

# The IRS's Pragmatic Approach to Determining Shareholder Overlap in Spinoffs

by Stephen M. Marencik and Ronald Goerke

Reprinted from *Tax Notes Federal*, June 1, 2026, p. 1525

## The IRS's Pragmatic Approach to Determining Shareholder Overlap in Spinoffs

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In this article, Marencik and Goerke examine a recent private letter ruling that sanctioned a public company spinoff as tax free under section 368(a)(1)(D) in accordance with section 355.

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On April 17 the IRS released LTR 202616004,<sup>1</sup> a 38-page private letter ruling sanctioning a public company spinoff as tax free.<sup>2</sup> The spinoff was followed by the acquisition of the publicly traded corporation resulting from the spinoff (SpinCo) by a third-party publicly traded acquiring corporation (Acquiring) in a tax-free reverse merger<sup>3</sup> (the merger, collectively with the spinoff and all preceding steps, constitute “the transaction”).

As evident from the breadth of the ruling, the transaction presents several notable issues. Generally, a tax-free spinoff cannot occur under a planned acquisition of 50 percent or more of the stock of SpinCo (or the distributing corporation) (the section 355(e) requirement). Here, however, Acquiring acquired 100 percent of SpinCo's stock under a plan in a so-called reverse *Morris Trust* transaction.<sup>4</sup>

A second notable issue arises from the complex capital structure of the publicly traded distributing corporation (Distributing). We understand from the ruling that a disregarded entity (DRE) of Distributing indirectly owned a portion of Distributing's common stock. That stock (the hook stock) has full force and effect for legal purposes, including for purposes of effectuating the spinoff distribution, but is disregarded for U.S. federal income tax purposes. Various rabbi trusts, which are grantor trusts formed by Distributing for the benefit of its employees, also held common stock in Distributing. Both tranches of Distributing stock present an interesting technical tax issue that, if not managed, could prevent the spinoff from qualifying as tax free.<sup>5</sup>

Finally, embedded in the ruling is a series of transaction steps preceding the public spinoff that result in an internal taxable transaction — likely a “busted” section 351 transaction. The letter ruling provides evidence that the IRS was concerned that such a transaction could generate a valuable tax loss that would benefit Distributing. While other issues abound throughout the 38 pages of text, this article focuses on the issues discussed above.<sup>6</sup>

<sup>5</sup> Section 355(a)(1)(D).

<sup>6</sup> LTR 202616004 also provides guidance (and helpful insight) on the following: the classification of certain lenders of Distributing debt as creditors for purposes of section 361 and established cash segregation procedures for paying off that debt with SpinCo borrowing proceeds; a ruling (ruling 44) permitting a shareholder to designate the shares of SpinCo stock that are received as a distribution for a particular share of Distributing stock; the treatment of cash received in lieu of fractional shares; the treatment of certain payments between Distributing and SpinCo following the distribution as deriving their character from the relationship of the corporations before the spinoff under “relation-back”/ *Arrowsmith* principles; and considerations associated with certain continuing arrangements between Distributing and SpinCo.

<sup>1</sup> LTR 202616004 was originally issued to the taxpayer on January 22.

<sup>2</sup> The IRS ruled that the spinoff qualified as a reorganization under section 368(a)(1)(D) in accordance with a distribution under section 355.

<sup>3</sup> The reorganization was represented to qualify as a reorganization under section 368(a). See LTR 202616004, additional representation 6.

<sup>4</sup> *Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966).

## The Section 355(e) Requirement and Shareholder Overlap

A series of rules tends to prevent the acquisition of the stock of a distributing corporation (here, Distributing) and a controlled corporation (here, SpinCo) following a tax-free spinoff. If violated, depending on the rule breached,<sup>7</sup> the acquisition may render the spinoff taxable to Distributing and, potentially, its shareholders (resulting in up to two levels of taxation). This has the potential to make a transaction prohibitively costly and thus is an area ripe for a private letter ruling.

