 purchase. (Note, however, that section 355(e) could apply to impose a corporate-level tax on this transaction, as P has acquired stock representing a 50-percent or greater interest in D within two years of D's distribution of C.) If only the triangular asset reorganization rule had applied, P would have been treated as purchasing 55 percent of D on January 1, 2002, and section 355(d) would have applied.

Query whether the "higher of" rule would apply even if A had purchased its P stock more than five years prior to the reverse subsidiary merger. Thus, assume that in the example in the previous paragraph, A had purchased its 60 percent interest in D on January 1, 1992. Will the Service treat P as purchasing the higher of 55 percent of the stock of D on January 1, 2002 under the triangular asset reorganization rule, or 60 percent of the stock of D on January 1, 1992 under the transferred basis rule? If so, section 355(d) will not apply. The Service would seemingly argue that any purchases more than five years prior to the reverse subsidiary merger are not treated as purchases for purposes of Treas. Reg. § 1.355-6(d)(5).

<sup>179</sup> Treas. Reg. § 1.355-6(d)(5)(ii); see P.L.R. 9620014 (Feb. 14, 1996) (requiring the taxpayer to enter into a closing agreement with the Service, agreeing to determine its basis using the over-the-top method, in order to receive ruling that section 355(d) did not apply). Alternatively, if the parent corporation obtains a letter ruling from the Service and enters into a closing agreement under section 7121 in which the parent corporation agrees to determine its basis using the method in Treas. Reg. § 1.358-6(c)(2)(ii)(B), then the parent corporation will be treated as purchasing the amount of stock that would be treated as purchased under the transferred basis rule. Id. Thus, this exception allows the taxpayer to choose which rule it uses, as long as it agrees to conform its basis with such choice.

obtained a letter ruling and entered into a closing agreement, P would be treated as purchasing 20 percent of the D stock on January 1, 2002 -- the amount determined under the triangular asset reorganization rule.<sup>180</sup>

c. Group Structure Changes

The regulations also provide special rules for “group structure changes.”<sup>181</sup> A group structure change generally occurs if a corporation succeeds another corporation as the common parent of a consolidated group due to: (1) a section 368(a)(1)(F) reorganization; (2) a transfer of the common parent’s assets to an affiliated subsidiary; or (3) a reverse acquisition.<sup>182</sup> If there is a group structure change, the regulations provide that in determining the amount purchased under section 355(d), the taxpayer must use the over-the-top method, i.e., the taxpayer must treat the new common parent as having acquired the assets of the former common parent in a transaction in which the new common parent’s basis in the former common parent’s assets was determined under section 362(b), and then having transferred the acquired assets to the former common parent in a section 351 transaction (with the new and former common parent being treated as not in the same affiliated group at the time of the transfer solely for purposes of applying the affiliated group exception to the Cash/Stock/Debt rule).<sup>183</sup>

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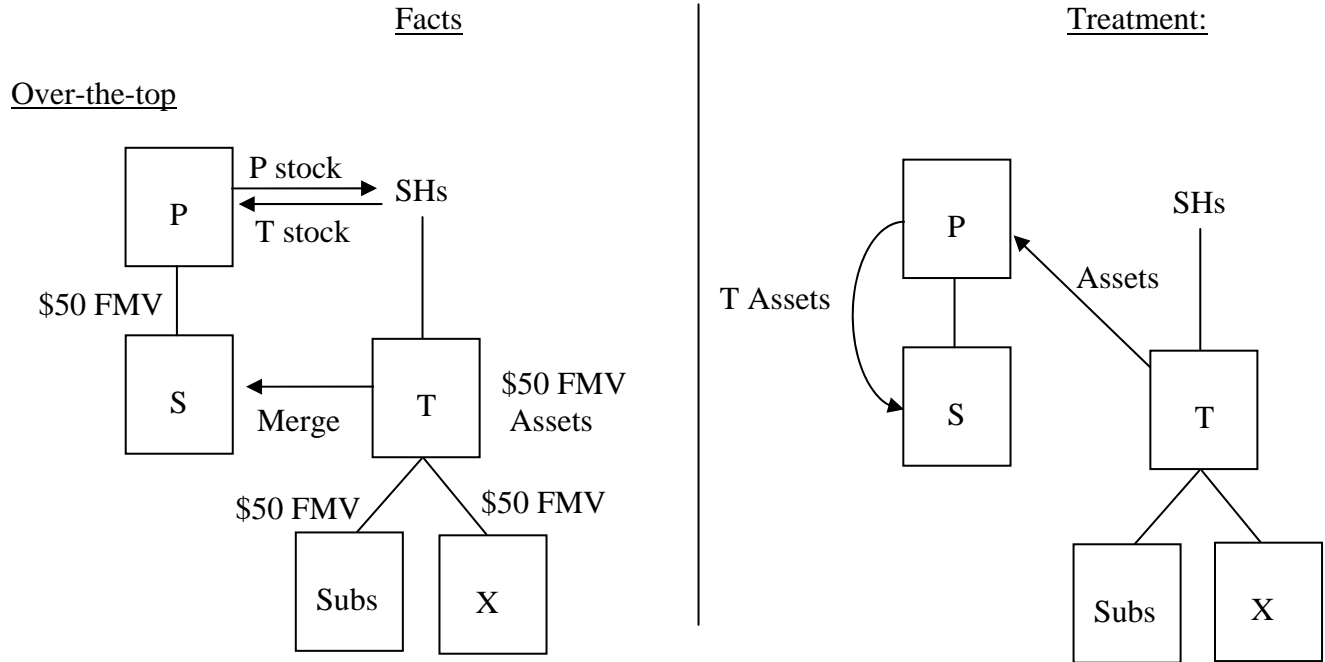
<sup>180</sup> See Treas. Reg. § 1.355-6(d)(5)(iii), Example (ii).

