OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CC:DOM:FS:CORP April 19, 1999
TL-N-4571-97
UILC: 355.01-01
368.09-01

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE
Number: **199929013**
Release Date: 7/23/1999
MEMORANDUM FOR [redacted]

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Section 355 Split-Off

This Field Service Advice responds to your memorandum dated January 13, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND:</u>

P =
PS =

X =
XS1 =
XS2 =

Y =

Country X =

Year 1 =

Year 2	=
Year 3	=
Year 4	=
Month 1	=
Month 2	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=

<u>ISSUES:</u>

1) Whether the distribution by P of the PS stock to XS2 in exchange for all of the P stock owned by XS2 (the "stock distribution") failed to qualify as a tax-free split off under I.R.C. § 355 because, under the step transaction doctrine, XS2's ownership of P stock failed to satisfy the continuity of interest requirement of Treas. Reg. § 1.355-2(c).

2) Alternatively, if the stock distribution nevertheless qualifies as a tax-free split off under I.R.C. § 355, whether, under the step transaction doctrine, the contributions from P to PS, the distributions from PS to P (the “property distributions”), the distribution of $f from PS to P (the “equalizing distribution”), and the stock distribution should all be treated as part of the reorganization. If so, then P may be required to recognize gain under I.R.C. § 361(b)(1)(B). If not, then the property distributions and the equalizing distribution would each be considered distributions by PS to P with respect to its stock, which would be eliminated from P’s income under Treas. Reg. § 1.1502-14(a)(1).

CONCLUSIONS:

1) The stock distribution fails to qualify as a tax-free split off under I.R.C. § 355 because, under the step transaction doctrine, XS2's ownership of P stock failed to satisfy the continuity of interest requirement of Treas. Reg. § 1.355-2(c). In that case, P is treated as having sold the PS stock to XS2 and would be required to recognize gain on such sale. Alternatively, XS2 would be treated as having redeemed its P stock in exchange for the PS stock. Because this redemption would result in a complete termination of XS2's interest in P under I.R.C. § 302(b)(3), XS2 would recognize gain on this exchange under I.R.C. § 302(a). In addition, P would recognize gain under I.R.C. § 311(b).

2) Alternatively, if the stock distribution nevertheless qualifies as a tax-free split off under I.R.C. § 355, then, under the step transaction doctrine, the contributions, the property distributions, the equalizing distribution and the stock distribution should all be treated as part of the reorganization. Therefore, P may be required to recognize gain under I.R.C. § 361(b)(1)(B).

FACTS:

P was the common parent of an affiliated group of corporations filing consolidated Federal income tax returns for Year 1, Year 2, Year 3 and Year 4. For the years at issue, P owned all of the stock of PS.

Corporation Y began buying P’s stock in Year 1. Y’s shareholder had a reputation as a corporate raider. By the fall of Year 1, Y owned approximately a% of P.

On Date 1, P’s Board of Directors met and discussed the sale of one of its divisions and certain other assets. The reason stated in the minutes for the sale was to eliminate a capital intensive segment of P’s business.

In Month 1 of Year 2, Y bid for the rest of the P stock. P’s Board rejected Y’s offer.

On Date 2, P’s Board presented its plan to sell of two of P’s most valuable divisions.

X is a Country X corporation. X owns all of the stock of domestic corporation XS1, which owns all of the stock of domestic corporation XS2.

On Date 3, P’s Board of Directors continued their discussions of the disposition of a division. XS1 was identified by P’s investment banker as an interested purchaser of that division and the terms of the possible agreement with XS1 were discussed. The reasons stated in the minutes for arranging the disposition of the division as a split-off are: (a) disposition of the division in a tax efficient manner, and (b) the elimination of Y as a shareholder. The Board was concerned with Y interfering with P's objectives.

On Date 4, P and XS1 entered into an agreement, which provided as follows:

· XS2 had the right to purchase from P's shareholders up to b shares of P's outstanding stock.