For example, a distribution will not qualify for tax-free treatment if the distributing corporation or controlled corporation is acquired in a subsequent planned taxable transaction (for example, a cash sale) because the sale effects a tax-efficient monetization of corporate earnings and profits by distributing's shareholders because of basis recovery. The transaction is considered a "device" for the distribution of corporate E&P and is therefore impermissible.<sup>8</sup> The transaction here does not raise "no-device requirement" concerns because the merger is structured as an all-stock tax-free reorganization under section 368(a)(2)(E).<sup>9</sup>

Section 355(e) imposes a separate requirement that prevents one or more persons from acquiring directly or indirectly 50 percent or more of the vote or value of the stock of the distributing or controlled corporation as part of the same plan as the distribution, and it is relevant whether or not the acquisition qualifies as a tax-free reorganization. The transaction is therefore directly within the crosshairs of the section 355(e) requirement.

As it pertains to the transaction, the section 355(e) requirement focuses on Distributing's

historical shareholder base and the amount of post-merger ownership that Distributing's shareholders have in Acquiring following the merger. If the historical shareholders of Distributing (that became shareholders of SpinCo in the spinoff) own more than 50 percent of Acquiring (and SpinCo, indirectly) following the merger, section 355(e) will not be violated because there has not been a prohibited 50-percent-or-greater acquisition of SpinCo.

On its face, the section 355(e) requirement appears to suggest that SpinCo must exceed Acquiring in size (that is, equity value). Otherwise, how can Distributing's shareholder base retain more than 50 percent of SpinCo stock indirectly? The answer is that SpinCo's equity does not need to exceed Acquiring's equity value because of shareholder overlap — that is, to the extent that Distributing's shareholders also own shares in Acquiring, that overlap counts favorably in assessing the continuing indirect ownership of SpinCo by Distributing's shareholders.

To illustrate, assume that D distributes the stock of C pro rata to its shareholders in a purported tax-free spinoff. Following the distribution, C has an equity value of \$85. A, an unrelated corporation, acquires 100 percent of the stock of C for A stock in a tax-free reorganization. Before the acquisition, A is valued at \$100 (that is, more than C). However, there is one shareholder that owns 10 percent of the stock of both D (and, in turn, C immediately following the spinoff) and A immediately before the series of transactions.

Following the series of transactions, the historical shareholders of D that become shareholders of C in the purported tax-free spinoff collectively own stock of A valued at \$95, which represents more than 50 percent of the value of the stock of A (and, indirectly, SpinCo). To compute the magnitude of C stock acquired in

<sup>7</sup> If a spinoff fails the section 355(e) requirement, it is taxable only at the corporate level, and thus the shareholders may still be eligible for tax-free treatment under section 355.

<sup>8</sup> The "no device requirement" was more fully examined in Stephen Marencik and Nick Tulp, "Technical Update: IRS Ruling PLR 202521019, Spin-Offs, the No Device Requirement, and Stock Repurchase Plans," *WilliamsMarston* (June 9, 2025).

<sup>9</sup> In the merger, cash was or will be paid in lieu of fractional shares, however the taxpayer obtained the customary ruling that, for U.S. federal income tax purposes, the holders of SpinCo stock are treated as receiving a fractional share of Acquiring stock and then disposing of that fractional share for cash.

the merger, the “net decrease methodology” in the legislative history<sup>10</sup> indicates that only the net reductions in the ownership of C by the D shareholder base should be aggregated. This is appropriate because the reductions are attributable to the nonoverlapping shareholders, and thus overlapping ownership does not contribute to the acquisition percentage. Under the facts of this example, the acquired percentage is about 48.6 percent (that is, equal to 90 percent of C stock owned by the nonoverlapping shareholders that experience a reduction in ownership minus the 41.35 percent owned by those shareholders through A following the merger). The section 355(e) requirement is satisfied even though A’s equity value immediately preceding the acquisition exceeded the equity value of C.

The IRS implicitly approved this net decrease methodology in LTR 202616004.<sup>11</sup> The taxpayer in the ruling relied on shareholder overlap to satisfy the section 355(e) requirement. Though redacted from the ruling, this is apparent from the language in LTR 202616004’s step 22:

Under the terms of the Merger Agreement, each share of [SpinCo] stock issued and outstanding immediately prior to the Merger will convert into the right to receive a number of shares of Acquiring common stock equal to an exchange ratio

resulting in Distributing shareholders owning approximately i percent of the combined company (before accounting for the Overlapping Shareholders) and at least n percent of the combined company (when taking into account the Overlapping Shareholders).