<sup>181</sup> See Treas. Reg. § 1.355-6(d)(6).

<sup>182</sup> Treas. Reg. §§ 1.1502-33(f)(1) and 1.1502-31; see Treas. Reg. § 1.1502-75(d)(2) and (3).

<sup>183</sup> Treas. Reg. § 1.355-6(d)(6)(i).

Example 18: Group Structure Changes



Facts: P and T are common parents of two separate consolidated groups. P has owned S for more than five years, and the fair market value of the S stock is \$50. T's assets consist of: (1) non-marketable stock of wholly owned subsidiaries with a value of \$50; (2) business assets with a value of \$50; and (3) marketable stock not used in T's business with a value of \$50. T merges into S, with T's shareholders exchanging their T stock for P stock with a value of \$150 (in a section 368(a)(2)(D) forward subsidiary merger). S will use T's business assets in its business, but will hold the \$50 of marketable stock for investment purposes. The former T shareholders will own more than 50 percent of the value of the P stock immediately after the transaction, so the transaction qualifies as a group structure change.<sup>184</sup>

Under the regulations, P is treated as having acquired the assets of T in a transaction in which P's basis in T's assets was determined under section 362(b), and then

<sup>184</sup> See Treas. Reg. § 1.355-6(d)(6)(iii).

transferred the acquired assets to S in a section 351 transaction (with P and T being treated as not in the same affiliated group at the time of the transfer). Thus, under the triangular asset reorganization rule discussed in Part IV.F.6.a. above, P is treated as purchasing 25 percent of its S stock (i.e., \$50 (the amount attributable to the marketable stock) of the \$200 total fair market value of S stock). (The remaining \$100 of value acquired from T and transferred to S is not treated as purchased, because it is not received in exchange for cash, marketable stock, or debt of the transferor under Treas. Reg. § 1.355-6(d)(3).)<sup>185</sup>

8. Attribution and Aggregation Rules

a. General Rule

The regulations provide guidance as to the mechanics of the attribution and aggregation rules of sections 355(d)(8) and (d)(7) (discussed in Part IV.E.2. above). In general, under section 355(d)(8), if a person purchases an interest in any entity, and that person is attributed stock ownership of a lower-tier entity as a result of such purchase under section 318(a) (except that stock ownership will be attributed from corporations if a person owns 10 percent of such corporation, instead of 50 percent), the attributed stock is treated as purchased on the later of: (1) the date of the purchase of the interest in the entity; or (2) the date the stock is acquired by purchase by such entity.<sup>186</sup> Thus, if Individual A purchases 30 percent of the stock of P

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<sup>185</sup> Again, the Service inexplicably cites the active trade or business exception in arriving at the conclusion that P is treated as having purchased \$50 of the S stock but is not deemed to have purchased the remaining \$150 of the S stock. See note 176, supra.

<sup>186</sup> Section 355(d)(8); Treas. Reg. § 1.355-6(e)(1)(i). Under section 318(a)(2)(C) (as modified by section 355(d)(8)), if a person owns 10 percent or more of a corporation, such person is considered as owning the stock owned directly or indirectly by such corporation, in proportion to such person's percentage interest in the corporation.

