EVALUATING PROPOSALS TO TAX INTRAGROUP SPIN-OFFS

by Martin D. Ginsburg and Jack S. Levin

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The authors examine proposed 1997 legislation dealing with intragroup spin-offs from one member of an affiliated group to another member of the group. The legislative objective is, or ought to be, to prevent taxpayers inappropriately shifting stock basis among subsidiaries in an affiliated group by using a basis reallocation scheme currently contained in the consolidated return regulations. The legislative proposal — new section 355(f) — is, unfortunately, grossly disproportionate to that objective.

The form of proposed section 355(f) passed by the House of Representatives on June 27, as part of its version of the 1997 tax legislation (the "1997 bill"), would require a distributing corporation to recognize gain on an intragroup spin-off, even though the spin-off otherwise qualifies under section 355. Under the consolidated return regulations, the gain would be treated as deferred intercompany gain, to be triggered into income when, for example, the relevant subsidiary leaves the group, perhaps years later by way of an otherwise tax-free spin-off.

The version of new section 355(f) passed by the Senate on June 27 would also tax an intragroup spin-off, but only if it is part of a plan involving an acquisition that is taxable at the corporate level under a separate segment of the 1997 bill addressing so-called *Morris Trust* transactions. The Senate bill — in new section 358(g) — also authorizes Treasury to adjust the stock basis of affiliated group members that are parties to an intragroup spin-off to reflect appropriately the proper treatment of the spin-off.

The authors find the House version of section 355(f) an unfortunate example of poor tax law and bad tax policy. The Senate version of section 355(f), while less objectionable because it will apply to few spin-off transactions, is badly flawed, producing tax consequences the drafters likely did not intend including, in one subset of cases, a reduction in the corporate-level tax otherwise imposed under the *Morris Trust* provision of the 1997 bill.

On the other hand, the authors find the Senate's new section 358(g), tasking Treasury to promulgate regulations to allocate stock basis more appropriately in intragroup spins, a sensible response to legitimate legislative concerns. The authors urge Congress to scrap both versions of proposed section 355(f) and to adopt the Senate's proposed section 358(g).

H.R. 2014, the 1997 tax legislation (the "1997 bill"), in the form passed by the House of Representatives on June 27 (the "House version," section 1012) amends section 355[1] to, among other things, subject to corporate-level tax (a) *Morris Trust* spin-offs in which 50 percent or more (by vote or value) of the stock of either the controlled/distributed subsidiary or the distributing parent is acquired as part of a plan that includes the spin-off (the "*Morris Trust* provision") and (b) all intragroup spin-offs from one member of an affiliated group filing a consolidated return (a "consolidated

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[1]All section references are to the Internal Revenue Code of 1986, as amended, or the regulations thereunder, except as otherwise noted.

group") to another member (the "intragroup spin-off provision").

The form of the 1997 bill passed by the Senate, also on June 27 (the "Senate version," section 812), includes (a) the *Morris Trust* provision, substantially as proposed by the House, and (b) a significantly modified form of the intragroup spin-off provision. Under the Senate version, corporate-level tax is imposed only if the intragroup spin-off is part of a plan resulting in an acquisition that imposes tax on either the controlled/distributed subsidiary or the distributing parent under the *Morris Trust* provision. However, the Senate version of the intragroup spin-off provision imposes tax whether or not the affiliated corporate group is filing a consolidated return (in the House version a consolidated return is a necessary condition to taxation). Additionally, the Senate bill, in proposed section 358(g), authorizes Treasury to adjust the stock basis of members in an intragroup spin-off to which section 355 applies to reflect appropriately the proper treatment of the spin-off.

The House version of proposed section 355(f), we understand, is crafted as a draconian way to prevent a consolidated group from using an intragroup spin to shift tax basis from the stock of one member of the group to the stock of another member.

Legislation designed to tax certain *Morris Trust* transactions was first proposed by the Clinton administration in December 1995. The Clinton proposal was the subject of substantial commentary, most of it critical,[2] and we do not today look to fight that battle again. We focus instead on proposed section 355(f), the intragroup spin-off provision in the 1997 bill, both the expansive House version and the Senate's targeted version. The intragroup spin-off provision was not the subject of substantial commentary during the past 18 months because the Clinton proposal did not include this provision, an omission that in retrospect seems the best thing about the Clinton proposal.

The intragroup spin-off provision first emerged on April 17, 1997, as part of the anti-*Morris Trust* bill, H.R. 1365/S. 612, co-sponsored by Representative Bill Archer, R-Texas, and Senators William V. Roth Jr., R-Del., and Daniel Patrick Moynihan, D-N.Y. It came as a complete surprise, the more so because this provision, as it was unveiled on April 17 and as it persists in the House version of the 1997 bill, has little to do with the *Morris Trust* transactions that the legislation dominantly addresses. As we demonstrate below, if any aspect of an intragroup spin merits legislative attention, the legislation merited is not either version of proposed section 355(f) that is currently before Congress.

