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Proposed Treasury regulations on corporate separations, reorganizations, and related reporting requirements

Tax Alert

Overview

On January 13, 2025, Treasury and the IRS issued two sets of proposed Treasury regulations (the "Proposed Regulations") providing guidelines for corporate separations under section 355, reorganizations under section 368, certain other subchapter C matters, and related reporting requirements.

The first set of Proposed Regulations (REG-112261-24) (the "Substantive Proposed Regulations") address certain matters relating to section 355 spin-offs, section 351 transactions and section 368 reorganizations. The purpose of the Substantive Proposed Regulations is to establish a comprehensive set of rules to implement core definitional and operative provisions of subchapter C. The Substantive Proposed Regulations are intended to facilitate the ability for taxpayers to achieve increased comfort on the US federal income tax treatment of corporate M&A transactions without the need for a private letter ruling (a PLR). In addition, the preamble states that the Substantive Proposed Regulations are intended to focus the PLR program primarily on significant issues not addressed by the Substantive Proposed Regulations. In general, the Substantive Proposed Regulations would apply to transactions that occur after final regulations are published. However, in a statement accompanying the release of the Substantive Proposed Regulations, the IRS stated that it will follow the Substantive Proposed Regulations when issuing PLRs and will revise Rev. Proc. 2024-24 (related to section 355 spin-off PLRs) to incorporate changes made by the Substantive Proposed Regulations.

Highlights of the Substantive Proposed Regulations include:

1. Rules that define a plan of reorganization for purposes of section 368, which apply to divisive reorganizations (transactions intended to qualify as a reorganization described in sections 355 and 368(a)(1)(D) or (G)) as well as other types of section 368 reorganizations and parallel rules defining a plan of distribution under section 355(c).
2. Guidance related to (i) the application of section 355(a)(1)(D)(ii) to the continued ownership by the distributing corporation of stock or securities of the controlled corporation after a distribution (a "retention") and (ii) monetization transactions occurring as part of a divisive reorganization whereby controlled corporation debt securities or stock are used by the

distributing corporation to satisfy distributing corporation debt in intended nonrecognition transactions under section 361.
3. Guidance under section 357 related to the assumption of debt in connection with section 351 and section 361 exchanges.

The second set of Proposed Regulations (REG-116085-23) (the "Reporting Proposed Regulations") introduce multi-year reporting for section 355 spin-off transactions. These regulations revise existing Treas. Reg. § 1.355-5 and are intended to enhance the IRS's ability to administer and enforce the requirements of section 355 and related Code provisions. The Reporting Proposed Regulations would require certain taxpayers to annually submit new Form 7216, *Multi-Year Reporting Related to Section 355 Transactions*, with their tax returns. If finalized, the Reporting Proposed Regulations would apply to taxable years ending after January 16, 2025, with respect to section 355 transactions occurring after January 16, 2025.

Plan of reorganization and plan of distribution

Plan of reorganization

The Substantive Proposed Regulations contain rules that define a plan of reorganization for purposes of section 368 and provide for significantly more reporting requirements. These rules apply to divisive reorganizations as well as other types of section 368 reorganizations.

The preferred approach

The Substantive Proposed Regulations would permit a plan of reorganization to be determined in several different manners. As stated in the preamble to the Substantive Proposed Regulations, under the "preferred" approach of the Treasury and IRS, taxpayers would prepare and file with the IRS a single document that meets the requirements of Prop. Treas. Reg. § 1.368-4(d). Specifically, the plan of reorganization should:

1. Identify (i) all parties to the reorganization, (ii) all transactions properly included in the plan of reorganization, (iii) all liabilities (including debt) to be assumed by the acquiring corporation and the obligees (or creditors) of those liabilities, and (iv) all debt of the target corporation that will be satisfied with section 361 consideration (*that is*, consideration received by a target corporation from an acquiring corporation) and the creditors of that debt.
2. Describe the intended US federal income tax treatment for each transaction.
3. Describe the business purpose for each transaction.
4. Establish that each transaction facilitates the continuance of the business of a corporation a party to the reorganization.

Notably, Prop. Treas. Reg. § 1.368-4(a)(3) would provide that failure to comply with any requirement or procedure (including filing the plan with the IRS) *does not, on its own*, prevent a transaction (or series of transactions) from being considered part of the plan of reorganization, qualifying as a reorganization under a definitional provision (*for example*, section 368), or qualifying for nonrecognition treatment (in whole or in part) under an operative provision (*for example*, section 354).

Prop. Treas. Reg. § 1.368-4(d)(2) would provide that, prior to the first step of a reorganization, the plan of reorganization must be finalized and adopted by the party to the reorganization. Taxpayers would demonstrate satisfaction of this

requirement through (i) the acts of duly authorized officers and directors of the corporation and (ii) the official records of the party to the reorganization.