· P granted XS2 a one year put option to require P to acquire its P stock from XS2. This option commenced g years after the closing date, Date 6. Thus, XS2's right to exercise the option commenced on Date 7.

· Once XS2 exercised its option, P could acquire its own stock in exchange for either the PS stock or cash based on a specified price per share (or have a third party acquire such stock for such price). If P chose the former option, the value of the P stock and the value of the PS stock would be determined according to a formula in the agreement. If the value of the P stock held by XS2 was less than the value of the PS stock, then the values would be equalized by a distribution from PS to P.

· On or before Date 6 (but not later than Date 7), P shall contribute certain specified assets to PS.

· On or before the distribution by P of the PS stock to XS2, PS shall have distributed certain specified assets to P.

Also on Date 4, Y granted XS2 an option to purchase all of its P stock, a total of c shares. The option was to expire on Date 5. On Date 5, XS2 exercised the option and purchased c shares of P stock from Y. Thus, Y no longer owned any P stock.

Pursuant to the agreement: (a) on Date 4, PS distributed certain assets to P, and (b) after Date 4 (but within Year 2), P made a series of contributions of certain assets to PS.

As of Date 8, the value of the P stock in the hands of XS2 was $d and the value of the PS stock was $e. The difference of $f was distributed by PS to P on Date 9.

On Date 10, XS2 exercised its option and P redeemed the c shares owned by XS2 in exchange for all of the outstanding PS stock. In addition, P sold certain assets to XS2 for cash.

LAW AND ANALYSIS

Law

I.R.C. § 355(a)(1) provides that if: (A) a corporation distributes to a shareholder, with respect to its stock, solely stock of a corporation which it controls immediately before the distribution, (B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both, (C) the active trade or business requirements of I.R.C. § 355(b) are satisfied, and, (D) as part of the distribution, the distributing corporation distributes all of the stock in the controlled corporation held by it immediately before the distribution, then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder on the receipt of the such stock.

Treas. Reg. § 1.355-2(c)(1) provides that I.R.C. § 355 applies to a separation that effects only a readjustment of continuing interests in the property of the distributing and controlled corporations. In this regard I.R.C. § 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. This continuity of interest requirement is independent of the other requirements of I.R.C. § 355.

(2) Examples.

Example (1). For more than five years, corporation X has been engaged directly in one business, and indirectly in a different business through its wholly owned subsidiary, S. The businesses are equal in value. At all times, the outstanding stock of X has been owned equally by unrelated individuals A and B. For valid business reasons, A and B cause X to distribute all of the stock of S to B in exchange for all of B's stock in X. After the transaction, A owns all the stock of X and B owns all the stock of S. The continuity of interest requirement is met because one or more persons who were the owners of X prior to the distribution (A and B) own, in the aggregate, an amount of stock establishing a continuity of interest in each of X and S after the distribution.

Example (2). Assume the same facts as in Example (1), except that pursuant to a plan to acquire a stock interest in X without acquiring, directly or indirectly, an interest in S, C purchased one-half of the X stock owned by A and immediately thereafter X distributed all of the S stock to B in exchange for all of B's stock in X. After the transactions, A owns 50 percent of X and B owns 100 percent of S. The distribution by X of all of the stock of S to B in exchange for all of B's stock in X will satisfy the continuity of interest requirement for section 355 because one or more persons who were the owners of X prior to the distribution (A and B) own, in the aggregate, an amount of stock establishing a continuity of interest in each of X and S after the distribution.

Example (3). Assume the same facts as in Examples (1) and (2), except that C purchased all of the X stock owned by A. After the transactions, neither A nor B own any of the stock of X, and B owns all the stock of S. The continuity of interest requirement is not met because the owners of X prior to the distribution (A and B) do not, in the aggregate, own an amount of stock establishing a continuity of interest in each of X and S after the distribution, i.e., although A and B collectively have retained 50 percent of their equity interest in the former combined enterprise, they have failed to continue to own the minimum stock interest in the distributing corporation, X, that would be required in order to meet the continuity of interest requirement.

I.R.C. § 361(a) provides that no gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance to a plan of reorganization, solely for stock or securities in another corporation a party to a reorganization.