House Version

Proposed section 355(f) in the House version announces:

> Except as provided in regulations, this section [section 355] shall not apply to the distribution of stock from one member of an affiliated group filing a consolidated return to another member of such group, and the Secretary shall provide proper adjustments for the treatment of such distribution, including (if necessary) adjustments to (1) the adjusted basis of any stock which (A) is in a corporation which is a member of such group, and (B) is held by another member of such group, and (2) the earnings and profits of any member of such group.

If this unfortunate provision were enacted, all consolidated return intragroup spins would be governed at the corporate level by section 311(b), so that the excess of fair value ("FV") over tax basis ("TB") in the distributed stock would create deferred intercompany gain (DIG). This DIG would be triggered into the group's income under reg. section 1.1502-13 at the time either the distributing subsidiary or the controlled/distributed subsidiary ultimately leaves the group (including a tax-free departure from the group, such as a further spin-off of either subsidiary or a section 332 liquidation of the controlled/distributed subsidiary).

The House version of proposed section 355(f), we understand, is crafted as a draconian way to prevent a consolidated group from using an intragroup spin to shift tax basis from the stock of one member of the group to the stock of another member. In an extreme case of basis shifting, illustrated by Example 1 below, an affiliated group (here the P group) may attempt to use the current intragroup spin-off rules to eliminate an excess loss account (an ELA) created when S2, P's second-tier subsidiary whose stock will be spun by its parent S1, borrows against its assets and, prior to the spin-off, distributes the borrowed funds to S1, the first-tier distributing subsidiary.[3]

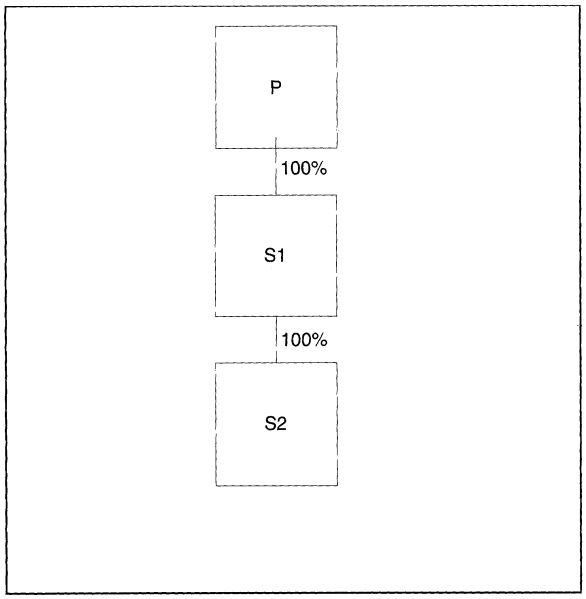
However, by taxing the full amount of appreciation in S2's stock, the House version of section 355(f) in fact would require gain recognition far in excess of the amount of any ELA (or other potential basis shift), as illustrated by Example 2 on p. 254.

[2] *See, e.g.*, Statement of Martin D. Ginsburg before the Senate Finance Committee, April 17, 1997 (enactment of the Clinton administration's proposed *Morris Trust* legislation will either "impose an additional tax on [the distributing corporation] or . . . encourage the sort of under-the-table, economically inefficient planning that promotes the general distaste for the taxing system"); Sheffield & Schlunk, "Reconciling Spin-Offs With *General Utilities* Repeal," 74 *Taxes* 941, 951-52 (1996).

[3] An equivalent case of separating liability for the debt from the proceeds of the borrowing, but one in which no ELA is created, would be as follows: (1) P's first-tier subsidiary S, conducting businesses X and Y, borrows $20 from a bank, (2) S contributes business X plus the $20 to NewSub in exchange for all of NewSub's stock, (3) S spins off NewSub to P, and (4) P then spins off S — which holds the Y business and is liable for the $20 bank debt — to P's shareholders.

