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August 1, 2011

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning Guidance Under Section 355(d)

Dear Commissioner Shulman:

Enclosed are comments concerning guidance under section 355(d). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Charles H. Egerton
Chair, Section of Taxation

Enclosure

cc: William Wilkins, Chief Counsel, Internal Revenue Service
Emily McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury

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**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION
COMMENTS CONCERNING
GUIDANCE UNDER SECTION 355(d)**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Martin Huck, Philip J. Levine, David D. Sherwood and Robert H. Wellen of the Corporate Tax Committee of the Section of Taxation (the “Committee”). Substantive contributions were made by Timothy S. Shuman and Michael J. Wilder. The Comments were reviewed by Roger M. Ritt, Committee Chair, John P. Barrie of the Section’s Committee on Government Submissions and Eric Solomon, the Section’s Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject of these Comments.

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Date: August 1, 2011

Executive Summary

Under section 355(d),¹ gain may be recognized to a distributing corporation (“Distributing”) on a distribution of stock of a controlled corporation (“Controlled”), even though the distribution otherwise qualifies as tax-free. Section 355(d) generally applies to a distribution under the following circumstances:

- Immediately after the distribution, a person holds (directly or under stock ownership attribution and aggregation rules) a 50% or greater interest in Distributing or Controlled.
- During the five years preceding the distribution (the “Five-Year Period”), such person either acquired such interest by “purchase” (actual or deemed) or received such interest in the distribution with respect to stock that was acquired by “purchase” during the Five-Year Period.

A distribution meeting both of these conditions is referred to as a “Disqualified Distribution,” and the person is referred to as a “Disqualified Person.”

The purpose of section 355(d) is to prevent avoidance of *General Utilities* repeal in spin-offs that resemble sales, principally where a Disqualified Person could use its cost basis in stock of Distributing or Controlled to reduce tax in a later disposition.

The mechanical rules in section 355(d) could result in Distributing being taxed where there is no avoidance of *General Utilities* repeal. These rules also create situations in which it is overly cumbersome to prove that no Disqualified Distribution has occurred. The regulations address these problems in a number of ways. They are helpful but not fully effective.

In these Comments, we identify certain specific areas in which the regulations do not adequately address inconsistencies between the mechanical rules and the purposes underlying section 355(d), and we request new guidance to eliminate these inconsistencies.

Section 355(d) and the regulations leave open the potential for unintended consequences beyond those identified in these Comments. Thus, apart from guidance on specific matters, we recommend that a “Commissioner’s Discretionary Rule,” similar to Regulation section 1.1502-13(c)(6)(ii)(D), be added to Regulation section 1.355-6.

¹ References to a “section” are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

Comments

Introduction

Under section 355(d), enacted in 1990,² taxable gain may be recognized to Distributing on a distribution of Controlled stock, even though the distribution otherwise qualifies as tax-free under section 355. The distribution is a Disqualified Distribution, and section 355(d) generally applies, if there is a Disqualified Person,³ *i.e.*, if:

- Immediately after the distribution, a person holds a 50% or greater interest in Distributing or Controlled.
- During the Five-Year Period, such person either acquired such interest by “purchase” or received such interest in the distribution with respect to stock that was acquired by purchase.

As reflected in the legislative history, the purpose of section 355(d) is to prevent avoidance of *General Utilities* repeal in spin-offs that resemble sales, principally where a Disqualified Person obtains a fair market value cost basis and can use this basis to reduce tax in a later disposition of Distributing or Controlled stock.⁴ The mechanical rules in section 355(d) could result in Distributing being taxed where there is no avoidance of *General Utilities* repeal. These rules also create situations in which it would be overly cumbersome, or even impossible, to prove that no Disqualified Distribution has occurred.

² Amendment by section 11321(a) of Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 101st Cong., 2d Sess., generally effective for distributions after October 9, 1990.