Transactions as part of a plan of reorganization

For a transaction to be treated as properly included in a plan of reorganization, Prop. Treas. Reg. § 1.368-4(e)(1) would provide that, prior to the first step of a reorganization, one or more parties to the reorganization must evidence a "definite intent" to carry out the transaction, evidenced through a written commitment in one or more official records of the party that substantiates the plan of reorganization. In addition, a transaction would be treated as part of the plan of reorganization only if, on its own or as part of a series of transactions, the transaction either (i) is necessary to satisfy one or more requirements of the definitional provision or (ii) is an integral part of a series of transactions carried out to satisfy the requirements of the definitional provision. Further, a transaction would be treated as part of the plan of reorganization to which an operative provision can apply only if, on its own or as part of a series of transactions, the transaction either (i) would not have occurred but for the reorganization that is covered by the plan of reorganization or (ii) is an integral part of a series of transactions carried out to satisfy the requirements of the definitional provision intended to apply to the reorganization.

Prop. Treas. Reg. § 1.368-2(d)(3) would require that, considering all facts and circumstances (including the one or more business purposes for a reorganization), all parties to the reorganization must complete the plan of reorganization as expeditiously as practicable, and in the manner described in the plan. The "expeditious completion" requirement is presumed to be satisfied if all parties to a reorganization complete the plan of reorganization within the 24-month period beginning on the date of the first step of the plan of reorganization.

Amended and corrected plan of reorganization

Prop. Treas. Reg. § 1.368-4(f) would provide rules for amendments to a plan of reorganization. In general, if a taxpayer amends a plan of reorganization after the first step of the original plan (an "amended plan of reorganization"), those amendments do not cause the taxpayer to fail to satisfy the "plan of reorganization" requirement if (i) the amendments to the plan are in direct response to an identifiable, unexpected, and material change in market or business conditions that occurs after the date on which the original plan of reorganization is adopted by the party to the reorganization, (ii) the amendments are necessary to effectuate the reorganization, and (iii) the amended plan of reorganization satisfies all requirements set forth in Prop. Treas. Reg. § 1.368-4(d) to qualify as a plan of reorganization. The US federal income tax consequences of all transactions properly included in the amended plan of reorganization would be determined based on the amended plan of reorganization (and not the original plan of reorganization).

In addition, if a taxpayer (i) fails to file a plan of reorganization with the IRS or (ii) files a plan of reorganization that fails to satisfy any requirement set forth in Prop. Treas. Reg. § 1.368-4(d), the IRS may correct or identify a plan of reorganization. The IRS may determine that a transaction or series of transactions should be included in, or excluded from, a plan of reorganization based on (i) all facts and circumstances regarding the transaction or series of transactions and (ii) all relevant provisions of the Code and general principles of US federal income tax law, including the step transaction doctrine.

Plan of distribution

Under rules meant to "parallel the proposed plan of reorganization provisions," Prop. Treas. Reg. § 1.355-4 contains provisions pursuant to which a taxpayer would establish its plan of distribution for a distribution under section 355(c)

(*that is*, a section 355 distribution not occurring as part of a divisive reorganization). In general, section 355 would apply to those distributions of controlled corporation stock or securities that are properly included in the plan of distribution and, therefore, are treated as "part of the distribution" within the meaning of section 355(a)(1)(D).

Under Prop. Treas. Reg. § 1.355-4(a)(2), a plan of distribution means: (i) (A) a plan of distribution that satisfies the requirements in Prop. Treas. Reg. § 1.355-4(c) (described below) and (B) is filed with the IRS; (ii) a plan of distribution of the distributing corporation that results from the Commissioner correcting a plan, or (iii) a plan of distribution of the distributing corporation that results from the Commissioner identifying a plan of distribution (in the event of a failure to file the plan with the IRS).

Notably, Prop. Treas. Reg. § 1.355-4(a)(3) provides that failure to comply with any requirement or procedure (including filing the plan with the IRS) *does not, on its own,* prevent a transaction from being considered part of the plan of distribution.

To qualify as a plan of distribution under Prop. Treas. Reg. § 1.355-4(c), the following requirements must be satisfied:

1. The plan of distribution is provided in a single, comprehensive document that (i) identifies the distributing corporation and each controlled corporation, (ii) identifies all distributions properly included in the plan, (iii) describes the intended US federal income tax treatment of the distributions properly included in the plan, and (iv) describes the corporate business purpose for each distribution.
2. Prior to the first distribution, the plan is finalized and adopted by the distributing corporation, as established by (i) the acts of the distributing corporation's duly authorized officers and directors and (ii) the distributing corporation's official records.
3. The distributing corporation completes the distribution as expeditiously as practicable (presumed to be satisfied if plan of distribution completed within 24-month period beginning on date of first distribution).
4. All distributions included in the plan must be carried out in the manner described in the plan.