Example 1:
S2 borrows and pays a dividend, creating an ELA

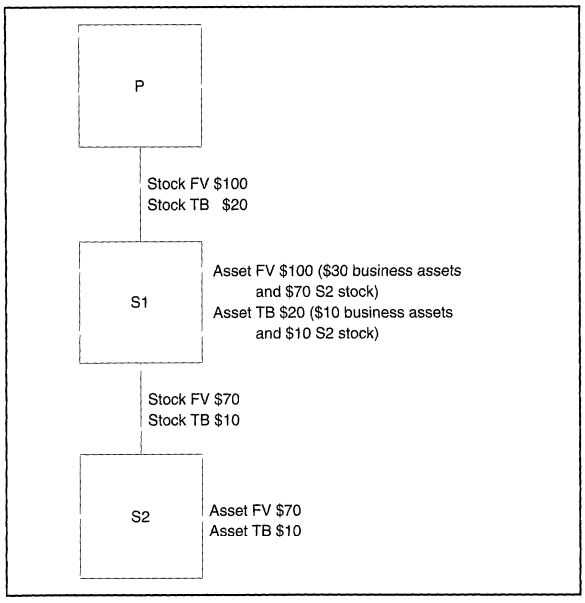
P owns 100 percent of S1's stock and S1 in turn owns 100 percent of S2's stock. The P-S1-S2 group files a consolidated return.



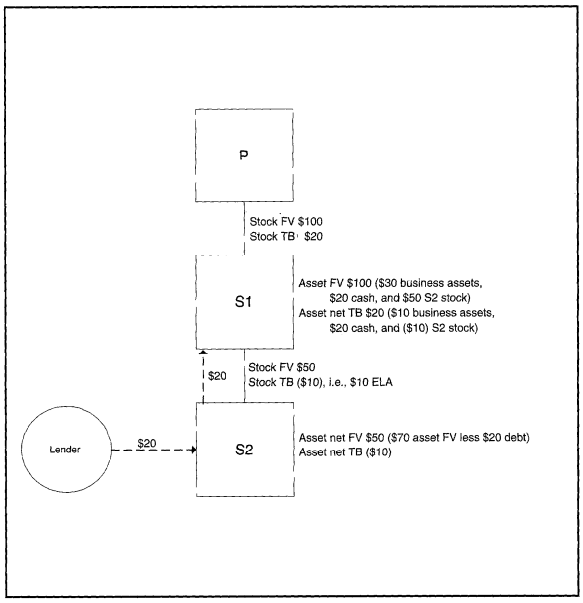
S1's stock has a $100 FV and a $20 TB.

S1's assets have a $100 aggregate FV and a $20 aggregate TB and consist of (a) business assets with a $30 FV and a $10 TB and (b) S2 stock with a $70 FV and a $10 TB.

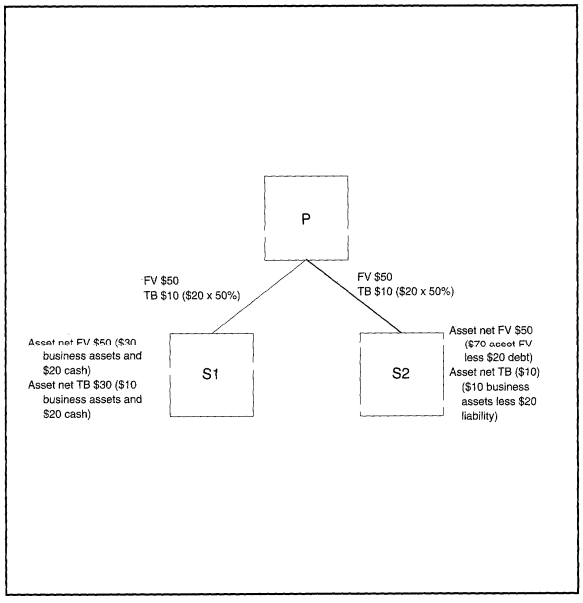
S2 owns business assets with a $70 FV and a $10 TB.



S2 borrows $20 and distributes the $20 to S1 as a dividend, thus (a) reducing S2's FV from $70 to $50 and (b) reducing the TB in S2's stock from $10 to ($10), i.e., creating a $10 ELA in S2's stock.



S1 then spins S2's stock to P in a transaction satisfying section 355's requirements. The spin-off eliminates the $10 ELA in S2's stock (see reg. section 1.1502-19(g) example 3). After the spin-off, S1 and S2 each has a $50 FV. Hence, under current section 358, P's original $20 basis in S1's stock is allocated $10 (50 percent) to P's S1 stock and $10 (50 percent) to P's S2 stock (i.e., in proportion to S1's and S2's relative FVs).



Current law thus creates a $20 disparity between stock TB and asset net TB for each of S1 and S2 where none previously existed. Thus, S1's stock TB is $10 while its asset net TB is $30. Similarly, S2's stock TB is $10 while its asset net TB is ($10), since its $20 debt exceeds its $10 asset TB.