I.R.C. § 361(b)(1) provides that if I.R.C. § 361(a) would apply to an exchange but for the fact that the property received in the exchange consists not only of stock or securities permitted by I.R.C. § 361(a) to be received without the recognition of gain, but also of other property or money, then (A) if the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but (B) if the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the distributing corporation shall be recognized. The amount of gain recognized under I.R.C. § 361(b)(1)(B) shall not exceed the sum of the money and the fair market value of the other property so received which is not so distributed.

I.R.C. § 361(b)(3) provides that, for purposes of I.R.C. § 361(b)(1), any transfer of the other property or money received in the exchange by the corporation to its creditors in connection with the reorganization shall be treated as a distribution in pursuance of the plan of reorganization.

I.R.C. § 368(a)(1)(D) provides that, for purposes of I.R.C. §§ 301 through 368, the term "reorganization" means a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer, the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer) or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under I.R.C. § 354, 355, or 356.

Treas. Reg. § 1.368-2(g) provides that the term "plan of reorganization” has reference to a consummated transaction specifically defined as a reorganization under I.R.C.

§ 368(a). The term "plan of reorganization" is not to be construed as broadening the definition of "reorganization" as set forth in I.R.C. § 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 I.R.C. § 368(a). Moreover, the transaction, or series of transactions embraced in a plan of reorganization, must not only come within the specific language of I.R.C. § 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.

Treas. Reg. § 1.1502-14(a)(1) provides that a dividend distributed by one member to another member during a consolidated return year shall be eliminated.

Analysis

Continuity Issue

In general, the continuity of proprietary interest requirement is a doctrine of judicial origin which developed in the reorganization context to distinguish between taxable purchases of corporate assets and mere corporate readjustments. *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 939-940 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933); *Penrod v. Commissioner*, 88 T.C. 1415, 1427 (1987). The former are taxed currently, whereas the latter are not taxed until a future date when a more tangible gain or loss is realized. *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir. 1951), *citing Commissioner v. Gilmore's Estate*, 130 F.2d 791, 794 (3rd Cir. 1942).

In the case of a distribution or exchange under I.R.C. § 355, Treas. Reg. § 1.355-2(c)(1) provides that I.R.C. § 355 applies to a separation that effects only a readjustment of continuing interests in the property of the distributing and controlled corporations. To that end, Treas. Reg. § 1.355-2(c)(1) further provides that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. Finally, Treas. Reg. § 1.355-2(c)(1) provides that this continuity of interest requirement is independent of the other requirements under I.R.C. § 355.

In this case, as noted above, P distributed all of the PS stock to XS2 in exchange for all of the P stock owned by XS2 (the “stock distribution”). If the stock distribution qualifies as a tax-free split off under I.R.C. § 355, then neither P nor XS2 would recognize gain as a result. However, for the reasons explained below, the continuity of interest requirement is not satisfied. In other words, the stock distribution was, in substance, a sale by P of the PS stock to XS2. Consequently, P would be required to recognize gain on such sale in Year 4. Alternatively, XS2 would be treated as having redeemed its P stock in exchange for the PS stock. Because this redemption would result in a complete termination of XS'2 interest in P under I.R.C. § 302(b)(3), XS2, in Year 4, would recognize gain on this exchange under I.R.C. § 302(a). In addition, P would recognize gain, in Year 4, under I.R.C. § 311(b). In any event, if XS2 had purchased its P stock immediately prior to the stock distribution, such distribution would not have satisfied the continuity requirement. See Treas. Reg. § 1.355-2(c)(2), *Ex. 3*.

In *Ex. 3*, C acquired all of the stock of the distributing corporation (X) from A immediately before X split off the stock of the controlled corporation (S) to B. *Ex. 3* states that the continuity of interest requirement was not satisfied since the owners of X prior to the distribution (A and B) owned none of the stock of X after the split off. In this case, XS2 acquired all of the stock of the controlled corporation (PS) rather than of the distributing corporation (P). Nevertheless, if XS2 had acquired its P stock immediately prior to the split off of PS, the owners of P prior to the split off would not have owned any interest in PS after the split off. In that case, the continuity of interest requirement would not have been satisfied.