Corporation on January 1, 1999, and P Corporation had purchased all the stock of T Corporation on January 1, 1998, A is treated as purchasing 30 percent of the stock of T on January 1, 1999 (the later of the date of A's purchase of P stock and the date of P's purchase of T stock).

However, if A had purchased 60 percent of the stock of P on January 1, 1999 instead of 30 percent, and thus was aggregated with P under section 355(d)(7)(A) (as discussed in Part IV.E.2. above) and thereby treated as owning 100 percent of the stock of T, A would only be treated as purchasing 60 percent of the stock of T on January 1, 1999.<sup>187</sup> A would be treated as purchasing the remaining 40 percent of the stock of T on January 1, 1998 -- when P purchased T.<sup>188</sup>

b. Purchases of Additional Interests in Aggregated Entities

The regulations also provide that if a person and an entity are aggregated under section 355(d)(7) (i.e., they are related under section 267(b) or 707(b)(1)), and the person later purchases an additional interest in such entity, the person is treated as purchasing the additional amount attributed from the entity to the person under section 355(d)(8)(A) on the date of the later purchase.<sup>189</sup> Thus, assume that P purchased 100 percent of the stock of T Corporation on January 1, 1998. A purchases 60 percent of the stock of P Corporation on January 1, 1999 and purchases an additional 20 percent of the stock of P on January 1, 2000. When A purchases the 60 percent of P on January 1, 1999, it is treated as owning 100 percent of T, because A and P are aggregated under section 355(d)(7)(A). Thus, A is treated as purchasing 60 percent of the stock of T on January 1, 1999 and 40 percent of the stock of T on January 1, 1998. When A purchases

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<sup>187</sup> The general rule only applies to amounts attributed under section 355(d)(8)(A).

<sup>188</sup> See Treas. Reg. § 1.355-6(e)(1)(v), Ex.1.

<sup>189</sup> See Treas. Reg. § 1.355-6(e)(1)(ii).

the additional 20 percent of the stock of P on January 1, 2000, A is treated under the regulations as purchasing an additional 20 percent of the stock of T. Thus, A is treated as purchasing 20 percent of the stock of T on January 1, 2000, 60 percent of the stock of T on January 1, 1999, and 20 percent of the stock of T on January 1, 1998.

c. Purchases Between Aggregated Persons

If two persons are aggregated under section 355(d)(7) (either because they are related or they act pursuant to a plan or arrangement), and one person later purchases stock or securities from the other, then under the regulations, the acquirer is treated as purchasing the stock on the date of such purchase.<sup>190</sup> Thus, assume Individuals A and B are sisters (and therefore treated as one person under section 267(b)). Each one purchases 50 percent of the stock of P Corporation on January 1, 1999, and A sells half of her interest in P (i.e., 25 percent of the stock of P) to B on January 1, 2000. As a result, as of January 1, 2000, A owns 25 percent of the stock of P and B owns 75 percent of the stock of P. Under the regulations, B is treated as purchasing 25 percent of her P stock (i.e., the 25 percent purchased from A) on January 1, 2000.<sup>191</sup> A is treated as purchasing her remaining 25-percent interest in P, and B is treated as purchasing her original 50-percent interest in P, on the date of the original purchases, January 1, 1999.<sup>192</sup>

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<sup>190</sup> See Treas. Reg. § 1.355-6(e)(1)(iii).

<sup>191</sup> See Treas. Reg. § 1.355-6(e)(1)(v), Ex.4.

<sup>192</sup> Id.

d. Purchases of Direct Interests

If a person is attributed stock under section 318(a)(2), and such person later directly purchases such attributed stock, the person is treated as purchasing the directly purchased stock on the date of such direct purchase.<sup>193</sup> Thus, assume P Corporation purchases all of the stock of T Corporation on January 1, 1998, and Individual A purchases 30 percent of the stock of P Corporation on January 1, 1999. Assume further that A purchases 20 percent of the stock of T directly from P on January 1, 2000. When A purchased his 30-percent interest in P on January 1, 1999, he was also treated as purchasing 30 percent of the stock of T under section 355(d)(8)(A). Under the regulations, A has purchased 20 percent of the stock of T on January 1, 2000. A is also treated as having purchased 24 percent of the stock of T on January 1, 1999 (i.e., his 30-percent interest in P multiplied by P's 80-percent interest in T after P's sale to A).<sup>194</sup> This rule should only apply when A owns between 10 percent and 50 percent of P stock, as Treas. Reg. § 1.355-6(e)(1)(iii) (purchase between persons treated as one person) will apply if A and P are aggregated under section 355(d)(7).

