

Section 355 Update

Federal Bar Association

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Significant Issue Ruling Program

- Pursuant to Rev. Proc. 2013-32, 2013-2 C.B. 55 the Service will no longer provide “no gain or loss” rulings with respect to section 355 (or sections 332, 351, 1036 or rulings on whether a transaction constitutes a reorganization within the meaning of section 368). The applicable provision is now contained in Rev. Proc. 2017-3, 2017-1 I.R.B. 130, § 3.01(51).
- The Service will instead rule only on significant legal issues under such sections.
 - A significant issue is a germane and specific issue of law, provided that a ruling on the issue would not be a comfort ruling or the conclusion in such a ruling otherwise would not be essentially free from doubt.
 - An issue is germane if resolution of the issue is necessary to determine an element of the tax treatment of the transaction. An issue is specific if it is the narrowest articulation of the germane issue. A change of circumstances arising after a transaction ordinarily does not present a significant issue with respect to the transaction
 - An issue the resolution of which is not essentially free from doubt under one Code section may nevertheless not be germane to determining the tax consequences of the transaction if, for instance, another Code section provides the same consequences as the first Code section
 - Rev. Proc. 2016-45, 2016-37 I.R.B. 344 adds the possibility of ruling on significant legal issues relating to business purpose and device provided that the issue is not inherently factual in nature.
- The Service will not issue rulings with respect to significant issues which are the subject of a no-rule position (e.g., whether a distribution and an acquisition are part of a plan under section 355(e) – see Rev. Proc. 2017-3, 2017-1 I.R.B. 130, § 3.01(54)).

Rev. Proc. 2017-52: No Gain or Loss Pilot Program Expires March 21, 2019???

- In addition to the significant issue ruling regime, a new pilot program provides for “no gain or loss rulings” with respect to transactions intended to qualify under sections 368(a)(1)(D) and 355 or under section 355(a) and 355(c) (“Covered Transactions” and such rulings with respect to them, “Transactional Rulings”).
- A Transactional Ruling may include the tax consequences of a D/355 or 355 distribution under sections 312, 355, 357, 358, 361, 362(b), 362(e), 368(a)(1)(D), 368(b), 1032(a), 1223(1) and 1223(2) and relevant consolidated return regulations.
- If a plan includes multiple D/355 transactions or section 355 distributions, a taxpayer may request a Transactional Ruling, significant issue ruling, or no ruling with respect to any of the transactions or distributions.
 - A single issue ruling as part of a Transactional Ruling, is also possible with respect to a legal device or business purpose issue. See Rev. Proc. 2017-52, § 3.03(6) (business purpose) and (7) (device). Presumably, other such single issue rulings are possible as part of a Transactional Ruling?
- All outstanding no-rules apply to any request for a Transactional Ruling or a significant issue ruling, e.g., the general issue of whether the distribution constitutes a device or whether the business purpose requirement is satisfied will not be addressed.
- Rev. Proc. 2017-52 is effective for all ruling requests postmarked, or if not mailed requests received, after September 21, 2017, and will expire March 21, 2019. Ruling requests pending when the revenue procedure became effective may elect to apply the new revenue procedure if desired.

Boot Purges and the Plan of Reorganization in Divisive Transactions

“Plan of Reorganization” – Statutory Framework

- Section 368(a)(1)(D) requires a distribution of C stock/securities “in pursuance of the plan” in a transaction that qualifies under Section 355.
- Section 361(a) provides that a corporate party to a reorganization recognizes no gain or loss on the exchange of property “in pursuance of the plan of reorganization” solely for stock or securities in another corporation that is a party to the reorganization.
- Section 361(b)(1) provides that if a corporate party to a reorganization receives money or other property (boot) from another party to the reorganization, it will not recognize gain so long as the money or other property is distributed “in pursuance of the plan of reorganization.”

“Plan of Reorganization” – Statutory Framework (cont.)