Of course, we recognize that XS2 did not acquire its P stock immediately before the stock distribution. Instead, XS2 acquired its P stock approximately g years earlier. Thus, P may argue that XS2 satisfied the continuity of interest requirement because XS2 had owned the P stock for g years prior to the stock distribution.

However, XS2 acquired its P stock pursuant to an agreement between P and XS1 by which, at the end of g years, XS2 would then be able to acquire all of the stock of PS (in exchange for its P stock). Thus, even though XS2 held its P stock for g years, under the step transaction doctrine, XS2's ownership of the P stock and the exchange by XS2 of such stock for P's PS stock should be regarded as occurring as part of one plan. In other words, under the step transaction doctrine, XS2 would be treated as if it had acquired such stock immediately before the stock distribution. In that case, as noted above, XS2's ownership of its P stock would not satisfy the continuity of interest requirement and the stock distribution would be recharacterized as a sale by P of the PS stock to XS2. As noted above, P would recognize gain on such sale. Alternatively, as also noted above, XS2 would be treated as having redeemed its P stock in exchange for the PS stock. Because this redemption would result in a complete termination of XS'2 interest in P under I.R.C. § 302(b)(3), XS2, in Year 4, would recognize gain on this exchange under I.R.C. § 302(a). In addition, P would recognize gain, in Year 4, under I.R.C. § 311(b).

The step transaction doctrine is a rule of substance over form that treats a series of formally separate but related steps as a single transaction if the steps are in substance integrated, interdependent and focused towards a particular result. *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987). There are three tests of that doctrine: (1) the "binding commitment" test; (2) the "interdependence" test; and (3) the "end result" test. *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987). Courts have often applied the step transaction doctrine to determine whether the continuity of interest requirement has been satisfied. *See, e.g.,* McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982), rev'g, McDonald's of Zion v. Commissioner, 76 T.C. 972 (1981); Estate of Elizabeth Christian v. Commissioner, T.C. Memo. 1989-413, and *Penrod*, *supra*.

Under the binding commitment test, a series of transactions are collapsed if, at the time the first step is entered into, there was a binding commitment to undertake the later step. *Penrod*, 88 T.C. at 1429. In this case, P and XS1 entered into an agreement by which, if XS2 surrendered its P stock to P, P was required to pay XS2 either cash (with the amount determined according to a formula in the agreement) or all of the PS stock. In fact, shortly after XS2 was eligible to put its P stock to P, XS2 surrendered its P stock and P in turn transferred all of its PS stock to XS2. Thus, as actually consummated, there was a binding commitment on the part of P to distribute the PS stock to XS2 in exchange for XS2’s P stock. Therefore, the binding commitment test of the step transaction doctrine is satisfied in this case.

We recognize that the agreement was structured so that P could choose whether to pay XS2 cash or the PS stock in exchange for XS2’s P stock. Thus, P may argue that its ability to choose the method of payment represents a contingency that defeats any argument that the binding commitment test applies. However, in *Seagram v. Commissioner*, 104 T.C. 75, 96 (1995), the Court, citing *Walt Disney v. Commissioner*, 4F.3d 735, 740 (9th Cir. 1993), disregarded contingencies included in the agreement. Instead, the Court looked to the steps that actually occurred and treated those steps as the steps of the transaction. Thus, under this analysis, the Court would disregard the ability of P to elect the method of paying XS2 for its P stock. Instead, the Court would focus on the fact that P actually payed XS2 with its PS stock.