e. Examples

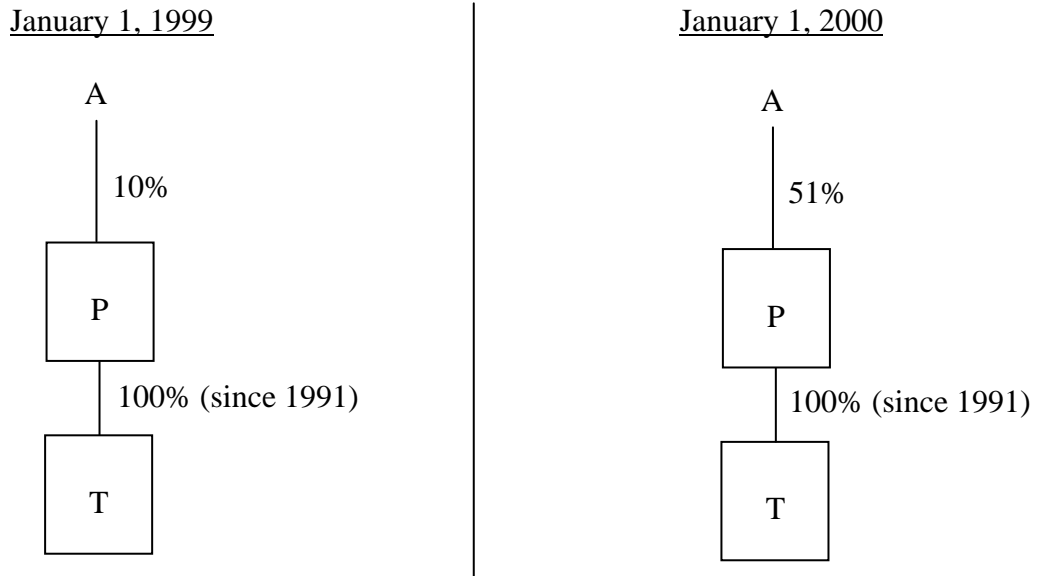
The regulations provide examples illustrating how the attribution and aggregation rules work together. This section provides a brief summary of some of these examples.

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<sup>193</sup> Treas. Reg. § 1.355-6(e)(1)(iv).

<sup>194</sup> Presumably, if P had owned only 50 percent of T, and A then purchased 20 percent of T directly from an unrelated party, such purchase would be treated as a separate 20-percent purchase of T stock by A.

Example 19: Attribution to Aggregation



Facts: Individual A purchases 10 percent of the stock of P on January 1, 1999. P has held all the stock of T since 1991. A purchases an additional 41 percent of the stock of P on January 1, 2000.<sup>195</sup>

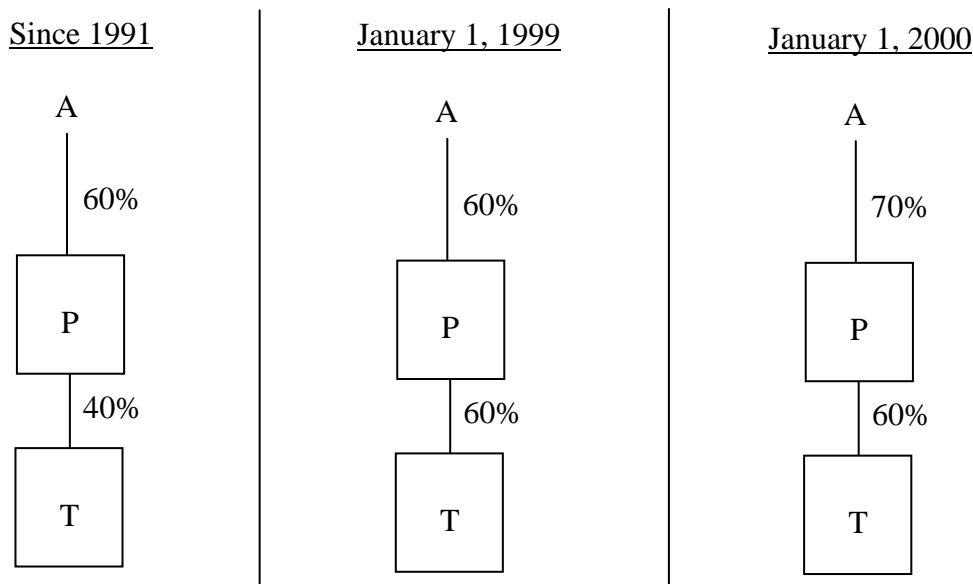
In this example, when A purchases 10 percent of the stock of P on January 1, 1999, A is also treated as purchasing 10 percent of the stock of T under section 355(d)(8)(A). When A purchases the additional 41 percent of P on January 1, 2000, A is treated as purchasing an additional 41 percent of P under section 355(d)(8)(A) on that date. However, because A holds 51 percent of the stock of P on January 1, 2000, A will be aggregated with P under section 355(d)(7)(A), and will be treated as owning all the stock of T. The additional 49 percent of T stock is treated as purchased on the date P purchased the stock of T. Thus, A is treated as