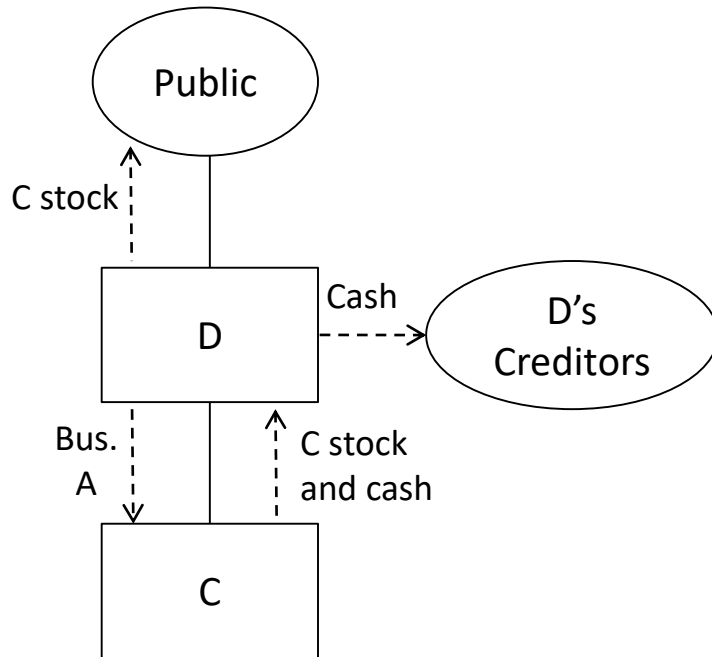
- Section 361(b)(3) provides that if any boot received in the exchange by a corporation is transferred to creditors “in connection with the reorganization,” it is treated as “a distribution in pursuance of the plan of reorganization.”
 - Limited to amounts up to the net basis of assets contributed to the transferee corporation in a divisive “D reorganization.”
- Section 361(c)(1) provides that a corporate party to a reorganization generally has no gain or loss on its distribution of “qualified property” (stock in the distributing or controlled corporation) to its shareholders “in pursuance of the plan of reorganization.”
- Section 361(c)(3) provides that the transfer of qualified property by the corporation to its creditors “in connection with the reorganization” is treated as a distribution to shareholders “pursuant to the plan of reorganization.”

“Plan of Reorganization” – Regulatory Framework

- Treas. Reg. Section 1.368-2(g):

“The term ‘plan of reorganization’ has reference to a consummated transaction specifically defined as a reorganization under Section 368(a). The term is not to be construed as broadening the definition of ‘reorganization’ as set forth in Section 368(a), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges or distributions as are directly a part of the transaction specifically described as a reorganization in Section 368(a). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of Section 368(a), but the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 368(a) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.”

Cash Boot Purge – Basic Transaction



- D contributes Business A to C, a newco, in exchange for C stock and an amount of cash that does not exceed D's basis in C.
- D distributes 100% of the C stock to its shareholders, and may distribute some of the C cash as a special dividend.
- D uses the remaining cash to repay D's creditors.
- If receipt and distribution of C cash to D's shareholders and creditors is "in pursuance of" or "in connection with" the plan of reorganization, no tax to D.

Recent Developments

- October 13, 2017 IRS statement:

“If, in connection with a section 355 distribution, a distribution of stock, securities or other property to the distributing corporation’s shareholders or creditors is substantially delayed, IRS will continue to rule on whether the delayed distribution is tax-free under section 355 or section 361. However, rulings on such issues will not be based solely on the length of the delay. Instead, IRS will rule on this issue only based on substantial scrutiny of the facts and circumstances (including the circumstances of the delay) and full consideration of the legal issues and the effects of a ruling on federal tax administration.

However, in determining whether a retention of stock or securities is in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax, within the meaning of section 355(a)(1)(D)(ii), IRS will continue to follow the guidelines in Appendix B of Rev. Proc. 96-30, even though Rev. Proc. 2017-52 has superseded Rev. Proc. 96-30. Thus, IRS will continue to rule in accordance with prior practice as to the application of section 355 to the distribution of the stock, or stock and securities, that are not retained.”

Recent Developments

- PLR 201802007
 - Cash boot used to pay down debt held by 3rd parties within e months.
 - Within f months any remaining proceeds used for stock repurchases under a buyback program adopted in connection with the distribution.
 - Representation that repaid D debt does not exceed weighted quarterly average of D debt outstanding for the 12-month period as of day before distribution.
 - Representation that D does not have a commitment to borrow an amount equal to repaid debt on same terms from same lenders.
 - IRS ruled that cash used to repay debt and used to repurchase stock treated as being distributed pursuant to a plan of reorganization for purposes of section 361(b).

Rev. Proc. 2018-53

- Only applies to satisfaction of “Distributing Debt” – noncontingent debt instruments payable in cash. Does not apply to payments to other creditors or shareholders, although the Service will issue rulings in those situations.
- Need to explain reasons for satisfaction more than 30 days after the stock distribution, with a higher burden after 180 days, and to explain reasons for any discretion as what Distributing Debt will be satisfied.