The next test of the step transaction doctrine is the interdependence test, which focuses on whether the steps are so interdependent that the legal relations created by one transaction would have fruitless without completion of the series. *Penrod*, 88 T.C. at 1430. In this case, XS2 would not have bought P stock without an agreement with P that XS2 would be able to obtain the PS stock in exchange therefor. In addition, P would not have agreed to transfer its PS stock to XS2 unless P could argue that the disposition of such stock was tax-free. Indeed, XS2’s acquisition of the P stock, under these circumstances, only makes sense if the parties are attempting to ensure that

XS2's ownership of P stock satisfies the continuity of interest requirement. Therefore, the interdependence test of the step transaction doctrine is satisfied.

The last test of the step transaction doctrine is the end result test. Under that test, a series of formally separated steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result. *Penrod*, 88 T.C. at 1429. In this case, XS2 purchased its P stock with the intent of ultimately acquiring the PS stock (and it did). In addition, P entered into its agreement with XS2 with the intent of removing a potentially disruptive shareholder (Y) and selling its PS stock without recognizing gain. Therefore, the end result test of the step transaction doctrine is satisfied in this case.

We recognize that our application of the step transaction doctrine does not eliminate steps. *See Esmark v. Commissioner*, 90 T.C. 171 (1988), aff'd. without published opinion 886 F.2d 1318 (7th Cir.1989) . In *Esmark*, the taxpayer, Esmark Inc., was planning to restructure its business by disposing of a certain subsidiary and redeeming a large block of its stock. Hence, it entered into an agreement with Mobil, in which Mobil would acquire by tender offer more that fifty percent of Esmark's outstanding stock and Esmark would then distribute all the stock of its subsidiary in redemption of the Esmark shares acquired by Mobil. The Tax Court held that Esmark's distribution to Mobil of its subsidiary stock in exchange for its own stock qualified for nonrecognition treatment under I.R.C. §§ 311(a) and 311(d)(2)(B), as then in effect.

The Service, based on its contention that Mobil's ownership should be disregarded as transitory, argued to the Tax Court that the tender offer/redemption should by application of the step transaction doctrine be recharacterized as a sale of the subsidiary stock to Mobil followed by a self-tender offer. The Tax Court refused to apply the step transaction doctrine in that case. It found that the Service's recharacterization was inappropriate, because it did not simply combine steps, but rather invented new ones. In addition, the Court determined that the form of the overall transaction coincided with its substance and should be respected. Moreover, the Court confirmed this interpretation of *Esmark* in *Seagram*, 104 T.C. at 94, and more recently in *Turner Broadcasting Systems, Inc. v. Commissioner*, 111 T.C. No. 18, slip op. at 21 (Dec. 23, 1998).

However, the Court has also held that *Esmark* does not apply to a case involving a reorganization. *Seagram*, at 94. Although not stated, the reason presumably is that the Code provision at issue in *Esmark* (I.R.C. § 311(d)(2)(B)) did not contain a continuity of interest requirement. By contrast, as noted above, a reorganization (or a distribution or exchange to which I.R.C. § 355 applies) does. Moreover, in the instant case, the Service is not trying to collapse a series of steps into one step nor is it trying to eliminate steps or add steps (as the Tax Court found was the case in *Esmark*). Nor is the Service trying in the instant case to reorder the steps taken. The Service accepts that XS2's purchase of P stock and the stock distribution are both meaningful, viable steps. Instead, as noted above, the Service is arguing that such steps are, under the step transaction doctrine, both component parts of one reorganization. As noted above, courts apply one or more of the three tests to determine whether the continuity requirement is satisfied.

Boot/Gain Issue

Alternatively, if the stock distribution qualifies as a tax-free split off under I.R.C. § 355, then, as noted above, the issue is whether P is nevertheless required to recognize gain as a result of the reorganization (within the meaning of I.R.C. § 368(a)(1)(D)) that preceded the split off. In this case, pursuant to the agreement, P contributed assets to PS (the “contributions”), and PS distributed assets to P (the “property distributions”) and cash in the amount of $f (the “equalizing distribution”). P then, also pursuant to the agreement, distributed all of the PS stock to XS2 in exchange for all of the P stock owned by XS2 (the "stock distribution"). Thus, the issue is whether, under the step transaction doctrine, the contributions, the property distributions, the equalizing distribution and the stock distribution were all part of a reorganization within the meaning of I.R.C. § 361(a).