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<sup>195</sup> See Treas. Reg. § 1.355-6(e)(1)(v), Ex.1.

purchasing 41 percent of the stock of T on January 1, 2000, 10 percent of the stock of T on January 1, 1999, and 49 percent of the stock of T in 1991.

Example 20: Creeping Purchases



Facts: Individual A has owned 60 percent of the stock of P since 1991. P has held 40 percent of the stock of T since 1991. P purchases an additional 20 percent of the stock of T on January 1, 1999.<sup>196</sup> A purchases an additional 10 percent of the stock of P on January 1, 2000.<sup>197</sup>

In this example, in 1991, A is treated as owning all 40 percent of the stock of T, because A is aggregated with P under section 355(d)(7)(A). When P purchases the additional 20 percent of T stock on January 1, 1999, A is treated as purchasing an additional 20 percent of the stock of T on such date. When A purchases the additional 10 percent of P stock on January 1,

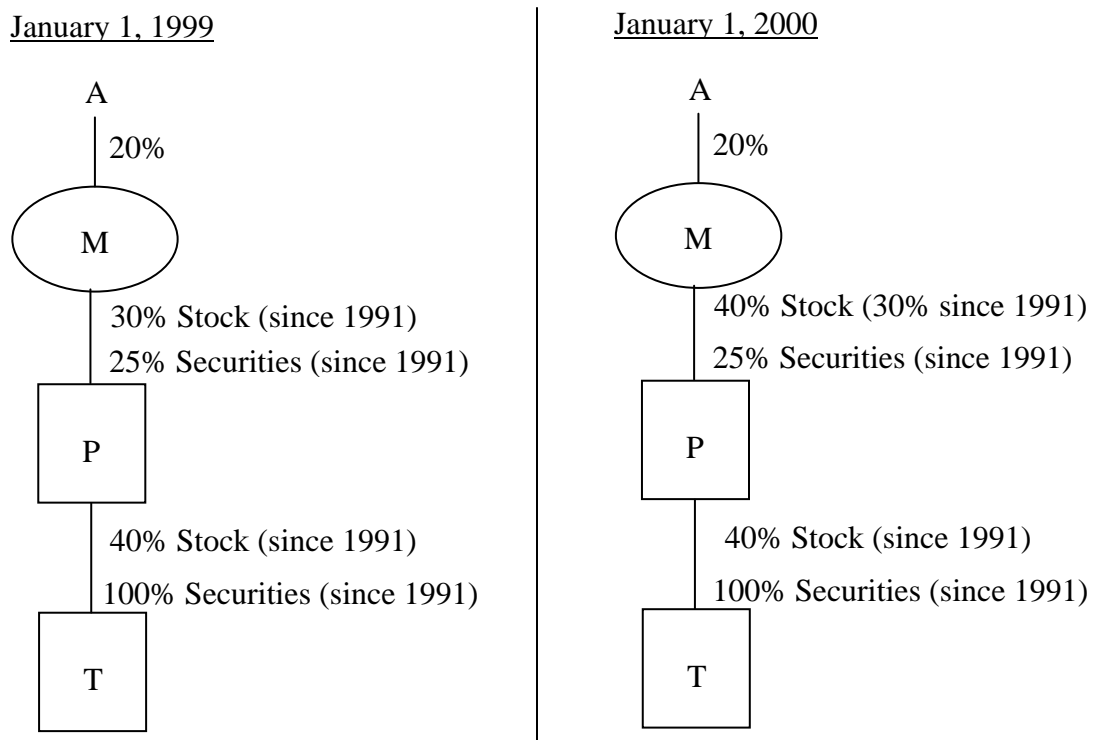
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<sup>196</sup> See Treas. Reg. § 1.355-6(e)(1)(v), Ex.1; see Conference Report, at 1090-91.