Cash Boot Purge – Legal Standards

- Is there a “Plan of Reorganization”?
 - Existing Authorities suggest yes: D’s Board has authorized a set of steps that constitute a reorganization, which has been reduced to writing. Note that a writing may not be required. *See, e.g., Redfield v. Comm’r*, 34 BTA 967 (1936); *Nat’l Bank of Commerce v. U.S.*, 87 F. Supp. 302 (W.D. Tenn. 1949).
- Are the distributions of C cash “pursuant to” / “in connection with” the plan of reorganization?
 - Case law appears to require a determination of the use of the proceeds contemporaneously with the adoption of the plan. *See Transport Products Corp. v. Comm’r*, 25 TC 853 (1956), *aff’d per curiam* 239 F.2d 859 (6th Cir. 1956); *Nat’l Bank of Commerce v. U.S.*, 87 F. Supp. 302 (W.D. Tenn. 1949).
 - However, uses in the alternative have been held to be acceptable. *See Avco Mfg. Corp. v. Comm’r*, 25 TC 975 (1956).

Cash Boot Purge – Legal Standards (cont.)

- No specific timeframe to complete transactions contemplated by “plan” required, but transaction may need to be reasonably related to purposes of reorganization.
 - The IRS has acknowledged that correctly aligning capital structures of C and D in a reorganization is often an integral part of a reorganization. *See* Rev. Rul. 79-258, 1979-2 CB 143.
 - *Douglas v. Comm’r*, 37 BTA 1122 (1938); *Wilson v. Comm’r*, T.C. Memo 1961-135; *Spangler v. Comm’r*, 18 TC 976 (1952); *Fry v. Comm’r*, 5 T.C. 1058 (1945), all of which find that a time gap between steps of an established plan is not inconsistent with a plan of reorganization.
 - But a significant time interval between steps may indicate that it is not part of the plan of reorganization. *See Anheuser-Busch, Inc. v. Comm’r*, 40 BTA 1100 (1939)

Issues for Purges to Creditors

- What debt? How “historic?”
- Related Party Creditors?
- Revolving Credit?
- When can you start?
- When must you finish?

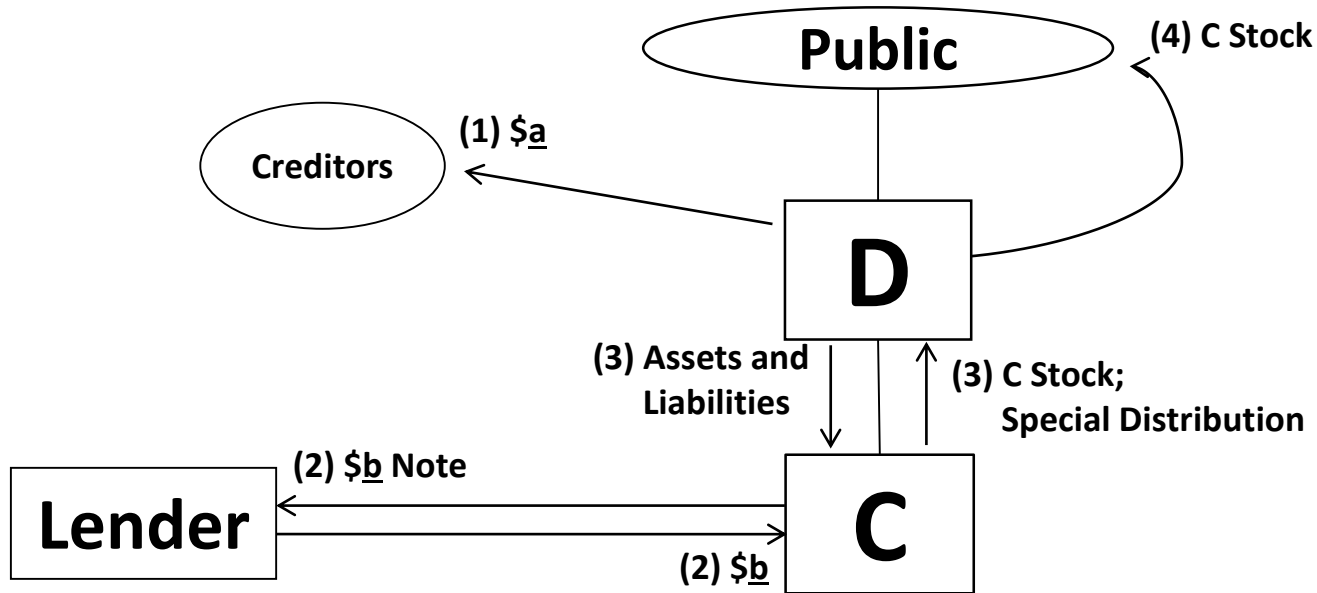
Issues for Purges to Shareholders

- Distributions that would have been made anyway (regular dividends/existing buyback programs)?
- Internal spins?