As illustrated in Example 1, the current intragroup spin-off rules can be used (a) to eliminate an ELA in the stock of the controlled/distributed subsidiary (S2) and (b) to create a disparity between the asset net TB and stock TB of the distributing subsidiary (S1) and the controlled/distributed subsidiary (S2) where none previously existed. In the tax world disparity is opportunity. In Example 1, P may take advantage of the additional tax basis allocated to S2's stock to reduce P's taxable gain in a subsequent taxable disposition of S2's stock. Thus, where (after an appropriately patient waiting period) P sells S2's stock for $50, P recognizes only $40 gain, $20 less than the $60 gain that would have resulted had S1, without a prefatory spin-off of S2, simply sold S2's stock, or had S2 sold its assets for $70. (Of course, any taxable gain avoided through the intragroup spin-off remains inherent in S2's assets and will be subject to corporate-level tax as and when S2 sells its assets.) Moreover, the P group need suffer no detriment from a low stock basis in the retained S1 stock, since that low basis will be eliminated if P liquidates S1 tax-free under section 332.

Enactment of the House version of section 355(f) would change the current-law results in Example 1 as follows: S1's intragroup spin of S2 would create $60 of DIG (i.e., S2 stock FV $50 compared to S1's ($10) TB in S2 stock). P's TB in S2's stock (after the $60 DIG is ultimately triggered) would be $50 (equal to the S2 stock FV), and P's TB in S1's stock would be $30 (i.e., $20 pre-spin TB plus $60 DIG less $50 FV of S2 stock distributed).[4]

If the current-law results described in Example 1 above are considered excessively pro-taxpayer (a conclusion legitimately subject to debate since S2's asset basis remains unchanged and no gain with respect to any underlying business asset will escape corporate-level tax), the House version of proposed section 355(f) — which produces the tax results described in the paragraph immediately above — is nevertheless a manifestly inappropriate way to address the problem, for at least five reasons:

1. The House version of proposed section 355(f) is grossly overbroad. The House version of proposed section 355(f) creates intercompany gain in every distribution of appreciated stock within a consolidated group — even where there is no pre-spin separation of debt and borrowed funds, and no ELA. Proposed section 355(f) thus adversely affects transactions that none should consider abusive. Moreover, where there is an ELA, the DIG is not limited to the amount of the ELA.

Example 2:
S2 does not borrow and pay a dividend, so there is no ELA

Same as Example 1, except (a) S2 does not borrow $20 and S2 does not distribute $20 to S1 before S1 spins S2's stock to P and (b) after S1 spins S2's stock to P — perhaps years later — one of the following events (the "subsequent event") occurs:

- P spins S1's or S2's stock to P's shareholders tax-free under section 355.
- S2 liquidates into P tax-free under section 332.
- P, S1, and S2 cease to file a consolidated return.

If the House version of proposed section 355(f) were enacted, any of these subsequent events inappropriately would force the P group to recognize the $60 DIG previously created when S1 spun S2 (i.e., $70 FV of S2 stock at time of spin less S1's pre-spin $10 TB in S2 stock). Under reg. section 1.1502-13 the DIG would be triggered into income at the time of the subsequent event, even though there was never any ELA with respect to S2's stock. This is an improper result since the earlier intragroup spin-off did not permit the P group to avoid a $60 ELA or otherwise inappropriately shift basis between subsidiaries. Indeed, DIG is triggered even where, for example, P's tax basis in the stock of S1 (or S2) is likely irrelevant because P is spinning off S1 (or S2) to P's shareholders.

2. The House version of proposed section 355(f) creates arbitrary distinctions. The effect of the House version of proposed section 355(f) is to tax currently to the P group every section 355 spin-off to P's shareholders of an appreciated second-tier or lower-tier subsidiary, if that external spin is preceded by one or more intragroup spin-offs. The result is arbitrary, an unwarranted corporate tax difference between the spin to P's shareholders of a first-tier subsidiary (unaffected by proposed section 355(f)) and the spin to P's shareholders of a lower-tier subsidiary (subjected to corporate tax under the House provision). Similarly, P is unfairly penalized where it must first reorganize multiple tiers of subsidiaries as a prelude to spinning off a previously decentralized enterprise.

3. The House version of proposed section 355(f) would result in more complicated, inefficient, and expensive transaction structures. The House version of proposed section 355(f) will also generate needlessly complex structures designed to avoid the more burdensome impacts of the proposed legislation. Thus, P may avoid creating DIG in Example 1 by causing S1 and S2 first to liquidate into P tax-free under section 332. P may later contribute S2's former assets and liabilities, together with an additional $20 of indebtedness recent, ancient, or refinanced, to newly formed subsidiary "New S" under section 368(a)(1)(D) and promptly spin off New S.