<sup>197</sup> See Treas. Reg. § 1.355-6(e)(1)(v), Ex.2; see Conference Report, at 1091.

2000, A is treated under Treas. Reg. § 1.355-6(e)(1)(ii) as purchasing the additional amount of T stock that would be attributed to A under section 355(d)(8)(A), or 6 percent (10 percent multiplied by 60 percent). Of this 6 percent, 2 percent is derived from the 20 percent purchased on January 1, 1999 (i.e., 10 percent of the 20 percent acquired on such date), and thus reduces the 20 percent treated as purchased on January 1, 1999 to 18 percent. Thus, A is treated as purchasing 6 percent of the stock of T on January 1, 2000, 18 percent of the stock of T on January 1, 1999, and the remaining 36 percent of the stock of T in 1991.

Example 21: Tiered Attribution



Facts: Individual A purchases a 20-percent interest in M Partnership on January 1, 1999. M has owned 30 percent of the stock and 25 percent of the securities of P since 1991. P has owned 40 percent of the stock and 100 percent of the securities of

T Corporation since 1991. On January 1, 2000, M purchases an additional 10 percent of the stock of P.<sup>198</sup>

In this example, M is initially treated as purchasing 12 percent of the stock of T in 1991 under section 355(d)(8)(A) (i.e., 30 percent multiplied by 40 percent). In addition, M is treated as purchasing 30 percent of the securities of T in 1991 (i.e., 30 percent multiplied by 100 percent). Upon A's purchase of 20 percent of M on January 1, 1999, A is treated under section 355(d)(8) and the regulations as purchasing 2.4 percent of the stock of T (i.e., A's 20-percent interest in M multiplied by M's 12-percent interest in the stock of T) and 6 percent of the securities of T (i.e., A's 20-percent interest in M multiplied by M's 30-percent interest in the securities of T). A is also treated on January 1, 1999 as purchasing 6 percent of the stock of P (i.e., A's 20-percent interest in M multiplied by M's 30-percent interest in the stock of P) and 5 percent of the securities of P (i.e., A's 20-percent interest in M multiplied by M's 25-percent interest in the securities of P).

When M purchases the additional 10 percent of the stock of P on January 1, 2000, M is treated as purchasing an additional 4 percent of the stock of T (i.e., 10 percent multiplied by 40 percent) and an additional 10 percent of the securities of T (i.e., 10 percent multiplied by 100 percent). As a result, A is treated on January 1, 2000 as purchasing an additional 0.8 percent of the stock of T (i.e., A's 20-percent interest in M multiplied by M's additional 4-percent interest in the stock of T) and an additional 2 percent of the securities of T (i.e., A's 20-percent interest in M multiplied by M's additional 10-percent interest in the securities of T). A is also treated on January 1, 2000 as purchasing an additional 2 percent of the stock of P (i.e., A's 20-percent

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<sup>198</sup> See Treas. Reg. § 1.355-6(e)(1)(v), Ex.3; see Conference Report, at 1091.

interest in M multiplied by M’s additional 10-percent interest in the stock of P). The following table summarizes the amounts that will be treated as purchased under section 355(d) on the various dates in this example:

		1991	Jan. 1, 1999	Jan. 1, 2000
M	T stock	12%	---	4%
	T securities	30%	---	10%
	P stock	30%	---	10%
	P securities	25%	---	---
A	T stock	---	2.4%	0.8%
	T securities	---	6%	2%
	P stock	---	6%	2%
	P securities	---	5%	---

9. Substantial Diminution of Risk

Under section 355(d)(6), if a holder’s risk of loss with respect to stock or securities of a corporation (or with respect to any portion of the activities of such corporation) is (directly or indirectly) substantially diminished for a period by an option, short sale, special class of stock,<sup>199</sup> or other device or transaction, the running of the five-year section 355(d) period is suspended during such period.<sup>200</sup> Under the regulations, whether a holder’s risk of loss is substantially diminished will be determined “based on all facts and circumstances relating to the

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<sup>199</sup> The term “special class of stock” includes “a class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to earnings, assets, or attributes of less than all the assets or activities of a corporation or any of its subsidiaries.” Treas. Reg. § 1.355-6(e)(5)(iv). For example, the term includes tracking stock and stock (or related instruments or arrangements) the terms of which provides for the distribution of any controlled corporation or other assets to the holder or to persons other than the holder. Id.