Context suggests that the section 355(e) requirement would have been violated but for accounting for shareholder overlap because “i percent” presumably did not exceed 50 percent but “n percent” did. In this regard, the tax advisers on the transaction wisely incorporated an adjustment mechanism to deal with fluctuations in the amount and value of Acquiring shares received by Distributing’s shareholders to prevent a situation in which “n percent” declined below the amount calculated and shared with the IRS. Step 22 also provided:

If the exchange ratio would result in Distributing’s shareholders receiving less than n percent of the combined company (when taking into account the Overlapping Shareholders), then certain adjustments (including a special dividend paid by Acquiring and/or a reduction to the amount of cash distributed by [SpinCo] to Distributing) will be made to bridge any shortfall.

The adjustment mechanism would thus either reduce the equity value of Acquiring or increase the equity value of SpinCo before the merger, thereby increasing Distributing shareholders’ continuing indirect ownership in SpinCo to satisfy the section 355(e) requirement.

To establish how “n percent” should be calculated in light of certain information deficiencies and gaps and the proliferation of complex and widely held investment vehicles when beneficial ownership is undetectable (for example, exchange-traded funds), the taxpayer and its tax advisers in LTR 202616004 established a series of “overlap counting principles” that were ultimately sanctioned by the IRS.<sup>12</sup> These overlap counting principles include: (1) the look-through

<sup>10</sup> LTR 202616004 also applied the “net decrease methodology” for computing overlap based on an example in the 1998 legislative history of section 355(e)(3)(A)(iv). In applying section 355(e), the net decrease methodology, as described in the legislative history to the IRS Restructuring and Reform Act of 1998, is intended to prevent double counting of ownership changes when shareholders hold stock in both the distributing and acquiring corporations (*i.e.*, overlapping shareholders). Under this approach, overlapping ownership is treated as continuing ownership to the extent that a shareholder’s economic interest does not decrease. Thus, only the net reduction in ownership of the historic shareholders of the distributing corporation is treated as an acquisition for purposes of section 355(e). This methodology is illustrated by an example in which shareholder A owns 10 percent of corporation D and 100 percent of unrelated corporation P, while the remaining 90 percent of D is held by nine equal shareholders. Following a spinoff and subsequent merger of D (worth 100x) with P (worth 900x), A owns 91 percent of the combined company, and each of the other former D shareholders owns 1 percent. In applying the net decrease methodology, A’s original 10 percent interest and the 1 percent retained by each of the other shareholders are treated as continuing ownership and are not counted toward an acquisition. However, the remaining 81 percent of the combined company reflects a net decrease in ownership by the nonoverlapping shareholders and is therefore treated as newly acquired ownership. Because this equals or exceeds 50 percent, the transaction results in a prohibited acquisition under section 355(e).

<sup>11</sup> See LTR 202616004, ruling 47.

<sup>12</sup> The overlap counting principles in the ruling are similar to those established in other private letter rulings. See, *e.g.*, LTR 202249011; LTR 202145020; LTR 201740015.

approach, (2) the sources of proof of overlapping shareholders, (3) reliance on actual knowledge, and (4) verification.

### 1. Look-through approach.

In applying the overlap rule and the net decrease methodology, Distributing will look through entities to the ultimate indirect owners of Distributing common stock and Acquiring common stock and will take into account the identified actual overlap in the ultimate indirect ownership of Distributing common stock and Acquiring common stock at that level, based on actual knowledge — or, if Distributing does not have actual knowledge, based on the sources of proof described below. Despite this, in proving the identity of overlapping shareholders and the extent of their share ownership for purposes of applying the overlap rule and the net decrease methodology, Distributing will treat as the ultimate owner of Distributing common stock and Acquiring common stock (1) widely held investment vehicles with public investors (such as a mutual fund or exchange-traded fund); (2) any regulated investment company; (3) any domestic pension trust described in section 401(a) that is exempt from tax under section 501(a); (4) any domestic charitable organization described in section 501(c)(3) (including an endowment or private foundation); (5) any state, local, or foreign government (or agency or instrumentality thereof), including any fund ultimately owned by a government and Fund A; and (6) any foreign trust or pension plan (provided that the beneficiaries of the trust or pension plan have a pro rata interest in the assets thereof).