³ The defined term “disqualified person” is not used in section 355(d) itself or in the general rules of Regulation section 1.355-6(b)(1). It is defined in Regulation section 1.355-6(b)(3)(ii), in connection with the “Purpose Exception,” and is also used in Regulation section 1.355-6(c)(3)(ii)(A), in connection with the treatment of stock options, and Regulation section 1.355-6(f)(1), in connection with taxpayers’ duty to determine their shareholders.

⁴ The House Report states:

The present-law provisions granting tax-free treatment at the corporate level are particularly troublesome because they may offer taxpayers an opportunity to avoid the general rule that corporate-level gain is recognized when an asset (including stock of a subsidiary) is disposed of. There is special concern about the possibility for the distributing corporation to avoid corporate-level tax on the transfer of a subsidiary. Therefore, although the provision does not affect shareholder treatment if section 355 is otherwise available, it does impose tax at the corporate level, in light of the potential avoidance of corporate tax on what is in effect a sale of a subsidiary.

STAFF OF H. COMM. ON WAYS AND MEANS, 101ST CONG., REP. ON TAX LAW 37 (Comm. Print 1990), 71-72.

The regulations address both of these problems in a number of ways, including the following:⁵

First, Regulation section 1.355-6(b)(3)(i) (the “Purpose Exception”) provides that a distribution is not a Disqualified Distribution if it does not violate the purposes of section 355(d), as described therein.

Second, section 355(d)(5)(B) treats certain stock issued in section 351 exchanges as purchased, but Regulation section 1.355-6(d)(3)(v) provides an exception in some instances involving domestic affiliated corporate groups.

Third, under sections 355(d)(7) and (8), stock held by one person may be attributed to other persons and/or aggregated with stock held by other persons, and a “purchase” of stock owned by one person may be deemed made by other persons, each in a wide variety of circumstances. Thus, detailed information on actual ownership of the Distributing stock is required to determine if a distribution might violate section 355(d). If the stock of Distributing is widely held, such information often is not knowable. The regulations address this problem as follows: Regulation section 1.355-6(f)(4) creates a presumption that no “less-than-five-percent shareholder” (as defined) purchased its stock during the Five-Year Period and provides that portions of sections 355(d)(7) and (8) do not apply in determining whether a shareholder qualifies as a less-than-five-percent shareholder. Regulation section 1.355-6(f)(3) allows taxpayers to rely on certain reports filed with the U.S. Securities and Exchange Commission (the “SEC”) to identify shareholders who do not qualify as less-than-five-percent shareholders.

In Parts 1-3 of these Comments, we identify certain specific areas in which the regulations do not adequately address inconsistencies between the mechanical rules and the purposes underlying section 355(d), and we request new guidance to eliminate these inconsistencies. In each instance, we recommend a specific type of guidance, but other types of guidance could be substituted for the type of guidance we recommend.⁶

We have identified a number of specific problems in the regulations, but we are quite confident that we have not been able to identify all such problems. Thus, apart from recommendations for guidance to solve specific problems, in Part 4 of these Comments, we recommend that a “Commissioner’s Discretionary Rule,” similar to Regulation section 1.1502-13(c)(6)(ii)(D), be added to Regulation section 1.355-6.

⁵ Section 355(d)(9) provides a grant of authority to prescribe “such regulations as may be necessary to carry out the purposes of” section 355(d).

⁶ In this regard, we note that Regulation section 1.355-6(b)(3)(v) provides:

The Commissioner may provide by guidance published in the Internal Revenue Bulletin that other distributions are not disqualified distributions because they do not violate the purposes of section 355(d).

1. “Purpose Exception” in Regulation Section 1.355-6(b)(3)

The attribution and deemed purchase rules of section 355(d)(8) can cause section 355(d) to apply in situations that do not implicate the purposes of section 355(d). Although the regulations mitigate this problem to a significant extent, the relief provided is narrow and does not cover many common situations.