<sup>200</sup> Section 355(d)(6).

stock, the corporate activities, and arrangements for holding the stock.”<sup>201</sup> However, Congress has stated that a holder’s risk of loss will ordinarily not be considered to be substantially diminished “solely by virtue of customary indemnities given by the seller of stock.”<sup>202</sup>

G. Duty to Determine Stockholders and Presumptions: Treas. Reg. § 1.355-6(f)

The regulations provide that in determining whether section 355(d) applies to a distribution, Distributing must determine whether a disqualified person holds its stock or the stock of Controlled.<sup>203</sup> This responsibility is properly placed on Distributing, which is the entity that must report the gain if section 355(d) applies. However, where Distributing is a public company, the burden could be enormous. Fortunately, the regulations provide various rules and presumptions regarding this determination.

First, Distributing is deemed to have knowledge of the existence and contents of all schedules, forms, and other documents filed with or under the rules of the Securities and Exchange Commission (“SEC”) with respect to “any relevant corporation.”<sup>204</sup> Such documents include, for example, Schedules 13D and 13G. The regulations do not define what constitutes a relevant corporation. Presumably it includes Distributing and Controlled. Further, because Distributing will need to know if the deemed purchase rule applies, relevant corporations most likely will also include any corporate shareholder to which ownership of purchased Distributing

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<sup>201</sup> Treas. Reg. § 1.355-6(e)(5)(iii).

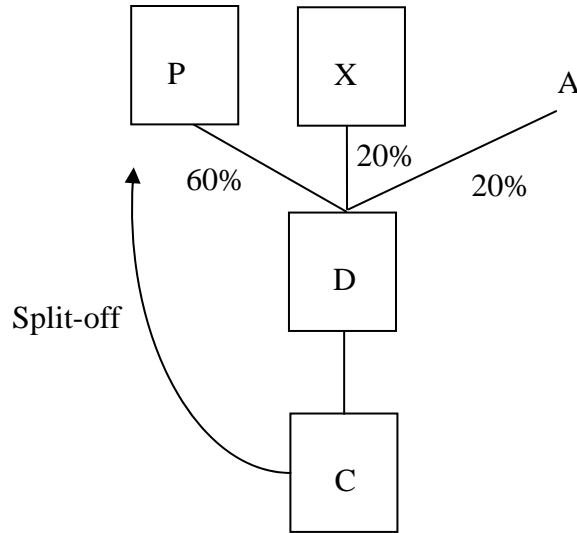
<sup>202</sup> Conference Report, at 1089.

<sup>203</sup> Treas. Reg. § 1.355-6(f)(1).

<sup>204</sup> Treas. Reg. § 1.355-6(f)(2).

or Controlled stock may be attributed. To illustrate this concept of a relevant corporation, consider the following example.

Example 21 – Relevant Corporation



Facts: X, a publicly traded corporation, owns 20 percent of the outstanding stock of D. The remaining D stock is owned 60 percent by P, a publicly traded corporation, and 20 percent by Individual A. All of D's shareholders have held their stock for more than five years. D owns all of the stock of C. D distributes its C stock to P in exchange for P's D stock.

P has increased its interest in C from a 60-percent indirect interest to a 100-percent direct interest. Although P has not purchased its interest in D within the past five years, it is possible that some of P's shareholders, to which the C stock may be attributed, have purchased their interests in P within the past five years. In order to determine whether section 355(d) applies, D would have to determine whether any of P's shareholders constitute a disqualified person. Thus, P would be a relevant corporation for purposes of Treas. Reg. § 1.355-6(f).

Next, the regulations provide two presumptions for the benefit of Distributing in meeting its duty. First, absent actual knowledge to the contrary, Distributing may presume that every shareholder or other person required to file a schedule, form, or other document with the SEC as of a given date has filed such document and that such document is accurate and complete.<sup>205</sup> However, this presumption applies only with respect to reporting stock. Reporting stock is stock described in SEC Rule 13d-1(i) of Regulation 13D.<sup>206</sup>

Second, absent actual knowledge (or deemed knowledge under Treas. Reg. § 1.355-6(f)(2)), Distributing may presume that no less-than-five-percent shareholder acquired stock by actual or deemed purchase during the five-year period.<sup>207</sup> A less-than-five-percent shareholder is a person that, at no time during the five-year period, held directly (or under the option rules) stock possessing five percent or more of the vote and value of the relevant corporation's stock. There are three exceptions to this presumption. The presumption does not apply to any less-than-five-percent shareholder that, at any time during the five-year period: (1) is related (under the aggregation rules of section 355(d)(7)(A)) to a shareholder that is not a less-than-five-percent shareholder; (2) acted pursuant to a plan or arrangement with a shareholder that is not a less-than-five-percent shareholder in acquiring stock of Distributing or Controlled; or (3) holds stock that is attributed under section 355(d)(8)(A) to a shareholder that is not a less-than-

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<sup>205</sup> Treas. Reg. § 1.355-6(f)(3).