The look-through component of the overlap counting principles establishes a helpful rule that turns off shareholder look-through in the case of widely held, publicly traded investment vehicles, effectively treating mutual funds and exchange-traded funds as “entities” with tax ownership.

Other shareholders that are treated as entities having tax ownership for purposes of the overlap calculation include RICs defined under section 851; pension funds described in section 501(a); charitable organizations described under section 501(c)(3); state, local, and foreign governments; and certain foreign trusts and pension plans.

The look-through approach is more than a helpful rule or a rule of convenience; it is essential

to developing a meaningful, accurate overlap calculation because of the complex webs of investors, beneficiaries, or citizens that sit atop these entities. For example, it is effectively impossible to look through publicly traded investment vehicles with indiscrete ownership that is perpetually fluid or in a state of flux. Moreover, it is impossible to identify the ultimate beneficiaries of investments held by charities, or the citizens or other persons most likely to benefit from investments held by state, local, and foreign governments.

### 2. Sources of proof of overlapping shareholders.

For purposes of determining the identity of, and number of shares owned by, overlapping shareholders — absent actual knowledge at the relevant time — Distributing will rely on publicly available information. Publicly available information includes (1) information filed under applicable federal securities laws by institutional investment managers (SEC forms 13F, 13D, and 13G) and registered management investment companies (SEC forms N-PORT and N-CSR) (together, SEC filings) and (2) information voluntarily posted on the investor’s or the investment adviser’s website (website posting). Distributing will rely on the Fund A information for Fund A. In determining the identity of and number of shares owned by overlapping shareholders, Distributing will rely on overlapping shareholder information from SEC filings or website postings at the relevant time, which may relate to stock ownership on certain dates before that time.

The sources of proof of the overlapping shareholders component of the overlap counting principles prioritize actual knowledge.<sup>13</sup> The taxpayer is permitted to identify overlapping ownership from publicly available information. Still, in this instance, publicly available information is not limited to SEC filings and can include voluntary disclosures on privately run investment company websites.

Further, there is an indication in LTR 202616004 that information provided directly by

<sup>13</sup> Prioritizing actual knowledge is consistent with the rules established in reg. section 1.355-7. See reg. section 1.355-7(h)(8).

Fund A, presumably through inquiry, is prioritized over publicly available information, presumably because the Fund A information provides more detail or is more current than the information reported in its SEC filings or on its website. One might guess that Fund A is a large institutional investor, such as Vanguard or BlackRock, with a complex portfolio of investors, including many entities treated as ultimate owners under the look-through approach described above.

### 3. Reliance on actual knowledge.

For purposes of these overlap counting principles, “actual knowledge” means the actual knowledge of the chief financial officer or general counsel of either Distributing or Acquiring. To determine overlapping shareholder information that is not publicly available on appropriate SEC filings or website postings, Distributing may obtain actual knowledge as of the relevant time through written or oral confirmation from a shareholder (or an authorized representative) about (1) its ownership of Distributing common stock and Acquiring common stock, (2) whether the beneficiaries or owners of a shareholder have direct or indirect pro rata interests in the shareholder’s assets, or (3) any other relevant information.

The “reliance on actual knowledge” component of the overlap counting principles clarifies which company personnel are relevant to assessing whether the taxpayer possesses actual knowledge. In this case, the ruling clarifies that actual knowledge is that of the CFO or general counsel of Distributing or Acquiring, or information obtained through direct shareholder inquiry.<sup>14</sup> Shareholder inquiries and surveys have been permitted in other cases to obtain ownership information or other information relevant to a corporation’s tax posture. For example, similar procedures have been applied to section 382<sup>15</sup> and

to assess a corporation’s tax basis in the stock of a publicly traded target corporation.<sup>16</sup>

### 4. Verification.

Distributing and Acquiring will compare the search results for each investor, showing overlap with any shareholding information on the investor’s website and its most recent securities law filings (if any) filed before the relevant time, and report historic ownership to find the most current and accurate data. If a discrepancy arises through the verification process that contradicts the information resulting from the search results, the most recent information will be used; if dates are the same, then the lower ownership number will be used (that is, providing a conservative view on the amount of overlap) in each case, unless Distributing or Acquiring knows that the more recent information or lower ownership number is incorrect.