In Example 2, where S2 has *not* borrowed and distributed $20 to S1, this approach, two section 332 liquidations followed by a "D" reorganization incorporation of S2's assets — or indeed the simpler approach

[4]P's post-spin TB in S1 stock and S2 stock are not calculated under section 358 (which, in a section 355 transaction, allocates P's pre-spin TB in S1's stock between S1 and S2) because, after proposed section 355(f)'s enactment, S1's distribution of S2 to P is not a section 355 spin-off.

of a section 332 liquidation of S1 into P followed by P's section 355 distribution of P's now first-tier subsidiary S2 — would achieve the desired result, avoiding corporate-level gain on a stock distribution that is tax-free to P's shareholders, whether or not proposed section 355(f) is enacted.

In Example 1, where S2 has borrowed and distributed $20 to S1, the prefatory liquidation of both S1 and S2 would cause P, upon P's creation of New S, to recognize a $10 gain under section 357(c), i.e., (a) gain to the extent New S's liabilities exceed its asset TB, rather than (b) gain measured by the full $60 of appreciation inherent in S2's stock, whether or not proposed section 355(f) is enacted. Moreover, when P recognizes $10 of gain on New S's creation, New S under section 362(a) is awarded a $10 step-up in asset TB. While significantly more complicated, and while ultimately producing a result not quite as favorable as the current regime allowing P nonrecognition treatment for intragroup spins, prefatory liquidations can eliminate the more punitive tax burdens imposed by the House version of section 355(f), and impose instead transaction and efficiency costs that do no one any good other than, perhaps, the lawyers.

4. The House version of proposed section 355(f) may have unintended adverse state tax consequences. In the many states where P, S1, and S2 do not or cannot file combined state tax returns, but which otherwise generally follow federal tax principles, the House version of proposed section 355(f) would attract for state income tax purposes immediate recognition of gain that is deferred for federal income tax purposes by reg. section 1.1502-13. This is true in both Example 1 where there is an ELA and Example 2 where there is no borrowing and no ELA.

5. The House version of proposed section 355(f) will encourage a shift from consolidated return groups to LLC subsidiaries. We believe consolidated return corporate groups able to do so sensibly will avoid the House version of section 355(f) by converting wholly owned subsidiary corporations to LLCs taxed, under the recently adopted "check-the-box" classification regulations, as divisions of the parent corporation. Such a restructuring will (a) terminate consolidated return tax reporting for the group, substituting a single corporate return for the old consolidated group of corporations, (b) retain limited liability for each old corporate subsidiary which has become an LLC, (c) eliminate second- and lower-tier corporate subsidiaries and hence obviate application of the House version of section 355(f), and (d) permit tax-free restructuring (under sections 368(a)(1)(D) and 355) whenever a tax-free spin is subsequently desired. A consolidated group should not be forced to convert its corporate subsidiaries to LLCs simply to counter a new and likely exorbitant corporate-level tax.

Senate Version

The Senate bill proffers two related additions to subchapter C. Proposed section 355(f) in the Senate version states:

> Except as provided in regulations, this section [section 355] . . . shall not apply to the distribution of stock from one member of an affiliated group (as defined in section 1504(a)) to another member of such group if such distribution is part of a plan (or series of related transactions) described in subsection (e)(2)(A)(ii) [i.e., is part of a *Morris Trust* transaction in which 50 percent or more (by vote or value) of the stock of P (the distributing corporation) or of S (the controlled/distributed corporation) is acquired, post-spin-off, pursuant to a plan or arrangement in existence on the date of distribution].

Proposed section 358(g) announces:

> In the case of an exchange to which section 355 . . . applies and which involves the distribution of stock from one member of an affiliated group (as defined in section 1504(a)) to another member of such group, the Secretary may, notwithstanding any other provision of this section, provide adjustments to the adjusted basis of any stock which (1) is in a corporation which is a member of such group, and (2) is held by another member of such group, to appropriately reflect the proper treatment of such distribution.

The Senate's intragroup spin-off provision, proposed section 355(f), requires corporate-level gain recognition, but only for those spin-offs that are part of a larger transaction in which corporate-level gain recognition is already required by the *Morris Trust* provision. We evaluate the Senate's version of proposed section 355(f) in the familiar way, good news and bad news.