Optionality

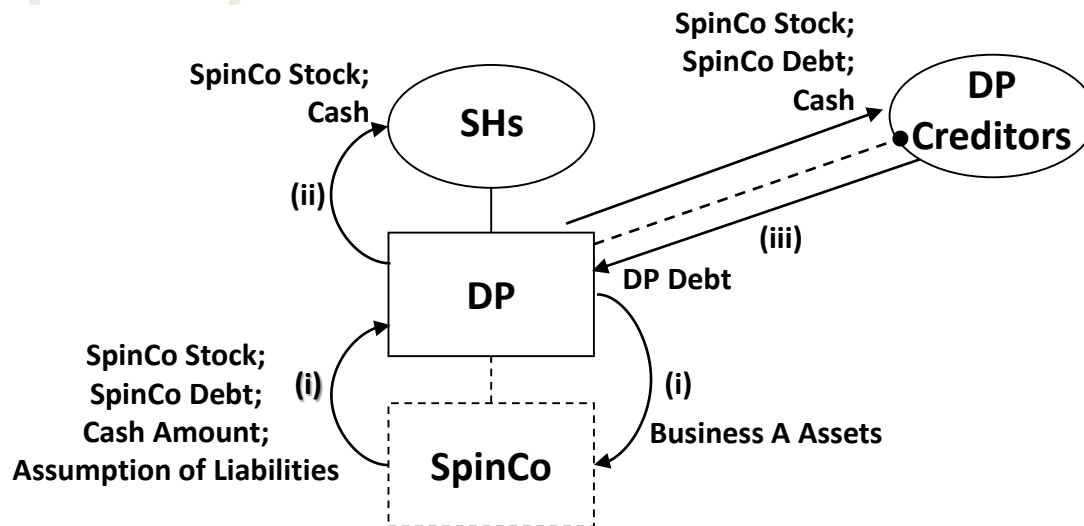
- How much post-distribution discretion is available to D to decide between otherwise acceptable uses of funds?
- What sort of board resolutions should D adopt?
- Is it ever ok to change plans after the stock distribution?

Simplified PLR 201524005: Pre-Contribution/Pre-Spin Boot Purge



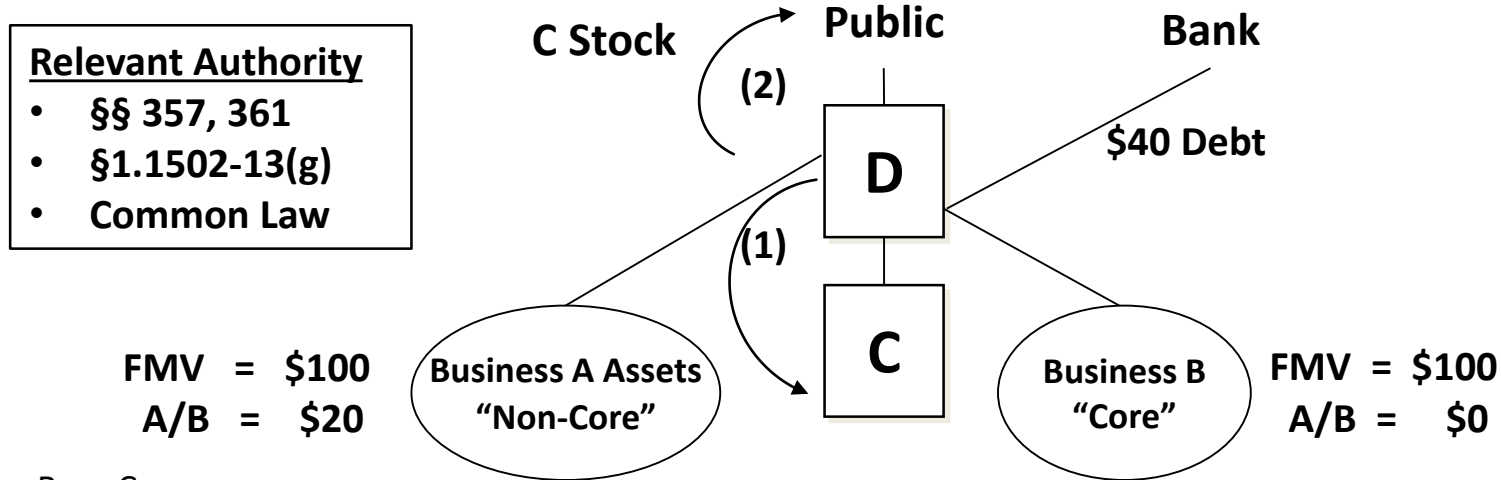
- Step 1:** On Date B following the formation of C, D paid pre-existing creditors \$a (the “Date B Payment”).
- Step 2:** C borrowed \$b from unrelated third party lenders.
- Step 3:** D transferred assets to C in exchange for C common stock, \$c of the \$b borrowed in Step (2) (the “Special Distribution”), and the assumption of certain liabilities.
- Step 4:** D distributed all of the stock of C pro rata.
- Provided the Date B Payment otherwise qualified as a distribution in pursuance of the plan of reorganization within the meaning of sections 361(b)(1)(A) and 361(b)(3), the fact that the Date B Payment was made prior to the Special Distribution will not preclude it from being considered a payment to creditors within the meaning of section 361(b)(3). See PLR 201524005 (Feb. 24, 2015) (Ruling (1)); cf. Rev. Rul. 72-343 (pre-merger purge of cash to creditors treated as pursuant to the plan of reorganization)