Under I.R.C. § 361(a), P would recognize no gain or loss upon the transfer of property (i.e., the contributions) to PS solely in exchange for PS stock.[1] However, as noted above, P was not deemed to have received solely PS stock. P also received the property distributions and the equalizing distribution. In that case, I.R.C. § 361(b) applies.

Under I.R.C. § 361(b)(1)(A), P would not recognize gain upon the receipt of the property (as part of the property distributions and the equalizing distribution) if such property was distributed by P pursuant to the reorganization (i.e., either to its shareholders or creditors, see I.R.C. § 361(b)(3)). On the other hand, P would recognize gain if such property was not distributed pursuant to the reorganization. In any event, P would not recognize loss. Section 361(b)(3).

In addition, the contributions, the property distributions, the equalizing distribution and the stock distribution were all part of the "plan of reorganization," within the meaning of Treas. Reg. § 1.368-2(g). In order for a reorganization to qualify as tax-free, one of the

[1] Since P already owned all of the PS stock, it would not have been necessary for PS to actually issue additional shares of its stock to P in exchange for such property. Therefore, PS would be deemed to have issued such shares to P in exchange for such property. *See, e.g., Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989).

requirements the parties to the reorganization must satisfy is that they have a "plan of reorganization". Unlike certain other requirements a reorganization must also meet, such as business purpose, continuity of proprietary interest, and continuity of business enterprise, which have all been judicially created (and are now described in the regulations), the requirement of a "plan of reorganization" is statutory. See I.R.C. §§ 354(a)(1) and 361(a).

The "plan of reorganization" requirement defines the scope of what is and is not within the reorganization. Under that requirement, the Service would argue that such plan would include all steps intended by the parties to accomplish the reorganization. *See Seagram v. Commissioner*, 104 T.C. 75 (1995). In this case, these steps would include the contributions, the property distributions, the equalizing distributions as well as the stock distribution, all of which had to occur in order for the transaction to be successfully completed.

Further, since the contributions and the property distributions occurred at the same time as, or shortly after, XS2 acquired its P stock from Y, the plan of reorganization was in effect the entire time XS2 held its P stock. Thus, in testing whether the continuity of interest requirement is satisfied, it is appropriate to examine the ownership of P immediately prior to the start of the plan of reorganization and compare it with the ownership of P immediately after the completion of the plan of reorganization.

Immediately prior to the start of the plan of reorganization, XS2 did not own any P stock. Thus, any P stock that XS2 subsequently acquired does not count in testing whether the continuity of interest requirement is satisfied. Immediately after the stock distribution, XS2 was the only shareholder of PS. To put it another way, no shareholder of P immediately prior to the start of the plan of reorganization owned any stock of PS. Therefore, the continuity of interest requirement was not satisfied.

In order to determine whether these steps are part of the reorganization, it is appropriate to apply the step transaction doctrine. *See Seagram*, 104 T.C. at 98. As noted above, there are three tests of that doctrine: (1) the "binding commitment" test; (2) the "interdependence" test; and (3) the "end result" test.

Under the binding commitment test, a series of transactions are collapsed if, at the time the first step is entered into, there was a binding commitment to undertake the later step. *Penrod*, 88 T.C. at 1429. In this case, the agreement between P and XS1 required that P make contributions to PS and that PS make the property distributions and, if XS2 put its P stock to P, that PS make the equalizing distribution to P, followed by the stock distribution. Thus, there was a binding commitment on the part of P to make the contributions to PS and on the part of PS to make the property distributions to P and, as discussed above, since XS2 put its P stock to P, there was a binding commitment on the part of PS to make the equalizing distribution to P, followed by P's stock distribution. Therefore, the binding commitment test of the step transaction doctrine is satisfied in this case.