Prop. Treas. Reg. § 1.355-4(d)(1) would require the distributing corporation to evidence a definite intent to carry out the distribution through a written commitment in one or more official records that substantiate the plan of distribution. A distribution that is merely one of several contemplated possibilities would not be properly included in the plan of distribution. Under Prop. Treas. Reg. § 1.355-4(d)(2)(iii), distributions that are carried out in close temporal proximity with a section 355(c) distribution would not be properly included in the plan of distribution unless under US federal income tax principles (including the step transaction doctrine) those distributions are in substance part of the plan of distribution.

Similar to the plan of reorganization provisions, (i) Prop. Treas. Reg. § 1.355-2(b)(2) would provide rules regarding a correction or identification of a plan of distribution due to the failure to file a complete plan of distribution and (ii) Prop. Treas. Reg. § 1.355-4(e) would provide rules regarding an amended plan of distribution.

Retentions and monetization transactions

Prop. Treas. Reg. § 1.355-2(e)(2) would require the distributing corporation to, pursuant to a plan of distribution or plan of reorganization, distribute an amount of stock of the controlled corporation constituting control (within the meaning of section 368(c)) either (i) within a single taxable year or (ii) over two taxable years, but only if all distributions are effectuated pursuant to a binding commitment that is described in the plan of distribution or plan of

reorganization. Any stock of the controlled corporation that is not distributed as part of the first distribution must satisfy the requirements for a qualifying retention.

> ***Observation:*** Regardless of whether controlled corporation stock is intended to be disposed of in taxable transactions within a five-year period after the distribution or will be disposed of in non-recognition transactions, it appears that any controlled corporation stock not distributed in the first distribution must satisfy the qualifying retention requirements.

Qualifying retentions

Section 355(a)(1)(D)(ii) requires that in the case of distributions of less than 100 percent of stock in the controlled corporation, it must be established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) of the controlled corporation was not pursuant to a plan having as one of its principal purposes the avoidance of US federal income tax.

Under Prop. Treas. Reg. § 1.355-10(c)(1), a retention would be treated as pursuant to a plan having as one of its principal purposes the avoidance of US federal income tax (such that the distribution of section 368(c) control of the controlled corporation stock would fail to qualify under section 355) unless the retention is a *qualifying retention*. A retention is a qualifying retention if it (i) meets the safe harbor under Prop. Treas. Reg. § 1.355-10(c)(3) or (ii) establishes compliance through the satisfaction of a facts-and-circumstances test.

To satisfy either the safe harbor or facts-and-circumstances test, Prop. Treas. Reg. § 1.355-10(c)(2)(iii) requires the distributing corporation to vote any retained controlled corporation stock in proportion to the votes cast by the controlled corporation's other shareholders (other than persons related to the distributing corporation).

> ***Observation:*** Satisfaction of the safe harbor would appear to remove the need for a PLR in connection with a retention.

Safe harbor

To qualify under the safe harbor, the retention must satisfy the following requirements:

1. The distributing corporation has a specific corporate business purpose for the retention as of the date of adoption of the plan of distribution or plan of reorganization (as applicable) and at all times during the period of retention.
2. The controlled corporation stock must be widely held during the period of retention.
3. Any overlap between the officers, directors, or key employees of the distributing corporation separate affiliated group (DSAG, as defined in section 355(b)(3)(B)) and of the controlled corporation separate affiliated group (CSAG, as defined in section 355(b)(3)(B)) must be limited as follows:

   i. The officer, director, or key employee of a member of the DSAG serves as an officer, a director, or a key employee of a member of the CSAG solely to accommodate the CSAG's business needs;
   ii. The overlapping directors do not constitute a majority of the CSAG member's board; and
   iii. The duration of the overlap for officers, directors, and key employees is for an identified, limited period of time, not in excess of two years after the first distribution date (including no ability to stand for re-election.

4. Continuing arrangements between the distributing corporation and controlled corporation during the period of retention either (i) must be negotiated on and reflect arm's-length terms, or (ii) within two years after the first distribution date, must be terminated or renegotiated to reflect arm's-length terms.
5. The plan of distribution or plan of reorganization, as appropriate, must reflect a definite intent in the official records of the distributing corporation that the distributing corporation will dispose of all retained controlled corporation stock (or securities) by the end of the five-year period beginning on the first distribution date.
6. The disposition of retained controlled corporation stock (or securities) must not result in less US federal income tax to the distributing corporation (determined based on the fair market value and adjusted basis of that stock (or securities) as of the first distribution date) than if that stock (or securities) had been distributed in the first distribution.