By its terms, section 355(d)(8) generally would cause the stock of any direct or indirect subsidiaries of a parent corporation to be treated as acquired by purchase to the same extent as the stock of its direct or indirect parent. For example, assume A purchased 60% of the stock of corporation P, and P wholly owned a vertical chain of subsidiaries, Sub 1 through Sub 5. Assume further that Sub 5 was a holding company that owned directly the stock of Sub 6 through Sub 10. Under section 355(d)(8), Sub 4 would be treated as having purchased 60% of the stock of its direct subsidiary, Sub 5. Thus, if Sub 5 were to distribute the stock of Sub 6 to Sub 4 in a distribution that qualified under section 355(a), the distribution would be taxable under section 355(d) unless an exception applied.

The exception potentially relevant to this fact pattern is the Purpose Exception, which provides that a distribution is not a Disqualified Distribution if it does not violate the purposes of section 355(d). Under Regulation section 1.355-6(b)(3)(i), the purposes of section 355(d) are not violated—

...if the effect of the distribution is neither—

(A) To increase ownership (combined direct and indirect) in the distributing corporation or any controlled corporation by a disqualified person; nor

(B) To provide a disqualified person with a purchased basis in the stock of any controlled corporation.

For this purpose, Regulation section 1.355-6(b)(3)(iii) provides that basis in controlled corporation stock is not treated as “purchased basis”—

...if the controlled corporation stock and any distributing corporation stock with respect to which the controlled corporation stock is distributed are treated as acquired by purchase *solely* under the attribution rules of section 355(d)(8) and paragraph (e)(1) of this section.

(Emphasis added.) Examples 1 and 2 of Regulation section 1.355-6(b)(3)(vi) illustrate this rule and show that section 355(d) will not apply to a distribution that otherwise would be a Disqualified Distribution solely by reason of the attribution rules of section 355(d)(8). Thus, in the example above, section 355(d) would not apply if the stock that Sub 4 held in Sub 5 were treated as acquired by purchase solely by reason of the attribution rules of section 355(d)(8).

However, the word “solely” in the Purpose Exception could be read as causing the Purpose Exception not to apply if *any* of the stock of Distributing or Controlled is treated

as acquired by purchase other than by reason of the attribution rules. To illustrate, assume that, in the example, during the Five-Year Period, P had acquired the stock of Sub 7 by purchase and transferred this stock down the chain to Sub 5. Under the deemed purchase rule of section 355(d)(8)(B) and Regulation section 1.355-6(e), a portion of the bases in the stock of Sub 1 through Sub 5 would be treated as purchased by reason of the purchase and the serial transfers of the Sub 7 stock. Thus, even if the Sub 7 stock represents only a tiny fraction of the value of Sub 5, and the basis of Sub 7 is the only directly-purchased basis below P, the Purpose Exception may not apply, and the distribution of the Sub 6 stock by Sub 5 may be taxable under section 355(d).⁷ The same issue would exist if, in the example, Sub 4 had purchased a small percentage of the stock of Sub 5 from a minority shareholder during the Five-Year Period.

We see no reason for these distributions to be taxable. Regulation section 1.355-6(b)(3)(iii) embodies a conclusion by the Internal Revenue Service (the “Service”) and the Department of the Treasury that the attribution and deemed purchase rules in section 355(d) apply too broadly in this context. However, the regulatory solution seems to address only part of the problem. Moreover, the overbreadth of the attribution and deemed purchase rules imposes substantial administrative burdens on both taxpayers and the Service, potentially requiring an examination of every intercompany transaction over the Five-Year Period without regard to the relative size of the transaction or the relationship of the earlier transaction to the current distribution.

These issues could be addressed in a number of ways. For example, the Purpose Exception could be amended to make clear that a distribution will be a Disqualified Distribution only if it would be so treated without regard to attribution under section 355(d)(8) and Regulation section 1.355-6(e)(1). Thus, if stock with actual or deemed purchased basis represented less than 50% of the stock of Distributing or Controlled (as applicable), the Purpose Exception would apply.