<sup>206</sup> Id. Stock that is described in Rule 13d-1(i) is generally any equity security that is registered pursuant to section 12 of the Securities Exchange Act of 1934, or any equity security of an insurance company or a closed-end investment company. The term does not include, however, any nonvoting security.

<sup>207</sup> Treas. Reg. § 1.355-6(f)(4).

five-percent shareholder.<sup>208</sup> The final regulations clarify that the application of statistical sampling procedures to estimate the basis of shares acquired in certain reorganizations does not have the effect of giving actual knowledge of a purchase of stock beyond the sample group.<sup>209</sup>

For example, assume that Distributing distributes the stock of Controlled pro rata to its shareholders. Assume further that Distributing is a publicly traded company with a single class of reporting stock. If Distributing determines that no documents have been filed with the SEC with respect to its stock (or the stock of any relevant corporation), and it has no actual knowledge of five-percent shareholders, Distributing may presume that all of its shareholders are less-than-five-percent shareholders, and none of its shareholders acquired Distributing stock by purchase during the five-year period.<sup>210</sup> If Distributing's search of the SEC documents had come up with one shareholder, Individual A, which owns 15 percent of Distributing's stock, then Distributing may presume that A is the only five-percent shareholder that must be tested for disqualified person status, and that no other shareholder acquired Distributing stock by purchase. This presumption does not apply, however, to any shareholder that is related to A, acted pursuant to a plan or arrangement with A, or holds stock that is attributed to A.<sup>211</sup> Such shareholders would also have to be tested for disqualified person status.

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<sup>208</sup> Id.

<sup>209</sup> See Treas. Reg. § 1.355-6(f)(5), Ex.3; Preamble to Treas. Reg. § 1.355-6, 65 Fed. Reg. at 79,722.

<sup>210</sup> Treas. Reg. § 1.355-6(f)(5), Ex.1.

<sup>211</sup> Treas. Reg. § 1.355-6(f)(5), Ex.2.

On the other hand, if Distributing were not a publicly traded company and did not have reporting stock outstanding, then Distributing may rely only on one of the presumptions -- that no less-than-five-percent shareholder acquired stock by purchase. For example, if Distributing has 20 shareholders, and it knows that Individual A owns 40 percent but does not know of any other five-percent shareholders, then Distributing may presume that its less-than-five-percent shareholders (who are not related to A, did not act pursuant to a plan or arrangement with A, and do not hold stock attributed to A) did not acquire their Distributing stock by purchase. Distributing may not, however, rely on the presumption regarding timely, accurate, and complete SEC filings, because its stock is not reporting stock.<sup>212</sup>

Moreover, the presumptions survive a transferred basis transaction. For example, if an acquiring corporation acquires Distributing in a transferred basis transaction, and Distributing shortly thereafter distributes the stock of Controlled, Distributing may rely on the presumptions to determine whether section 355(d) applies as a result of pre-acquisition purchases by Distributing's former shareholders.<sup>213</sup>

The five-percent presumption is an extremely practical rule. It permits Distributing to rely on public filings to identify five-percent shareholders. Moreover, Distributing is forced to question only the five-percent shareholders, which are relatively easy to identify, with respect to the identity of less-than-five-percent shareholders who are related, acted pursuant to a plan or arrangement, or whose stock is attributed to such five-percent shareholders.

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<sup>212</sup> Treas. Reg. § 1.355-6(f)(5), Ex.4.

<sup>213</sup> Treas. Reg. § 1.355-6(f)(5), Ex.3.

However, there is no guarantee that such shareholders will reply when contacted by Distributing.

What is Distributing's duty with respect to five-percent shareholders who do not respond?

Presumably, Distributing would be required to follow up with non-responsive shareholders, but what if further contact still fails to elicit a response from the shareholder? Does the presumption that no less-than-five-percent shareholder acquired Distributing stock by purchase apply?

Should a good faith exception apply?

## **V. CONCLUSION**

Although some clarifications of the statute are still necessary, the section 355(d) regulations provide taxpayers with much needed guidance, and focus the application of section 355(d) on the abusive transactions that Congress intended to eliminate. The Service should be congratulated for issuing these excellent regulations.