Finally, the verification component of the overlap counting principles establishes procedures to verify data using publicly available information from SEC filings, triangulated against information presented on a particular investor’s website, and to provide the most contemporaneous ownership picture possible. Under the ruling, the default is to use the most recent data for computation. If no portion of otherwise-conflicting data is more current, then the procedures are to adopt the more conservative approach to minimize the benefits of overlapping ownership unless there is a clear indication that the more conservative number is false.

In total, the IRS’s willingness to accept the overlap counting principles reflects a pragmatic approach to a computation that can be daunting in practice. The IRS has previously agreed to similar procedures, and this reflects a valuable use of the private letter ruling practice.<sup>17</sup> In another instance, the IRS accepted a similarly pragmatic “shareholder identification

<sup>14</sup>Whose “actual knowledge” is relevant is not otherwise clarified in the regulations.

<sup>15</sup>See, e.g., LTR 201110006 (ruling that overlapping ownership information to be obtained through written inquiries was an acceptable method of determining actual knowledge within the meaning of reg. section 1.382-2T(k)(2)).

<sup>16</sup>Rev. Proc. 2011-35, 2011-25 IRB 890.

<sup>17</sup>LTR 202249011; LTR 202145020; LTR 201740015.

methodology” and “overlap calculation” guidelines for a merger between two publicly traded corporations.<sup>18</sup>

As related to the section 355(e) requirement, LTR 202616004 also provides a favorable ruling (ruling 48) that limits potentially adverse effects on the section 355(e) acquisition percentage because of share repurchases by Distributing or Acquiring in the pre- or post-transaction period. LTR 202616004 provides facts establishing that the share repurchases were or would be generally conducted on the open market or through tender offers in which the public shareholder base could participate. The ruling stipulates that the share repurchases were not intended to achieve a particular tax result.

LTR 202616004 provides that Distributing has historically instituted (and plans to continue instituting) a share repurchase program under which it repurchases shares of its common stock to achieve an appropriate capital structure. It says all share repurchases by Distributing occurring within the period beginning two years before, and ending two years after, the date of the proposed transactions will have been made through (1) open market purchases (including through an SEC Rule 10b5-1 plan or a purchase in compliance with SEC Rule 10b-18), (2) accelerated share repurchase programs, (3) one or more tender offers open to all holders of Distributing common stock, or (4) a combination thereof. Further, Acquiring may also engage in share repurchases following the proposed transactions. All share repurchases by Acquiring occurring within the period beginning on the date of the merger and ending two years after the date of the separation will be made through (1) open market purchases (including through an SEC Rule 10b5-1 plan or a purchase in compliance with SEC Rule 10b-18), (2) accelerated share repurchase programs, (3) one or more tender offers open to all holders of Acquiring common stock, or (4) a combination thereof. Further, see representations “with respect to the Controlled 1 Contribution and Controlled 1

<sup>18</sup> LTR 202141005. See also Mark R. Hoffenberg, Marencik, and Adam Murphy, “Determining Control in Public M&A Transactions,” *Tax Notes Federal*, Dec. 13, 2021, p. 1487 (republished in “Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2026,” Practising Law Institute (2025)).

Distribution” — in particular, representations 4(iv)(1-4).

In LTR 202616004’s ruling 48, the IRS established that the share repurchases will be treated as made pro rata from shareholders other than those constituting controlling shareholders or 10 percent shareholders of Distributing or Acquiring. The effect of ruling 48 is that share repurchases could be de-linked from the spinoff plan under various safe harbors provided for under reg. section 1.355-7(d) — in particular, because no controlling shareholder or 10 percent shareholder was a party to the share repurchases.<sup>19</sup> Further, for purposes of classifying shareholders as public shareholders versus controlling shareholders and 10 percent shareholders, LTR 202616004 treats as public shareholders persons that file SEC disclosures indicating their status as controlling shareholders and 10 percent shareholders within five days before the repurchase, or that status becomes actually known by company representatives within five days before the repurchase. This may be appropriate when considered in light of the administrative time lag between the decision to effectuate a repurchase and the repurchase itself — in particular, the repurchase could not have been a planned acquisition of Distributing or SpinCo stock from a controlling shareholder or 10 percent shareholder because the decision to effect the repurchase likely preceded disclosure or awareness of that status. Finally, the IRS provided procedures for interpreting SEC Form 13G filings, which, in our experience, can be prepared in wildly inconsistent ways depending on the investment firm reporting ownership.<sup>20</sup>

We also note that the ruling does not concede that the share repurchases were planned, but the

<sup>19</sup> For purposes of LTR 202616004, “controlling shareholder” and “10 percent shareholder” are defined in reg. section 1.355-7(h)(3) and (14). A controlling shareholder is a “5 percent shareholder” under reg. section 1.355-7(h)(8) that actively participates in the management or operation of the relevant corporation as described in reg. section 1.355-7(h)(3). A 10 percent shareholder is defined in reg. section 1.355-7(h)(14).