Simplified PLR 201612012 (Apr. 1, 2016): Temporary Investment of Cash Boot



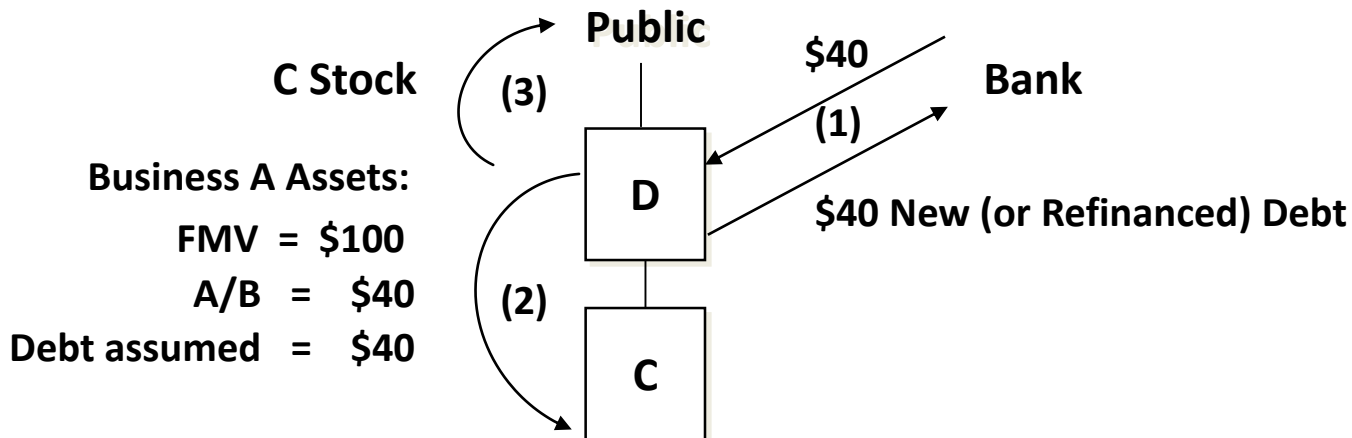
- Possibly in two or more transactions, DP will contribute its Business A assets to SpinCo in exchange for (i) the Cash Amount, (ii) SpinCo debt, (iii) assumption by SpinCo of certain DP liabilities, and (iv) actual or constructive SpinCo stock (collectively, the “SpinCo Contributions”).
- DP will transfer the Cash Amount to (i) its shareholders and/or (ii) its creditors in full or partial satisfaction of DP debt. *See* Step (I xvii)(e). Transfers of the Cash Amount described in Step (I xvii)(e) are referred to collectively as the “Cash Amount Purge.”
- The Cash Amount Purge will be treated as being distributed pursuant to the External Spin-Off plan of reorganization for purposes of sections 361(b)(1)(A) and 361(b)(3). *See* Ruling (2).
- In receiving such ruling, the taxpayer provided that it would not segregate or trace the Cash Amount, and that it may actually purge cash from any source (i.e., it did not have to purge the exact cash received). *See* Step (I xvii)(a). Further, the taxpayer provided that there was no need to identify or distribute any earnings attributable to any investment of the cash received from Controlled. *Id.*

Divisive Reorganizations — Establishing Capital Structure



- Base Case:
 - D is engaged in Non-Core Business A (\$100 FMV and \$20 A/B) and Core Business B (\$100 FMV and \$0 A/B)
 - D seeks to spin off newly formed C which will own Non-Core Business A
 - D will retain Core Business B
 - D has determined that an appropriate capital structure for C includes \$40 debt and \$60 equity
- Base Alternatives for Establishing Initial Capital Structure:
 - C assumes \$40 of D's debt in connection with D's contribution of Business A
 - C borrows \$40 and distributes the proceeds to D
 - C issues \$40 securities to D
 - Combinations of the above
 - D instead contributes Core Business and cash (financed by Business A) to C which is spun off