In addition, the plan of distribution or plan of reorganization, as applicable, must include a description of each agreement and transaction that establishes the satisfaction of the foregoing requirements.

Facts and circumstances test

If the safe harbor cannot be satisfied, the distributing corporation may establish compliance with section 355(a)(1)(D)(ii) through satisfaction of the facts-and-circumstances test in Prop. Treas. Reg. § 1.355-10(c)(2)(ii).

Under this test, the distributing corporation would be required to establish that (i) the distribution resulted in a genuine separation of the DSAG and the CSAG, (ii) the retention does not allow the DSAG to retain any practical control over the CSAG, (iii) a sufficient corporate business purpose exists for the retention as of the date the plan of distribution or the plan of reorganization (as applicable) is adopted, (iv) a sufficient corporate business purpose exists for the retention at all times during the period of retention, and (v) the disposition of retained controlled corporation stock (or securities) must not result in less US federal income tax to the distributing corporation (determined based on the fair market value and adjusted basis of that stock (or securities) as of the first distribution date) than if that stock (or securities) had been distributed in the first distribution.

The existence of (i) overlapping officers, directors, or key employees between the DSAG and the CSAG and (ii) non-arm's-length continuing contractual agreements between the DSAG and the CSAG, would be facts and circumstances indicating that the retention fails the requirements under section 355(a)(1)(D)(ii), particularly where the purported business purpose for the section 355 transaction is "fit and focus."

Monetization transactions

In a divisive reorganization, under sections 361(b) and (c), the distributing corporation generally does not recognize gain or loss on the transfer of section 351 consideration to creditors in satisfaction of the distributing corporation debt held by those creditors. Prop. Treas. Reg. § 1.361-5 would provide that a transfer of section 361 consideration by a distributing corporation to a creditor of the distributing corporation would not qualify for nonrecognition treatment unless the transfer is:

1. To a *qualifying creditor* of the distributing corporation;
2. In satisfaction of *eligible distributing corporation debt*;
3. In amount not greater than the *maximum amount* of distributing corporation debt; and
4. Part of a *qualifying debt elimination transaction*.

Qualifying creditors

In general, Prop. Treas. Reg. § 1.361-5(b)(1) would define a qualifying creditor as a creditor that (i) holds historical distributing corporation debt (including certain refinanced distributing corporation debt and revolving credit agreements), qualifying trade payables, or direct issuance debt and (ii) is not related to the distributing corporation or controlled corporation (as determined under section 267(b) or section 707(b)(1)).

Eligible distributing corporation debt

Prop. Treas. Reg. § 1.361-5(c)(1) would provide that distributing corporation debt is not eligible to be satisfied with section 361 consideration unless that debt qualifies as eligible distributing corporation debt. Eligible distributing corporation debt includes the following:

1. *Historical distributing corporation debt*. Distributing corporation debt qualifies as historical distributing corporation debt if the distributing corporation debt (i) was incurred before the earliest applicable date, (ii) has an original term that ends after the date of the exchange described in Prop. Treas. Reg. § 1.361-2(a) or Prop. Treas. Reg. § 1.361-3(a), and (iii) is identified in the plan of reorganization or original plan of reorganization (if amended). The earliest applicable date is defined as the earliest date of three specified events: (i) the date of the first public announcement of the divisive reorganization or a similar transaction; (ii) the date the distributing corporation entered into a written agreement to effectuate the divisive reorganization or a similar transaction; and (iii) the date the distributing corporation's board of directors approved the divisive reorganization or a similar transaction.
2. *Refinance historical distributing corporation debt*. Distributing corporation debt incurred after the earliest applicable date is treated as historical distributing debt only if: (i) the distributing corporation debt is (A) a refinancing of historical distributing corporation debt or (B) a refinancing of refinanced historical distributing corporation debt (that is, the debt must be traced directly through one or more refinancings to debt that qualifies as historical distributing corporation debt); (ii) the incurrence of refinanced historical distributing corporation debt is not part of a plan to incur debt in addition to historical distributing corporation debt in anticipation of the divisive reorganization; (iii) the distributing corporation must engage in a qualifying debt elimination transaction solely under Prop. Treas. Reg. § 1.361-5(e)(3) or (4) to eliminate that refinanced historical distributing corporation debt; and (iv) the qualifying debt elimination transaction must be described and identified in the plan of reorganization or original plan of reorganization (if amended) for the divisive reorganization.
3. *Revolving credit agreements*. Revolving credit agreements to which the distributing corporation is a debtor qualifies as historical distributing debt only if (i) the distributing corporation entered into the agreement before the earliest applicable date; (ii) the agreement does not expire until after the date of the exchange described in Prop. Treas. Reg. § 1.361-2(a) or 1.361-3(a); and (iii) the agreement is identified in the plan of reorganization or original plan of reorganization (if amended).
4. *Qualifying trade payables*. Trade payables if (i) the trade payables are described in a plan of reorganization or original plan of reorganization (if amended); (ii) the trade payables were incurred in the ordinary course of business of the distributing corporation; and (iii) the satisfaction of such trade payables is necessary (A) to ensure the allocation to the controlled corporation of all liabilities properly associated with the business assets transferred to that corporation and (B) to result in the controlled corporation being allocated liabilities in an amount that properly relates to its business operations, the earnings of which will be used to properly satisfy those liabilities.