<sup>20</sup> Ruling 48 provides that “for purposes of determining whether a ‘ten-percent shareholder’ within the meaning of Treas. Reg. section 1.355-7(h)(14) exists, Distributing and Acquiring, as applicable, may disregard a Schedule 13G unless Item 6 reports such a shareholder or is left blank, or the filer discloses its status as a ‘ten-percent shareholder’ within the meaning of Treas. Reg. section 1.355-7(h)(14) on SEC Form 3 or SEC Form 4.”

taxpayer's advisers were appropriately sensitive to the issues, given the stakes.

Finally, and implicitly, in ruling that the spinoff satisfies the requirements under section 355, LTR 202616004 also seems to sanction relying on the overlap counting principles for purposes of assessing whether the section 355 continuity of interest requirement is satisfied. This is appropriate given the significant similarities of the section 355 continuity of interest requirement and the section 355(e) requirement, at least on the facts of this transaction.

### Hook Stock

The facts of the ruling establish that immediately before the spinoff, Distributing had a single class of common stock issued and outstanding and that a portion of that stock (the hook stock) was owned by DRE 1, an indirect wholly owned legal entity that is disregarded as separate from Distributing for federal income tax purposes. Although the hook stock is disregarded for federal income tax purposes, it continues to have full legal effects, meaning that any distribution of SpinCo stock with respect to Distributing stock returns a portion of SpinCo stock to Distributing from a federal income tax viewpoint.

A similar conundrum arises because of the Distributing stock held by the rabbi trusts as deferred compensation for employees and directors. Because the rabbi trusts are grantor trusts, Distributing is treated as the federal income tax owner of the stock held in trust. Therefore, if any SpinCo stock were distributed with respect to the Distributing stock held by the rabbi trusts, that SpinCo stock would also continue to be held by Distributing from a federal income tax viewpoint.

This boomerang effect, which is more appropriately viewed as a retention of SpinCo stock by Distributing, is problematic from a section 355 standpoint. Section 355(a)(1)(D) generally requires Distributing to distribute all

the stock or securities of SpinCo in the distribution.<sup>21</sup> The boomerang effect would amount to a retention of SpinCo stock in violation of section 355(a)(1)(D).

To address the retention issue and preserve section 355 treatment, the steps of the transaction in LTR 202616004 provide that the stock of SpinCo received by DRE 1 on account of the hook stock would be sold by DRE 1 for cash back to Distributing. Distributing would then transfer the SpinCo stock back to SpinCo for no further consideration, with the SpinCo stock (as Treasury shares) then being canceled. These steps would all occur under a legally binding commitment preventing any potential deviation from the plan and thereby rendering illusory the SpinCo stock distributed with respect to the hook stock. The IRS agreed to disregard that stock presumably based on its transitory or circular nature,<sup>22</sup> and the taxpayer vowed to treat the series of steps as a taxable distribution of cash by Distributing to DRE 1 (in its capacity as a shareholder of Distributing).<sup>23</sup>

A different approach was taken for the stock held by the rabbi trusts: Immediately before the spinoff, that stock was recapitalized into stock that did not participate in the spinoff, and thus no stock was retained by Distributing on account of the legal distribution to the rabbi trusts. Immediately after the spinoff, the stock held by the rabbi trusts was converted back into Distributing common stock at a ratio determined under an antidilution formula. The taxpayer represented that it would treat the recapitalization and conversion as a disregarded transaction for federal income tax purposes based

<sup>21</sup> A distribution can qualify under section 355 if there is a distribution of less than all the SpinCo stock, provided that there is a distribution of SpinCo stock that represents control of SpinCo (as defined in section 368(c)) and it is established to the satisfaction of the Treasury secretary that the retention by Distributing of stock (or stock and securities) in SpinCo was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax. Given the facts of LTR 202616004, it is unclear whether that path was feasible, because the amount of hook stock and stock held by the rabbi trusts (each redacted) may have prevented a distribution of section 368(c) control. Moreover, any amount of retained SpinCo stock would have made the section 355(e) analysis exceedingly complex and potentially not something the IRS would entertain in a letter ruling.