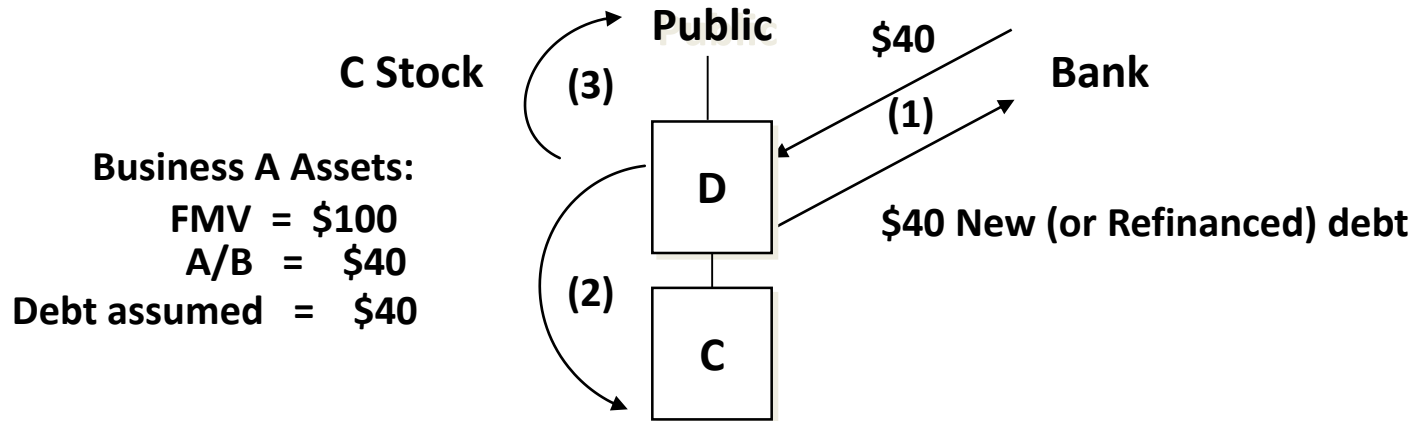
Debt Allocation/Identity of Debtor - Debt Assumption & Substance Over Form



Identity of tax debtor: If C is the true debtor, D's retention of financed cash will be taxable.

- Rev. Rul. 79-258, 1979-2 C.B. 143 (D respected as borrower of new assumable debt which refinanced pre-existing non-assumable debt incurred in connection with the business transferred to C; D's debt level not increased by virtue of the refinancing).
- *Southwest Consolidated Corp.*, 315 U.S. 195 (1942) (target newly borrowed funds and acquiring assumed liability pursuant to the overall acquisitive reorganization plan; assumption recast as payment by acquiring of cash boot to target which resulting in failure of the "solely for voting stock" requirement for "C" reorganization).
- See e.g., PLR 9751043 (Sept. 28, 1997) (D refinanced old debt with newly-incurred third-party debt; C assumed new debt; D represented new debt was attributable to business contributed to C).

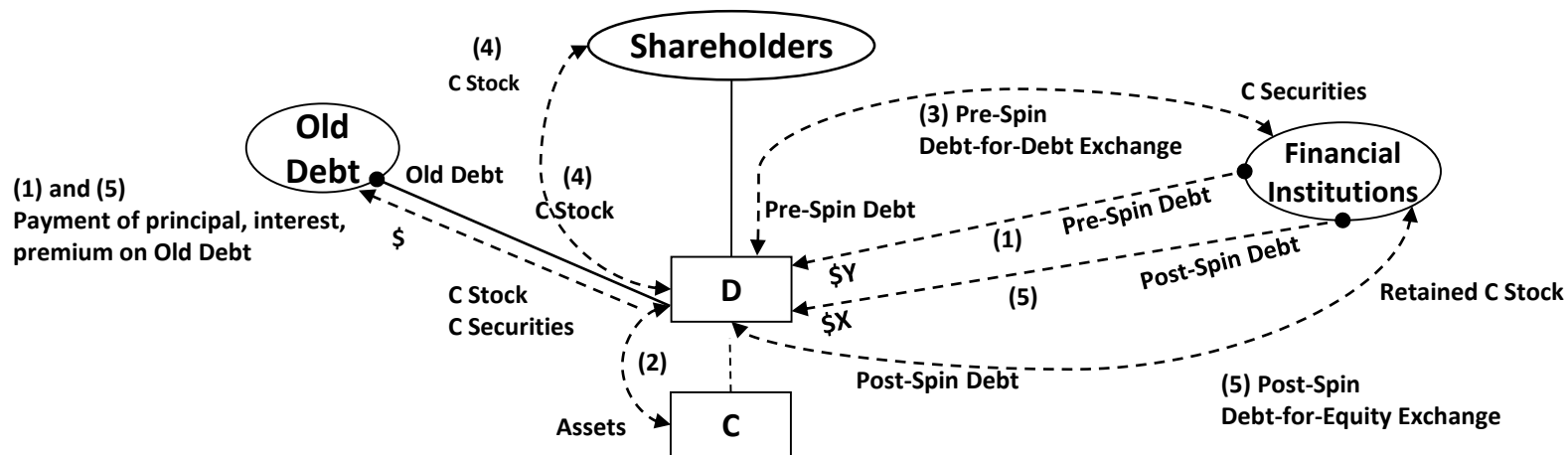
Debt Allocation – Debt Refinancing/Liability Assumption Section 357(b) Safe Harbor



Entire liability assumption treated as boot under Section 357(b) if principal purpose (a) was to avoid tax on the exchange, or (b) was not a bona fide business purpose.