5. *Direct issuance debt*. Direct issuance debt incurred as part of a direct issuance transaction (as defined in Prop. Treas. Reg. § 1.361-1(b)(17)) satisfying the requirements of Prop. Treas. Reg. § 1.361-5(e)(4).

Maximum amount

Prop. Treas. Reg. § 1.361-5(d)(1) would provide that the maximum amount of distributing corporation debt that can be satisfied with section 361 consideration equals the amount obtained by subtracting the aggregate amount of distributing corporation debt that the controlled corporation assumes pursuant to the plan of reorganization from the lesser of: (i) the amount of distributing corporation debt described in Prop. Treas. Reg. § 1.361-5(c)(2)(ii)(A) – (E) (reflecting historical distributing corporation debt, refinanced historical distributing corporation debt, revolving credit agreements, qualifying trade payables and direct issuance debt) considering any reduction required by Prop. Treas. Reg. § 1.361-5(c)(3)(iii) (that is, offsetting debts) and (ii) the aggregate amount of distributing corporation debt determined under the eight-quarterly-average test set forth in Prop. Treas. Reg. § 1.361-5(d)(2).

Qualifying debt elimination transactions

Prop. Treas. Reg. § 1.361-5(e) would define qualifying debt elimination transactions to include: (i) qualifying original creditor exchanges (*that is*, the satisfaction of distribution corporation debt with section 361 consideration not occurring as part of an intermediated exchange or a direct issuance transaction), (ii) qualifying intermediated exchanges, and (iii) qualifying direct issuance transactions.

Qualifying intermediated exchanges

An *intermediated exchange* is a transaction, or a series of transactions, in which an intermediary (i) acquires historical distributing corporation debt on a secondary market from the holders of that debt and (ii) exchanges that historical distributing corporation debt for controlled corporation stock or securities held by the distributing corporation. For an intermediated exchange to be a *qualifying intermediated exchange*, the following requirements must be satisfied:

1. Except for certain collateral benefits, no holder of a distributing corporation debt satisfied with section 361 consideration holds the distributing corporation debt for the benefit of the distributing corporation (or a related person) or the controlled corporation (or a related person).
2. The intermediary does not acquire historical distributing corporation debt that is satisfied with section 361 consideration from the distributing corporation (or a related person) or the controlled corporation (or a related person).
3. The exchange of section 361 consideration for historical distributing corporation debt between the distributing corporation and the intermediary is effectuated at arm's length.
4. Neither the distributing corporation (or a related person) nor the controlled corporation (or a related person) (i) participate in any profit gained by the intermediary upon the exchange of section 361 consideration or (ii) limit the intermediary's profit by agreement or other arrangement.
5. The intermediary must (i) act for its own account with regard to all components of the intermediated exchange and (ii) bear the risk of loss with regard to the historical distributing corporation debt and any subsequent disposition of any section 361 consideration received in the exchange.
6. The intermediary must hold the historical distributing corporation debt for a period of not less than 30 days ending on the control distribution date (*that is*, the date an amount of stock constituting section 368(c) control of the controlled corporation is distributed).

Observation: With respect to the 30-day ownership requirement, IRS officials have indicated informally that the period is intended to be a 30-day period ending on the date of the debt exchange, as opposed to the date of the control distribution.

Qualifying direct issuance transactions

A *direct issuance transaction* is a transaction, or a series of transactions, in which (i) the distributing corporation incurs distributing corporation debt with a creditor after the earliest applicable date; (ii) the distributing corporation uses the proceeds of the newly incurred distributing corporation debt (directly or indirectly) to repay historical distributing corporation debt; and (iii) the new creditor exchanges that newly incurred distributing corporation debt for controlled corporation stock or securities held by the distributing corporation. A direct issuance transaction is a *qualifying direct issuance transaction* if it (i) meets the safe harbor under Prop. Treas. Reg. § 1.361-5(e)(4)(iii) or (ii) establishes compliance through the satisfaction of a facts-and-circumstances test.