<sup>22</sup> See Rev. Rul. 74-564, 1974-2 C.B. 124; Rev. Rul. 78-397, 1978-2 C.B. 150; and Rev. Rul. 83-142, 1983-2 C.B. 68.

<sup>23</sup> See LTR 202616004, ruling 21. The IRS did not express an opinion about whether that treatment was appropriate. See Caveats.

on the fact that the stock issued in the recapitalization was transitory and the modification, taking into account the antidilution features, lacked substance.<sup>24</sup>

Hook stock presenting a retention issue is not necessarily a novel issue. It is generally manageable in cases in which there is a timely disposition of the retained controlled corporation stock.<sup>25</sup> The structuring performed in this case is also consistent with structural remedies employed by taxpayers in the past.<sup>26</sup> Still, the ruling is an example of a pragmatic way to avoid a technical issue through the private letter ruling process that ought not prevent a bona fide business transaction.

### The DRE 12 Steps: A Busted Section 351?

A series of steps (the DRE 12 steps) preceding the public spinoff were determined to result in a taxable transaction — likely a busted section 351 transaction. Context suggests that the IRS was concerned that the transaction could be a loss generator. In particular, out of the 24 total steps set forth in LTR 202616004, the following steps<sup>27</sup> occurred or will occur:

- Certain SpinCo business assets and liabilities, any corporations holding SpinCo business assets and liabilities, and any other newly formed DREs holding SpinCo business assets and liabilities that are owned by FSub 1 (or FSub 1's subsidiaries) will be transferred from FSub 1, or subsidiaries owned directly or indirectly by FSub 1, to DRE 12.
- DRE 12 will elect to be classified as a corporation for federal income tax purposes.

- FSub 1 (or a DRE of FSub 1) will sell all the issued and outstanding equity interests in DRE 12 to Distributing in exchange for cash or a note receivable (together with steps 5 and 6, the DRE 12 steps).

The assets and liabilities transferred in the DRE 12 steps are principally composed of assets and liabilities related to Business F. Business F was not one of the businesses for which financial information was submitted to support active trade or business status.

Viewed in isolation, steps 5 and 6 may constitute a section 351 exchange.<sup>28</sup> However, the subsequent upstream sale of DRE 12, particularly when combined with the contribution to SpinCo in step 17 (that is, the section 368(a)(1)(D) reorganization preceding the public section 355 distribution), under a plan would appear to bust the section 351 exchange.<sup>29</sup> As a result, the deemed transfer of assets by FSub 1 (and potentially its subsidiaries) would constitute a taxable asset transfer, potentially generating a taxable loss or gain subject to the global intangible low-taxed income or net CFC tested income regimes. A taxable loss or a taxable gain at reduced GILTI or NCTI rates could create valuable tax effects for FSub 1 and the Distributing group.<sup>30</sup> The IRS seemed concerned about this potential and requested the following additional

<sup>28</sup> The ruling acknowledges that there may be multiple entities (including corporations and DREs) that transfer assets to DRE 12. Also, immediately before the DRE 12 steps, DRE 12 is wholly owned by FSub 1, and therefore the only entity deemed to receive stock of DRE 12 is FSub 1. Thus, there would appear to be a series of deemed transaction steps necessary to explain the disconnect between the DRE 12 subsidiary asset transfers and the deemed issuance of all DRE 12 stock to FSub 1. Presumably, this would be explained by a series of deemed distributions and deemed contributions.