2. Section 351 Transaction and Purchase

Section 355(d)(5)(B) treats any stock issued in a section 351 exchange as “purchased” under section 355(d), if the property exchanged for such stock is cash, marketable stock or securities or debt of the transferor. Regulation section 1.355-6(d)(3)(v) creates an exception for certain section 351 exchanges if the transferor and the transferee in the section 351 exchange and Controlled are all members of the same “affiliated group.” The term “affiliated group” is defined for this purpose to include only domestic corporations.

⁷ The anomalies inherent in this rule can be further illustrated by assuming that, instead of acquiring the Sub 7 stock and transferring the stock down the chain to Sub 5, P transferred cash down the chain to Sub 5, which used that cash to acquire the Sub 7 stock. If the rule permitting transfers between affiliated group members (Regulation section 1.355-6(d)(v)) applies, the Purpose Exception might insulate Sub 5’s distribution of the Sub 6 stock to Sub 4 from section 355(d), even though Sub 4’s basis in the Sub 5 stock in part reflected a cash contribution.

By letter to the Service, dated July 10, 2009, Philip J. Levine and Michael J. Wilder recommended that the exception be broadened to include foreign as well as domestic affiliates and explained the reasons for the recommendation.⁸ We agree with the recommendation and the explanation in support of same.

3. Determination of Stockholders for Section 355(d) Purposes

As discussed above, section 355(d) is violated if there is a Disqualified Person. In determining whether a Disqualified Person exists, stock owned by one person is attributed to other persons and aggregated with stock owned by other persons, each in a wide variety of circumstances. Thus, detailed knowledge of actual ownership of the stock of Distributing and Controlled is required to determine if a violation of section 355(d) is possible. If the stock of Distributing (or Controlled) is widely held, however, the facts necessary to make this determination often are not determinable.

To address this problem, Regulation section 1.355-6(f)(4) provides special treatment for “less-than-five-percent shareholders,” defined as shareholders owning less than five percent of the stock of Distributing (or Controlled) at all times during the Five-Year Period. Specifically, this provision (a) creates a presumption that less-than-five-percent shareholders did not purchase stock during the Five-Year Period and (b) provides that portions of the attribution and aggregation rules do not apply in determining if a shareholder qualifies as a less-than-five-percent shareholder.

Other shareholders (referred to in these Comments as a “Five-Percent Shareholder”), however, are subject to the full scope of the stock ownership attribution and aggregation rules, and no favorable presumption is made as to their stock purchases. These rules could lead to any Five-Percent Shareholder (even one who owns only slightly more than five percent of the stock of Distributing or Controlled) being a Disqualified Person, again based on facts that may not be determinable by public companies.

To address this problem, Regulation section 1.355-6(f) provides further relief. This provision allows Distributing and Controlled to rely on the contents of certain reports filed with the SEC to rule out the existence of a Disqualified Person and a section 355(d) violation, absent actual knowledge to the contrary.

The regulations are helpful, but mismatches exist between SEC rules pertaining to these reports and the concept of a “less-than-five-percent shareholder,” as defined in Regulation section 1.355-6(f)(4). Because of these mismatches, reports filed with the SEC may not rule out the existence of a Disqualified Person. In other situations, the existence of a Disqualified Person may be ruled out based on these reports and other available information, but the process is needlessly time consuming and expensive.

⁸ 2009 TNT 135-10 (July 10, 2009). Consistent with Section of Taxation policy, we confirm that no client has engaged either of the authors of the attached letter, or their law firm, to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject of the letter or of this Comment.

In our view, guidance along the following lines would simplify the process of preparing tax opinions regarding section 355 transactions and increase the utility of private rulings under section 355,⁹ without opening the door to abuse.

a. Mismatches between Section 355(d) Regulations and SEC Rules

Regulation section 1.355-6(f)(3) allows Distributing to rely on certain reports filed with the SEC (absent actual knowledge to the contrary). Specifically, the regulation creates a presumption that everyone required to file reports does so on time and accurately. By taking this approach, the regulation leaves open situations where stock ownership need not be reported to the SEC but still counts in determining whether a shareholder is a Five-Percent Shareholder.