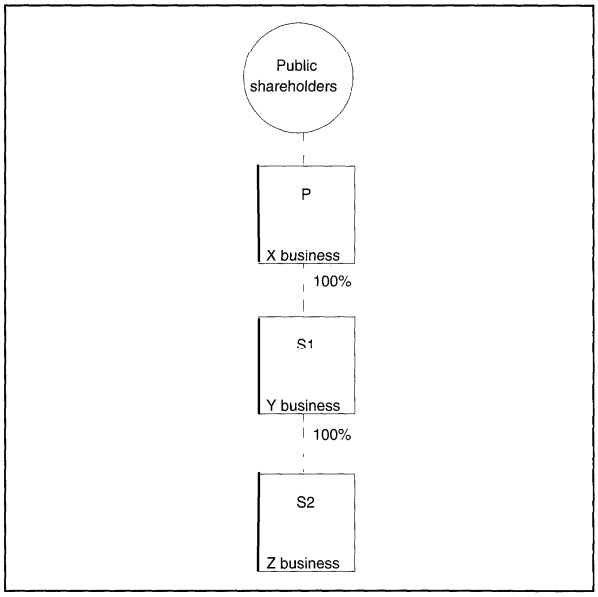
In sum, House section 355(f) is a disaster, Senate section 355(f) is a nuisance. So much for good news.

The good news: The Senate version, tied as it is to *Morris Trust* transactions, is much narrower and for that reason much better than the House version which afflicts every spin-off within a consolidated group. As a practical matter, the concerns we previously focused in reviewing the House version are muted on the Senate side. It is not likely taxpayers will intentionally consummate many transactions taxable under the *Morris Trust* provision, and even less likely they will begin with an internal spin if that internal distribution will ratchet up the corporate tax burden. In sum, House section 355(f) is a disaster, Senate section 355(f) is a nuisance. So much for good news.

The bad news: Tying the intragroup spin-off provision to the *Morris Trust* provision in practice may not do much harm, but it makes even less sense. Comprehension requires a brief tour of the *Morris Trust* provision. The simplest of examples will set the stage.

Example 3:
FV and TB are proportionate:
Controlled/Distributed is acquired

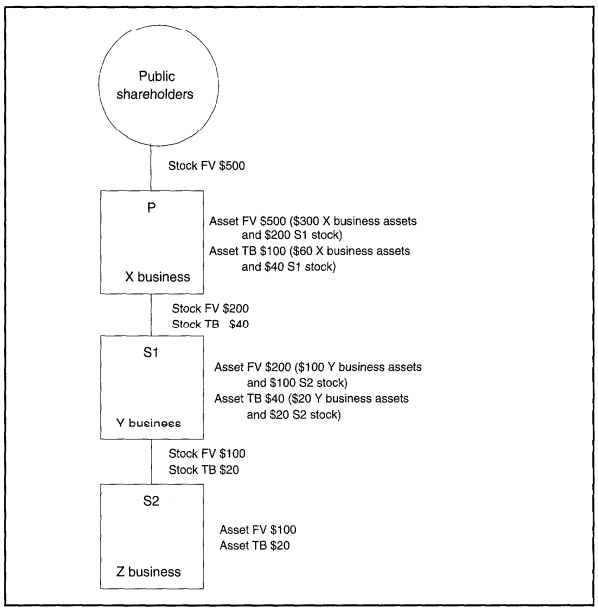
> P, a public company, conducts business X and owns 100 percent of S1's stock. S1 conducts business Y and owns 100 percent of S2's stock. S2 conducts business Z. The P-S1-S2 group files a consolidated return.



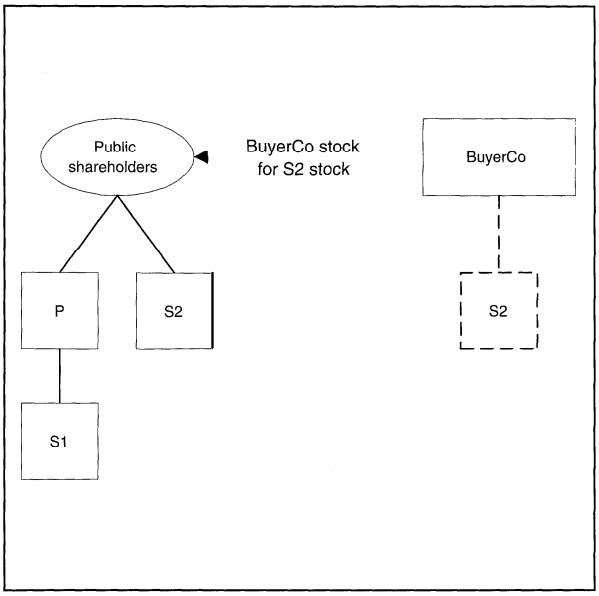
P's assets have a $500 aggregate FV and a $100 TB consisting of (a) X business assets with a $300 FV and a $60 TB and (b) S1 stock with a $200 FV and a $40 TB.

S1's assets have a $200 aggregate FV and a $40 TB consisting of (a) Y business assets with a $100 FV and a $20 TB, and (b) S2 stock with a $100 FV and a $20 TB.