<sup>29</sup> See, e.g., *Hazeltine Corp. v. Commissioner*, 89 F.2d 513 (3d Cir. 1937); Rev. Rul. 70-140, 1970-1 C.B. 73. There is perhaps some question about whether the upstream sale of DRE 12 to Distributing could constitute a distribution under section 351(c). While “distributes . . . to its shareholders” as used in section 351(c) implies a distribution to the corporate transferor or in exchange for its stock, historically the IRS has applied section 351(c) even more broadly, including to transfers to shareholders in exchange for non-stock property. See LTR 8025107 and LTR 8337063. We note that those private letter rulings are factually distinguishable from the present case, as here, Distributing is multiple tiers above FSub 1 through a complex web of corporate ownership, and thus the ruling does not involve a direct upstream sale by a domestic corporate transferor to its immediate shareholder. Further, DRE 12 is ultimately an entity transferred to SpinCo and distributed with SpinCo in the spinoff.

<sup>30</sup> Section 267(f) would not appear to limit the loss in this case. Further, any amount included as GILTI or NCTI when coupled with the basis effects under section 961 could create favorable tax effects because of rate arbitrage.

<sup>24</sup> Cf. Rev. Proc. 2016-40, 2016-32 IRB 228 (permitting a controlled corporation to engage in a recapitalization to enable its post-recapitalization controlling corporate owner — *i.e.*, the distributing corporation — to satisfy the control and distribution of control requirements under section 355, provided that no action is taken to unwind the post-recapitalization structure, and providing a safe harbor if no action is taken at any time before 24 months after the distribution). See also Rev. Rul. 69-407, 1969-2 C.B. 50; Rev. Rul. 56-117, 1956-1 C.B. 180; Cf. Rev. Rul. 63-260, 1963-2 C.B. 147 (ruling that a predistribution acquisition of control by the distributing corporation is not respected for purposes of section 355(a)(1)(A) if it is transitory or illusory).

<sup>25</sup> See LTR 200608016; LTR 200731025; LTR 202223004.

<sup>26</sup> LTR 202223004.

<sup>27</sup> See steps 5 through 7.

representations. The IRS presumably also required representations that isolated Business F from the active trades or businesses being relied on by SpinCo to support the spinoff<sup>31</sup>:

- Distributing expects that FSub 1 and each other member of the Distributing group that transfers SpinCo business assets and liabilities to DRE 12 in the DRE 12 steps will recognize net gain (and no loss) as a result of those transfers.
- Distributing does not expect that any gain recognized as a result of the transfer of SpinCo business assets and liabilities in the DRE 12 steps will cause the adjusted tax basis in the stock of any member of the Distributing group to exceed the fair market value of that stock.
- Distributing expects that, at the time of the Controlled 1 distribution, the gross and net assets transferred to DRE 12 (and DREs owned by DRE 12) in the DRE 12 steps will represent less than m percent of the aggregate FMV of the gross and net assets, respectively, of SpinCo's separate affiliated group within the meaning of section 355(b)(3)(B).
- The assets and liabilities transferred in the DRE 12 steps will be principally composed of assets and liabilities related to Business F.
- Distributing has no plan or intention to dispose of the stock of FSub 1 or any other member of the Distributing group that will transfer (or be treated as transferring through a DRE) assets and liabilities to DRE 12 in the DRE 12 steps, other than a transfer

of that stock to a member of the Distributing group in which any additional basis in the stock resulting from the transfers would not be used to reduce the amount of income or gain (or increase the amount of loss) recognized by the transferor.

Context suggests that the DRE 12 steps were business-motivated steps necessary to move the DRE 12 assets within the scope of the spinoff, and were not intended to drive a particular tax result. It is unclear why the DRE 12 steps did not take the form of a tax-free spinoff, but perhaps there were non-U.S. tax or legal limitations that needed to be managed or other facts that prevented a tax-free distribution for U.S. tax purposes.<sup>32</sup>

### Conclusion

This article only scratches the surface of the interesting issues presented and addressed throughout the 38-page letter ruling. As a general takeaway, distributions under section 355 remain a complex area of the tax law and entail significant risk because of the magnitude of the tax imposed if the parties are wrong. This is particularly acute when assessing section 355(e), a technically challenging area of law that is made exceedingly complex by current informational deficiencies and layers of investment vehicles. The ruling is an example of ways in which a taxpayer, its advisers, and the IRS can apply a series of pragmatic and flexible approaches to address technical issues and informational deficiencies that ought not prevent business-motivated transactions that are not otherwise abusive. ■

<sup>31</sup>See section 355(b)(2)(C).

<sup>32</sup>E.g., section 355(d).