To qualify under the safe harbor, the direct issuance transaction must satisfy the following requirements:

1. The distributing corporation does not have at any time, legal or practical dominion or control over any proceeds of the refinanced historical distributing corporation debt.
2. The creditor holds the refinanced historical distributing corporation debt for a period of not less than 30 days ending on the control distribution date.
3. Each exchange of section 361 consideration for refinanced historical distribution corporation debt between the distributing corporation and the creditor is effectuated on arm's-length terms and conditions.
4. Neither the distributing corporation (or a related person) nor the controlled corporation (or a related person) participates in any profit gained by the creditor upon the exchange of section 361 consideration, or limits by agreement or other arrangement any profit gained by the creditor upon the exchange of section 361 consideration.
5. The creditor acts for its own account with regard to all components of the direct issuance transaction.
6. The creditor bears the risk of loss with respect to the refinanced historical distributing corporation debt and any subsequent sale or other disposition of section 361 consideration transferred to the creditor in satisfaction of the refinanced historical distributing corporation debt.

If the safe harbor cannot be satisfied, a determination of whether a direct issuance transaction is a qualifying direct issuance transaction would be made using a facts-and circumstances test under Prop. Treas. Reg. § 1.361-5(e)(4)(ii). The following factors will be considered:

1. An exchange of section 361 consideration by the distributing corporation with a creditor that occurs pursuant to an arrangement that comprises part of a prearranged, integrated plan is substantial evidence of non-qualification. An exchange that does not occur pursuant to an arrangement that comprises part of a prearranged, integrated plan is evidence of qualification.
2. The failure to satisfy one or more of requirements 3 through 6 described above in the safe harbor is evidence of non-qualification. Substantial failure to satisfy any of these requirements, or any failure to satisfy a substantial number of these requirements, is substantial evidence of non-qualification. The satisfaction of all these requirements is substantial evidence of qualification.
3. The fact that the creditor holds the refinanced historical distributing corporation debt for a period of less than 30 days ending on the control distribution date is evidence of non-qualification. If the creditor holds the

refinanced historical distributing corporation debt for a period of at least 30 days ending on the control distribution date is evidence of qualification.

4. The distributing corporation's legal or practical dominion or control over any proceeds of the refinanced historical distributing corporation debt is substantial evidence of non-qualification. The distributing corporation's lack of legal or practical dominion or control over any proceeds of the refinanced historical distributing corporation debt is substantial evidence of non-qualification.
5. The distributing corporation's issuance of the refinanced historical distributing corporation debt with a principal purpose of avoiding any of the requirements or limitations of section 361 is evidence of non-qualification.

Replacement of distributing debt

Prop. Treas. Reg. § 1.361-5(f)(1) would reduce the amount of section 361 consideration that the distributing corporation is treated as transferring to a creditor in a qualifying debt elimination transaction by the amount of eligible distributing corporation debt that is "transitorily eliminated." In general, a distributing corporation is treated as transitorily eliminating an amount of eligible distributing corporation debt equal to the amount of such debt that the distributing corporation (or a related person) replaces after the earliest applicable date, directly or indirectly, with borrowing that the distributing corporation (or a related person) expects or is committed to, directly or indirectly, before that date. However, a borrowing is not treated as "expected" if the borrowing results from (i) an event unrelated to the divisive reorganization and not in the ordinary course of the distributing corporation and (ii) changed circumstances that were not expected prior to the control distribution date. Further, a borrowing is not considered transitorily eliminated if the borrowing (i) is incurred in the ordinary course of business of the distributing corporation (or a related person) and (ii) would have been incurred without regard to the divisive reorganization (or any transaction related to the divisive reorganization).

Assumption of liabilities (section 357)

Consistent with section 357(a), Prop. Treas. Reg. § 1.357-2(a) would provide that, if a transferor receives property that would be permitted to be received under section 351 or section 361 without the recognition of gain to the transferor if that property were the sole consideration received by the transferor, and if, as part of the consideration, the transferee corporation assumes a liability of the transferor, then the transferee corporation's assumption of that liability (i) will not be treated as the receipt of money or other property by the transferor and (ii) will not prevent the exchange from being within the provisions of section 351 or section 361.

Treatment of traveling notes

Prop. Treas. Reg. § 1.357-2(c) would provide that a transferee corporation is treated as assuming a traveling note (*that is*, debt of the transferor that converts into debt of the transferee corporation) with respect to which the transferor is the debtor at the time at which the debtor on the traveling note converts from the transferor to the transferee corporation under the terms of the note.