S2 owns Z business assets with a $100 FV and a $20 TB.



S1 spins S2's stock to P, and P in turn spins S2's stock to the public. As part of the same plan, large unrelated BuyerCo promptly acquires from the public, in a tax-free reorganization, all of S2's stock for less than 50 percent of BuyerCo's stock.



Under the *Morris Trust* provision, proposed section 355(e), and ignoring for the moment the intragroup spin-off provision, proposed section 355(f), P on its spin-off distribution to the public shareholders of S2's stock must recognize as gain the amount by which the $100 FV of S2's stock exceeds the basis of S2's stock in P's hands. In Example 3, P takes a TB in S2's stock under current section 358 equal to $20 (50 percent of the $40 TB at which P held the S1 stock immediately before S1 spun S2 to P).[5] Under the *Morris Trust* provision, disregarding proposed section 355(f), therefore, P's gain on its spin of S2's stock is $80 (i.e., S2 stock FV $100 less $20 S2 stock TB in P's hands).

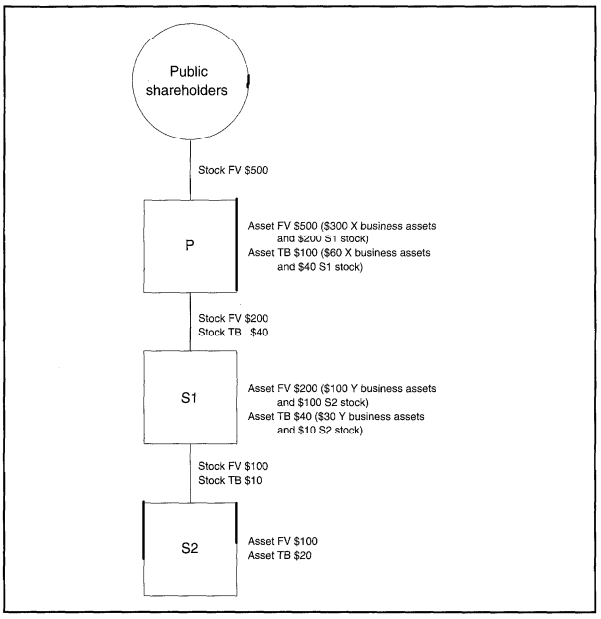
If the Senate version of section 355(f) is enacted, S1's intragroup spin of S2's stock will create $80 of section 311(b) DIG (i.e., S2 stock FV $100 less $20 TB of S2 stock in S1's hands). When P then spins S2's stock to P's public shareholders, no further gain will be recognized (because the TB of S2's stock has been stepped-up to $100 FV), but the $80 DIG will be triggered. Thus, when the *Morris Trust* provision is applied to P's distribution of S2 stock, P will have no further gain to recognize.

In Example 3, a baseline case, the P consolidated group's $80 taxable gain is the same whether section 355(f) is enacted or is discarded.

Example 4:
FV and TB are not proportionate:
Controlled/Distributed is acquired

Same as Example 3, except that S1's $40 of aggregate asset TB consists of $30 TB in the Y business assets and $10 TB in S2's stock (rather than the $20 and $20 in Example 3).

[5]We set aside any future changes that might be made in the allocation of TB between S1 and S2 stock pursuant to authority that would be granted if proposed section 358(g) were enacted.



Applying the *Morris Trust* provision, but ignoring for the moment the intragroup spin-off provision, proposed section 355(f), after the internal spin P's TB for its S2 stock is still $20 (50 percent of the $40 TB at which P held the S1 stock immediately before S1 spun S2 to P), and *Morris Trust* gain is still $80 ($100 FV of S2 stock less $20 TB of S2 stock in P's hands). However, if proposed section 355(f) is enacted, S1's intragroup spin of S2 causes S1 to recognize $90 of section 311(b) gain when S2's stock is spun to P's public shareholders (and P recognizes no additional gain under the *Morris Trust* provision).

Example 4A:

Same as Example 4, except that S1's pre-spin TB in S2 stock is $30 (rather than $10).

In this case S1's gain on the intragroup spin pursuant to proposed section 355(f) would be only $70 (and again P would recognize no additional gain under the *Morris Trust* provision), with the result that enactment of section 355(f) would enable the P group to avoid $10 of gain that the *Morris Trust* provision, standing alone, would have taxed.[6]

Nothing works one way in our wonderfully convoluted corporate tax system.

Example 5:
Distributing is acquired

Same as Example 3, but after P has spun S2 to P's public shareholders, BuyerCo acquires P rather than acquiring S2.