Examples include the following:

- Ownership of exactly five percent of the Distributing stock. Rule 13d-1(a).¹⁰ (As noted, the presumption under Regulation section 1.355-6(f)(4) applies only to *less-than-five-percent* shareholders.)
- Outstanding options with respect to Distributing stock that are reasonably certain to be exercised but are exercisable only after more than 60 days. Rule 13d-3(d). (In general under Regulation section 1.355-6(c)(3), options are treated as exercised if reasonably certain to be exercised without regard to any 60-day waiting period.)
- Ownership of non-voting stock of Distributing (unless ownership of voting stock alone exceeds five percent). Rule 13d-1(i). (Because section 355(d) is triggered based on vote or value crossing the 50% threshold, information regarding non-voting stock is relevant.)

Although such situations are unlikely, they are troublesome in issuing opinions, because they could exist with no SEC reporting and therefore no favorable presumption. This problem could be solved, for example, with guidance to the effect that, absent knowledge to the contrary on Distributing's part,¹¹ a conclusive presumption would exist that no such situation exists.

⁹ In issuing private rulings under section 355, the Service does not explicitly reserve or caveat section 355(d) (as it does with issues pertaining to the business purpose requirement, the device prohibition and the section 355(e) "plan" rules). The Service does, however, require a representation by Distributing to the effect that, immediately after the distribution, there will be no Disqualified Person with respect to either Distributing or Controlled. This representation incorporates the relevant provisions of Regulation section 1.355-6, including the uncertainties inherent in those provisions. As a result, in many situations this required representation has the same effect as a caveat.

¹⁰ The SEC rules cited in these Comments appear at 17 C.F.R. 240.

¹¹ Regulation section 1.355-6(f) allows the presumption absent "actual knowledge to the contrary." We have not considered whether a knowledge-based exception to the presumptions recommended herein should require actual knowledge or some other state of mind (*e.g.*, reason to know), or whether guidance should include a due diligence component.

b. Employee Benefit Plans

The aggregation and attribution rules under sections 355(d)(7) and 355(d)(8)(A) create the potential for the existence of a Disqualified Person in situations that fall outside the policy of section 355(d). The most troublesome example involves a relatively common situation: ownership of Distributing stock by a Distributing employee benefit plan.

A benefit plan for Distributing's employees may be a Five-Percent Shareholder of Distributing. If so, under sections 267(b)(6) and 355(d)(7)(A), stock owned by every participant in the plan is aggregated with the stock owned by the plan. *Dillard Paper Co. v. Commissioner*, 341 F.2d 897 (4th Cir. 1965); Rev. Rul. 61-163, 1961-2 C.B. 58. If the stock of Distributing is publicly traded, it would be highly unlikely for Distributing's employees to own 50% or more of the Distributing stock (let alone acquire such stock by purchase during the Five-Year Period), unless insiders own a very large amount of Distributing stock.

Rule 16a-3 requires certain Distributing insiders to report their stock ownership to the SEC. Distributing may have no way of knowing, however, about stock owned by rank and file employees, other than stock owned through its own benefit plans. Moreover, treating the plan itself as a stockholder for section 355(d) purposes (much less aggregating other stock owned by all employee-participants with stock in the plan) often is inappropriate: Many benefit plans allow employees to self-direct investments in their accounts. In these situations, numerous employees have the economic benefits and burdens of owning the stock and also control over their own economic investments in the stock.

As with the mismatch situations described in Part 3.a., above, it is unlikely that the attribution and aggregation rules would in fact cause an employee benefit plan sponsored by a publicly-traded corporation to be a Disqualified Person. Nevertheless, the impossibility (or at least impracticality) of verifying this factual conclusion poses an unnecessary obstacle to opining on section 355(d) and to making the representations required for a private ruling under section 355. *See* footnote 9, above.