The next test of the step transaction doctrine is the interdependence test, which focuses on whether the steps are so interdependent that the legal relations created by one transaction would have fruitless without completion of the series. *Penrod*, 88 T.C. at 1430. In this case, P would not have agreed to distribute the PS stock to XS2 (and XS2 would not have agreed to receive the PS stock) without P making the contributions to PS and without PS making the property distributions and the equalizing distribution to P. Indeed, P would have violated its fiduciary duty to its shareholders (and subjected itself and its board of directors to lawsuits) if it had made the stock distribution without first causing PS to make the equalizing distribution. In addition, P would not have made the contributions to PS, nor required PS to make the property distributions and the equalizing distribution without the planned subsequent stock distribution. Indeed, there would have been no reason for the contributions, the property distributions and equalizing distribution without the planned subsequent stock distribution. Therefore, the interdependence test of the step transaction doctrine is satisfied.

The last test of the step transaction doctrine is the end result test. Under that test, a series of formally separated steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result. *Penrod*, 88 T.C. at 1429. In this case, pursuant to the agreement between P and XS2, P intended to make the contributions to PS and to cause PS to make the property distributions and the equalizing distribution prior to the stock distribution. Therefore, the end result test of the step transaction doctrine is satisfied in this case.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:</u>

As we discussed, other arguments raised in the request for Field Service Advice will not be addressed.

<u>Continuity Issue</u>

[redacted] Under normal circumstances, a shareholder owning stock of a distributing corporation for two years would satisfy the continuity of interest requirement for purposes of I.R.C. § 355. *See, e.g.*, Rev. Rul. 74-5, 1974-1 C. B. 82.

However, in this case, [redacted] acquired its [redacted] stock pursuant to a plan by which it would ultimately acquire the [redacted] stock. Therefore, there is an argument that [redacted] ownership of [redacted] stock was designed with that limited goal in mind. For example, as noted above, the agreement put restrictions on [redacted] ability to vote or sell its [redacted] stock (or acquire additional [redacted] stock). Thus, there is an argument that the parties themselves viewed [redacted] role as solely to qualify the intended stock distribution under I.R.C. § 355 by satisfying the continuity of interest requirement. Further, since the contributions and the property distributions occurred at the same time as, or shortly after, XS2 acquired its P stock from Y, the plan of reorganization was in effect the entire time XS2 held its P stock.

Further, since the contributions and the property distributions occurred at the same time as, or shortly after, XS2 acquired its P stock from Y, the plan of reorganization was in effect the entire time XS2 held its P stock. Thus, in testing whether the continuity of interest requirement is satisfied, it is appropriate to examine the ownership of P immediately prior to the start of the plan of reorganization and compare it with the ownership of P immediately after the completion of the plan of reorganization.

Immediately prior to the start of the plan of reorganization, XS2 did not own any P stock. Thus, any P stock that XS2 subsequently acquired does not count in testing whether the continuity of interest requirement is satisfied. Immediately after the stock distribution, XS2 was the only shareholder of PS. To put it another way, no shareholder of P immediately prior to the start of the plan of reorganization owned any stock of PS. Therefore, the continuity of interest requirement was not satisfied.

[redacted]

Boot/Gain Issue

Under I.R.C. § 361(b), [redacted] would be taxed on the receipt of property only to the extent of gain. [redacted]

As noted in the facts, the contributions and the property distributions occurred approximately two years before the equalizing distribution and the stock distribution. If a court were to agree with [redacted] that it satisfied the continuity of interest requirement, it may then refuse to treat the contributions and the property distributions as part of the reorganization that includes the equalizing distribution and the stock distribution.

In any event, we note that $[redacted] of the $[redacted] equalizing distribution was used to pay [redacted] bank debt and the remainder was used to pay other expenses. Thus, under I.R.C. § 361(b)(3), because [redacted] distributed the entire $[redacted] distribution it received from [redacted] to [redacted] creditors, [redacted] would not be required to recognize gain to this extent. In other words, [redacted] would only be taxed to the extent that its gain exceeded $[redacted] (because it did not distribute the other property it received).

Please call if you have any further questions.

By: ______________________
STEVEN J. HANKIN
Special Counsel (Corporate)

cc: CC:WR
CC:WR:LC