- Rev. Rul. 79-258: Assumed liabilities were traceable to the business transferred to C.
- Rev. Proc. 96-30: Requesting a representation that often cannot be made: “[the assumed liabilities] were incurred in the ordinary course of business and are associated with the assets being transferred.”
- Private Letter Rulings: Above representation modified to reflect that the liability assumption was intended to establish an appropriate capital structure. *See e.g.*, PLR 201350007 (May 31, 2013); PLR 200510017 (Nov. 16, 2004); PLR 200217006 (Dec. 21, 2001); PLR 200146019 (July 11, 2001).
- Rev. Rul. 2003-110: Consider significance of ruling in analyzing § 357(b): avoiding gain on C stock is not tax avoidance in the context of a spin-off.

Simplified PLR 201835001: Direct Issuance Debt Retired in a Debt-for-Debt Exchange and a Debt-for-Equity Exchange



Steps:

- (1) D issues debt (“Pre-Spin Debt”) to Financial Institutions for \$X (the “First Debt Issuance”). Cash proceeds will not be segregated and will be used, contemporaneously with or prior to the External Distribution, to pay principal, interest, or premium on an existing debt (“Old Debt”) or for other strategic purposes. At least h days after the First Debt Issuance, D and Financial Institutions enter into an Exchange Agreement to transfer C Securities in exchange for the Pre-Spin Debt (the “Debt-for-Debt Exchange”).
- (2) D forms C and D exchanges various assets for C stock and C Securities.
- (3) At least j days after the First Debt Issuance, D will effectuate the Debt-for-Debt Exchange.
- (4) D distributes at least 80-percent of C in the External Distribution (the remaining C stock, the “Retained C Stock”).
- (5) D issues new debt (“Post-Spin Debt”) to the Financial Institutions for approximately \$Y (“Second Debt Issuance”). Proceeds used and exchange mechanics the same as with the Pre-Spin Debt, except that the Post-Spin Debt will be exchanged for Retained C Stock (the “Debt-for-Equity Exchange”).
- (6) At least j days after the First Debt Issuance, D will effectuate the Debt-for-Equity Exchange. Such exchange will be done no later that 30 days after the Form 10-K or 10-Q (as applicable) for the financial accounting quarter beginning after the External Distribution.

Representation (c):

The sum of D debt that is assumed under section 357 and the D debt satisfied under section 361 does not exceed the historic average of the total debt owed to unrelated persons by D and other members of the DSAG. The historic average will be computed as of the close of the eight fiscal quarters immediately before the date that is at least 60 days before the transaction or a similar transaction is disclosed or announced to the public or approved by D’s board of directors (whichever is earlier).

Ruling 6 (External Distribution): D will not recognize any gain or loss upon the External Distribution, the Debt-for-Debt Exchange, and the Debt-for-Equity Exchange. Section 361(c).

Rev. Proc. 2018-53: Distributing Debt & D/355 Transactions

Guidelines for (i) Distributing Debt assumed by Controlled or (ii) Distributing Debt satisfied with consideration Distributing receives from Controlled in the divisive reorganization in exchange for “Section 361 Consideration” (i.e., Controlled stock, certain Controlled securities, certain other Controlled debt, and other property).

- Applies to significant issue rulings as well as full no gain or loss transactional rulings.
- Distributing debt is covered by these guidelines only if (i) Distributing is the obligor, and (ii) the obligation is (x) evidenced by a debt instrument that is not a contingent debt instrument, and (y) by its terms is payable only in money.
- The Service will continue to rule on assumptions or exchanges of Distributing debt not covered by this revenue procedure (e.g., contingent liabilities of Distributing) per its general ruling guidelines.

Effective Date: Generally applies to requests made after October 3, 2018.