This problem could be solved with guidance to the effect that, absent knowledge to the contrary on Distributing's part, a conclusive presumption would exist that an employee benefit plan sponsored by Distributing or its affiliates is not a Disqualified Person.¹²

¹² Such a presumption could apply (a) only to plans that, at the time of the distribution, actually own less than a specified amount of Distributing stock (*e.g.*, 20%) or (b) only if the stock of Distributing is publicly traded. If any such limitation is adopted, we believe consideration should be given to more generous treatment of self-directed plans.

c. Mutual Funds

Mutual funds own substantial portions of the stock of most publicly-traded corporations. Under section 851(g)(1), each mutual fund in a family of funds is treated as a separate corporation, but the family files a single SEC Schedule 13F and/or Schedule 13G as a family. As a result, the fact that a family of funds reports ownership of more than five percent of the Distributing stock does not mean that Distributing has a Five-Percent Shareholder. Further information is necessary to determine whether any individual fund is a Five-Percent Shareholder.

Each fund reports its own investments periodically on Forms N-Q, N-1A and N-CSR,¹³ but these reports are filed at fixed intervals, and they include ownership of Distributing stock on the reporting date. Thus, if a fund's stock ownership spikes to five percent or more, but only between reporting dates, the fund would never report owning five percent of the stock. Regulation section 1.355-6(f)(3) does not allow Distributing to presume that no such spike occurred, and such a spike would create at least a theoretical possibility of the fund being a Disqualified Person, again due to the expanded attribution and aggregation rules applicable to Five-Percent Shareholders.

This problem could be solved with guidance to the effect that a mutual fund is conclusively presumed not to be a Five-Percent Shareholder (or at least not a Disqualified Person), unless reports filed with the SEC by the fund indicate otherwise, or Distributing has knowledge to the contrary.

4. Consideration of a "Commissioner's Discretionary Rule" under Section 355(d)

Based on experience with section 355(d) and the regulations, we have identified specific areas in which the regulations fail to address inconsistencies between the purposes of section 355(d) and the mechanical rules. Given the complexity of section 355(d) and the regulations, however, we are quite confident that other such areas exist. Although the Purpose Exception is intended to address these problems, it is largely a mechanical rule, and such a rule cannot have the flexibility to produce the right result in every case.

To deal with such situations, we believe the Purpose Exception should be amended to add a discretionary rule. Such a rule could be similar to the "Commissioner's Discretionary Rule" in Regulation section 1.1502-13(c)(6)(ii)(D), which sets forth conditions under which the Service may determine that exclusion of intercompany items from gross income is consistent with the purposes of Regulation section 1.1502-13. A taxpayer may obtain such a determination by private ruling.

¹³ Although Schedule 13F and Forms N-Q, N-1A and N-CSR are not cited in Regulation section 1.355-6(f)(2) or (f)(3), we read the regulations as allowing Distributing to presume their accuracy, completeness and timeliness, in the same manner as Schedules 13D and 13G. Guidance confirming this interpretation would be helpful.

Like the intercompany transaction regulations, section 355(d) and Regulation section 1.355-6 are highly intricate. Based on our experience, notwithstanding the Purpose Exception, a technical violation (with ruinous consequences) is possible even where there is no improper tax avoidance. We believe the additional flexibility that a Commissioner's Discretionary Rule would provide is needed to prevent such inappropriate results.

Moreover, in some cases relief may be warranted, but the situation is too unusual to justify general guidance (even pursuant to Regulation section 1.355-6(b)(3)(v), quoted in footnote 6). For example, as discussed in Part 3., above, a corporation may rely on stockholder reports filed with the SEC. But suppose the stock is registered with a foreign securities regulator and not the SEC. In this case, the corporation may not rely on reports filed with the foreign regulator. Under a discretionary rule, the Service could determine whether a particular foreign regulator's rules and practices warrant reliance on these reports.

To deal with unintended results and with unusual situations, we recommend that some form of discretionary rule be added to Regulation section 1.355-6.