Amount of liabilities assumed

Prop. Treas. Reg. § 1.357-2(d)(1)(i) would provide that a recourse liability (or portion thereof) of a transferor is treated as having been assumed by the transferee corporation if, as determined based on all facts and circumstances, the transferee corporation has agreed to, and is expected to, satisfy the liability (or portion thereof), whether or not the transferor has been relieved of the liability (or portion thereof).

Prop. Treas. Reg. § 1.357-2(d)(1)(ii)(A) would provide that a nonrecourse liability of a transferor is treated as having been assumed by the transferee corporation to which any asset subject to that liability is transferred. However, the amount of any nonrecourse liability of a transferor treated as assumed is reduced by the lesser of (i) the amount of that liability that an owner of other assets not transferred to the transferee corporation and also subject to that liability has agreed with the transferee corporation to, and is expected to, satisfy, or (ii) the fair market value of such other assets.

Legal or practical dominion or control over payment of assumed liability

Prop. Treas. Reg. § 1.357-2(e)(1) would apply if a transferee corporation (or, in the case of a divisive reorganization, a member of the CSAG) makes a payment to satisfy an assumed liability, and if the transferor (or, in the case of a divisive reorganization, a member of the DSAG) has legal or practical dominion or control over any part of the payment. If Prop. Treas. Reg. § 1.357-2(e)(1) applies, then that part of the payment is treated as money or other property received by the transferor and the rules in section 351(b) or 361(b) (as applicable) apply to determine the US federal income tax consequences of the receipt of that money or other property by the transferor (*that is*, section 357 does not apply).

The determination of whether a payment is within the transferor's legal or practical dominion or control is generally made based on all the facts and circumstances. Prop. Treas. Reg. § 1.357-2(e)(2)(ii) would treat a payment as within a transferor's legal or practical dominion or control if that payment is made to (i) a segregated account of the transferor (or, in the case of a divisive reorganization, a member of the DSAG) or (ii) any person through which the transferor (or, in the case of a divisive reorganization, a member of the DSAG) can direct the treatment or disposition of the payment, regardless of the brevity or transitory nature of the period in which the payment is in such an account.

Payments made pursuant to an indemnification agreement would not be treated as within the transferor's legal or practical dominion or control if (i) the transferee corporation is legally prohibited from assuming the liability; (ii) the indemnification agreement requires the transferor to first satisfy the obligation that is the subject of the indemnification before seeking payment from the transferee corporation; and (iii) the transferor is in the same net economic position as it would have been if the transferee corporation legally were allowed to assume the liability.

Payments not made pursuant to an indemnification agreement would not be treated as within the transferor's legal or practical dominion or control if (i) the payment is dedicated to the satisfaction of a liability of the transferor that is identified in an agreement or the plan of reorganization, (ii) the payment is made to an independent trustee or escrow agent that is not affiliated with the transferor, (iii) the payment is not made to any account of the transferor (or, in the case of a divisive reorganization, a member of the DSAG) or any person through which the transferor (or, in the case of a divisive reorganization, a member of the DSAG) could direct the payment, (iv) the transferor and transferee corporation treat any income, gain, or loss on the payment proceeds as income, gain, or loss of the transferee corporation, and (v) any excess of the payment account (and any income or gain thereon) over the amount paid in satisfaction of the liability reverts to the transferee corporation.

Tax avoidance purpose under section 357(b)

Consistent with section 357(b), Prop. Treas. Reg. § 1.357-3(a)(1) would provide that section 357(a) does not apply to any exchange involving the assumption of a liability if the principal purpose of the transferor with respect to the assumption is either (i) to avoid US federal income tax on the exchange or (ii) not a bona fide business purpose. A principal purpose is presumed to exist if

the liability was not incurred in the ordinary course of a business of the transferor.

Prop. Treas. Reg. § 1.357-3(c) would provide that if the Commissioner determines that the transferor's principal purpose with respect to the assumption of a liability was to avoid US federal income tax on the exchange or was not a bona fide business purpose, the burden is on the transferor to prove by a clear preponderance of the evidence that the liability assumption should not be treated as the receipt of money or other property.

The Substantive Proposed Regulations provide a special set of rules applying solely to divisive reorganizations. Prop. Treas. Reg. § 1.357-3(d)(2) would provide that a distributing corporation is presumed to have had a principal purpose if the controlled corporation assumes a distributing corporation liability that is not eligible to be assumed. Distributing corporation liabilities would be eligible to be assumed in a divisive reorganization if (i) the liabilities are described in a plan of reorganization or original plan of reorganization (if amended), (ii) the liabilities were incurred in the ordinary course of business of the distributing corporation, and (iii) the assumption of the liabilities is necessary (A) to ensure the transfer to the controlled corporation of all liabilities properly associated with the business assets transferred to that corporation and (B) to result in the controlled corporation assuming liabilities in an amount that properly relates to its business operations, the earnings of which will be used to properly satisfy those liabilities.