Under the *Morris Trust* provision, disregarding for the moment the intragroup spin-off provision, proposed section 355(f), S2 is taxed on the amount by which P's post-spin asset FV exceeds P's TB in those assets. As in Example 3, P's post-spin asset FV is $400 (i.e., $500 P asset FV before spin less $100 S2 FV) and P's post-spin asset TB is $80 (i.e., $100 P asset TB before spin less $20 S2 stock TB). Thus, S2 recognizes $320 gain.

Piling on proposed section 355(f) imposes on S1, as before, $80 of section 311(b) DIG (i.e., S2's $100 stock FV less S1's $20 pre-spin TB in S2's stock), taxed to the P group when P spins S2 to P's public shareholders. After S2 is spun to P's public shareholders without further gain (because P is not taxed on its external spin of S2 either by proposed section 355(e) or (f) and, in any event, because in P's hands S2's stock TB has stepped-up to its $100 FV to reflect the section 311(b) gain), P's TB in S1 stock is $20 (i.e., P's pre-spin $40 TB for S1 plus $80 of DIG recognized by S1 at the time of the second spin less $100 FV of S2 stock distributed by S1 to P, see reg. section 1.1502-32(b)).[7] However, P now has a tax liability of approximately $30 with respect to the $80 of DIG created by proposed section 355(f), which reduces P's post-spin net FV from $400 to $370. As a result, the section 355(e) *Morris Trust* gain taxed to S2 (when BuyerCo acquires P) is reduced from $320 to $290 (i.e., P's $370 asset FV less P's $60 TB in the X business and $20 TB in the Y business). But, as noted above, the fisc's take is augmented by $80 of section 355(f) gain taxed to P.

The bad news is that this construct makes absolutely no sense.

The bad news, you see, is that this construct, stapling section 355(f)'s intragroup spin-off provision to section 355(e)'s *Morris Trust* provision, makes absolutely no sense for several reasons. First, it makes no sense to impose tax on the S2 spin when S2 will continue to be owned by the same persons (the P public shareholders) who owned P. Second, corporate-level tax is being imposed on all of P's assets — the appreciation in S2 is taxed because of the intragroup spin-off provision and the appreciation in P's other assets (the X business and the S1 stock) is taxed because of the *Morris Trust* provision. Third, despite all of this corporate-level gain recognition, there is no asset TB step-up for any of P's assets, S1's assets, or S2's assets. Fourth, mind-numbing complexity has been escalated to an absurd level.[8]

[6]One could debate whether, in Example 4A, the proper amount of gain to recognize is $80 or $70 (the latter, after all, being the amount of corporate-level gain that would be recognized were section 355 repealed completely and were S2's stock distributed first by S1 to P and then by P to P's public shareholders), but what seems clear is that the drafters of this legislation have yet to reach closure on these complex issues.

[7]P's post-spin TB in S1 stock is not calculated under section 358 (which, in a section 355 transaction, allocates P's pre-spin TB in S1 stock between S1 and S2) because, after proposed section 355(f)'s enactment, S1's distribution of S2 to P is not a section 355 spin-off.

[8]Clever tax planning could avoid one of these four reasons: If P were to drop down to NewSub all the assets sought by BuyerCo (i.e., P's business X and S1's business Y), P were to spin off NewSub, and BuyerCo were to acquire NewSub, then in such case there would be no gain recogni-

(Footnote 8 continued on next page.)

On the other hand, the Senate's proposed section 358(g) — which by its terms applies only to an intragroup spin that qualifies under section 355 and hence a spin that is *not* taxed — is the one provision in this mess we do find sensible. It empowers Treasury to deal effectively with corporate divisions in which borrowed money and the obligation to repay are separated. If the Senate's concern underpinning its version of the intragroup spin-off provision is that there may exist, now or in the future, basis shifting schemes to prevent correct corporate-level gain recognition in *Morris Trust* transactions, or indeed in transactions unrelated to *Morris Trust*, proposed section 358(g), conjoined with Treasury's extant power to revise consolidated return regulations, offers the opportunity of a coherent approach. Proposed section 355(f) — the Senate version as well as the House version — does not.

Conclusion

The House version of proposed section 355(f) should be discarded. The Senate version of section 355(f), although surely better than the House version, should be dropped as well, because the Senate's proposed section 358(g) — unlike exorbitant section 355(f) — properly recognizes that the legitimate concerns motivating this legislative effort relate to stock basis (including ELA negative basis), and allows Treasury to address those concerns in a sensible manner.

tion with respect to S2, which P would retain. This demonstrates a fifth reason why proposed section 355(e) and proposed Senate section 355(f) in tandem make no sense: enactment of both would place yet another undue premium on the form selected for the spin-off and thus on clever, needlessly complex tax planning.