Rev. Proc. 2018-53: General Principles

- Framework for approving the tax-free division of Distributing Debt between Distributing and Controlled is based upon the principles underlying Revenue Ruling 79-258 sanctioning the assumption by Controlled of newly issued Distributing Debt (revenue ruling citing both case law and the legislative history of the reorganization provisions).
 - As long as the debt shifted to Controlled does not exceed an amount in excess of historic debt levels, the revenue procedure indicates that the form of the transaction is likely to be respected rather than recast pursuant to substance over form or step transaction principles.
 - Consistent with Revenue Ruling 79-258 in which the Service respected the form of the debt issuance as Distributing debt even though no intent existed for its repayment by Distributing as Distributing was immediately released from any repayment obligation upon the assumption of the debt by Controlled, Revenue Procedure 2018-53 does not require a minimum period of ownership or risk associated to establish holder of Distributing Debt is a creditor rather an agent of Distributing, i.e., the requirement of a 5/14 holding period is eliminated.
- Shifting Distributing Debt in excess of historic levels may be permitted upon an explanation justifying such a division, e.g., a merger shortly before the distribution.

Rev. Proc. 2018-53: Certain Required Information and Analysis

Considerations relevant to whether the transfer of the Section 361 Consideration is in connection with the plan of reorganization:

- **Time Period**. With respect to time periods, transfers of Section 361 Consideration within 30 days after the distribution is a safe harbor; substantial reasons for delay beyond such time must be provided with presumably a greater burden beyond 180 days.
- **Plan for Use**. If there is not a plan for the specific transfer of the Section 361 Consideration at the time of the first distribution of Controlled stock to Distributing shareholders, explanation of the business/financial considerations for the retained flexibility is required.
 - With respect to Controlled stock and securities, it would appear sufficient that there is a plan for a transfer to shareholders and creditors of Distributing as compared with a retention of such instruments for which no such commitment exists.
- **Exchanges with Intermediary Financials**. In the case of a facilitated exchange, explain the reasons that the value of the Section 361 Consideration received by the financial institutions(s) in satisfaction of the Distributing Debt might exceed the amount to which the holder is entitled under the terms of the Distributing Debt.
- **Respecting Form**. Analysis to establish that the transactions should not be recast or recharacterized or otherwise not qualify for the intended treatment.

Rev. Proc. 2018-53: Qualifying Distributing Debt

- Absent an explanation establishing that, based on all the facts and circumstances, the borrowing and the assumption or satisfaction of Distributing Debt will result in an allocation of historic Distributing Debt between Distributing and Controlled or an exchange of historic Distributing Debt for Controlled stock, the Distributing Debt that will be assumed or satisfied must have been incurred:
 - Before the request for any relevant ruling is submitted, and
 - No later than 60 days before the earliest of: (i) the date of the first public announcement (as defined in § 1.355-7(h)(10)) of the distribution or a similar transaction, (ii) the date of the entry by Distributing into a binding agreement to engage in the Divisive Reorganization or a similar transaction, and (iii) the date of approval by the board of directors of Distributing of the Divisive Reorganization or a similar transaction.
- Examples of debt not satisfying any one or more of the above conditions as qualifying:
 - Refinancing Qualifying Debt: The proceeds of the debt were used to satisfy other Distributing Debt that was incurred no later than the time described in this representation. *See e.g.*, Rev. Rul. 79-258, 1979-2 C.B. 143 (newly issued debt replaced historic debt incurred in connection with the business to be transferred to Controlled); PLR 201835001 (issued prior to Rev. Proc. 2018-53 and permitting facilitated debt-for-debt and stock-for-debt exchanges in exchange for newly-issued Distributing debt where the proceeds of the newly-issued Distributing debt were primarily used to pay principal, interest, or premium on an existing Distributing debt).
 - Funding Strategic Initiatives/Borrowing for Business Growth: The proceeds of the Distributing Debt assumed or satisfied were or will be used in Controlled's business. *See e.g.*, PLR 201835001 (proceeds could be used for "strategic purposes"). The use of proceeds for strategic purposes implies that Distributing Debt could occur in connection with increasing aggregate debt levels and whether the proceeds are used in the business of Distributing or Controlled.

Rev. Proc. 2018-53: Historic Average Distributing Indebtedness (“HADI”)

- In general, the total adjusted issue price of Distributing Debt that is assumed or satisfied must not exceed HADI which is comprised of the total adjusted issue price of (i) Distributing Debt owed to persons other than Related Persons and (ii) obligations that are evidenced by Non-contingent Debt Instruments and are owed by other members of Distributing’s SAG to persons other than Related Persons.
 - HADI is determined based on debt outstanding as of the close of the eight fiscal quarters ending immediately before approval of the Divisive Reorganization by the board of directors of Distributing.
 - Subject to acceptable explanations, the Distributing Debt assumed or satisfied may exceed HADI, e.g., a merger by Distributing with another corporation shortly before the distribution.
- The Revenue Procedure provides that the Distributing Debt satisfied MAY NOT be replaced; by its terms, the requirement is neither time limited nor a function of intent.
 - An exception is provided for “ordinary course” borrowing pursuant to a revolving credit agreement.