In addition, except as provided below, for distributing corporation debt to be eligible to be assumed it must be historical distributing corporation debt. The following exceptions apply: (A) qualifying trade payables, (B) refinanced distributing corporation debt (as defined in Prop. Treas. Reg. § 1.357-1(b)(17)) if certain requirements are satisfied, (C) a controlled corporation's assumption of a traveling note issued to refinance a historical distributing corporation debt if the requirements related to refinanced distributing corporation debt are satisfied, and (D) certain revolving credit agreements.

Liabilities in excess of basis under section 357(c)

Consistent with section 357(c), Prop. Treas. Reg. § 1.357-4(a)(1) would provide that, in an exchange described in section 351 or in section 361 (by reason of a divisive reorganization), the excess of (i) the sum of the amount of liabilities of the transferor assumed by the transferee corporation over (ii) the total adjusted basis of the property transferred by the transferor pursuant to the exchange, is treated as gain from the sale or exchange of a capital asset or of property that is not a capital asset, as applicable. The determination of whether gain resulting from the transfer of capital assets is long-term or short-term capital gain would be made under by reference to the transferor's holding period for the transferred assets, based on the proportionate fair market value of the transferor's long-term assets to its short-term assets.

The general rule would not apply to any exchange (i) to which Prop. Treas. Reg. § 1.357-3(a) applies, (ii) that is pursuant to a plan of reorganization for a reorganization described in section 368(a)(1)(G) in which no former shareholder of the transferor corporation receives any consideration for the shareholder's stock, or (iii) to which section 351 applies if that exchange also (A) qualifies as part of a reorganization described in section 368(a)(1)(A), (C), or (D) or (G) (provided the requirements of section 354(b)(1) are satisfied) and (B) is described as a reorganization in a filing with the IRS.

Prop. Treas. Reg. § 1.357-4(a)(3)(i) would provide that the following liabilities are excluded from Prop. Treas. Reg. § 1.357-4(a)(1): (i) a liability the payment of which would give rise to a deduction, (ii) a liability the payment of which would give rise to the creation of, or increase in, the basis of any property, and (iii) a liability the payment of which would be described in section 736(a). However, such liabilities would not be excluded to the extent (i) the incurrence

of the liability resulted in a deduction, (ii) the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property, or (iii) the liability is not incurred in the ordinary course of business or associated with any assets transferred.

Multi-year reporting

As stated in the preamble, Treasury and the IRS issued the Reporting Proposed Regulations due to their concern that the lack of a time limitation for completing a plan of reorganization raises administrability concerns for the IRS. Accordingly, Treasury and the IRS (i) issued Prop. Treas. Reg. § 1.355-5 and (ii) introduced new Form 7216. Covered filers must annually file Form 7216 with their tax return.

A covered filer is defined as (i) a distributing corporation or a US shareholder of a controlled foreign corporation (CFC) that is a distributing corporation; (ii) a controlled corporation or a US shareholder of a CFC that is the controlled corporation; (iii) a significant distributee or a US shareholder of a CFC that is a significant distributee; or (iv) any other person required by the Commissioner to file Form 7216. Covered filer also includes any successor (within the meaning of section 381(a)) to an entity described above.

Each covered filer would be required to file Form 7216 with regard to each section 355 spin-off transaction for (i) the covered filer's taxable year in which the first distribution occurs and (ii) each taxable year ending in the fifth taxable year after the taxable year in which the control distribution occurs.

Form 7216 requires disclosure of detailed information relating to the section 355 requirements such as the active trade or business requirement and device prohibition under section 355, and related matters such as continuing relationships between distributing and controlled corporations, and assumptions and satisfactions of distributing corporation debt.

Effective date and comments

The Substantive Proposed Regulations would apply to transactions occurring after the date of publication of final regulations in the Federal Register (publication date), but only if the earliest of the following dates with respect to the transaction occurs after the publication date (general applicability date): (1) the date of the first public announcement; (2) the date of entry by the taxpayer into a written agreement; (3) the date of approval by the board of directors of the taxpayer; (4) the date of a court order (or a plan confirmed, or a sale approved, by order of a court) in a title 11 or similar case, only if the taxpayer was a debtor in a case before such court; or (5) the date a ruling request is submitted to the IRS.

If finalized, the Reporting Proposed Regulations would apply to taxable years ending after January 16, 2025, with respect to section 355 transactions occurring after January 16, 2025.

Comments on both sets of Proposed Regulations are due on March 17, 2025.

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