

Letters to the Editor

APRIL 10, 89

DO THE SECTION 355 REGULATIONS GO THAT FAR?

To the Editor:

I am writing to correct what I believe is an overstatement in Lee Sheppard's article in the January 16, 1989 issue of Tax Notes on the topic of the final section 355 regulations ("Section 355 Regulations Do Not Prevent Aggressive Transactions," January 16, 1989, p. 274). The final regulations provide that a business purpose has not been demonstrated if the same purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive. It is not clear from the regulations how the "neither impractical nor unduly expensive" standard ought to be applied.

Ms. Sheppard correctly notes that one traditional business purpose for a section 355 transaction is a desire to award equity compensation to employees. For example, a spin-off may be undertaken where employees do not wish to purchase or cannot afford stock in the entire corporation, but wish to purchase (and can afford) stock in a spun-off entity. In applying this notion to the available alternatives concept, Ms. Sheppard comments that it may be necessary to show that other means of compensation for these employees are unworkable in order for the business purpose requirement to be met. Ms. Sheppard notes that there are available alternatives to real equity compensation, such as phantom stock plans, stock appreciation rights, and stock options, and that these can, and often do, serve similar compensation goals.

Surely we should all be concerned with the available alternatives notion of the regulations; that is, that a business purpose for a transaction may be viewed with suspicion if its ultimate goal could be achieved in some other way. (Of course, there were cases and rulings on this question long before the final regulations were released.)

But even under the new regulations, the notion that nonstock alternatives such as phantom stock and SARs would have to be explored seems far-fetched. Admittedly, the bounds of the "neither practical nor unduly expensive" standard are not set forth. Yet a purpose to issue stock to shareholders is still a valid business purpose. See regulation section 1.355-2(b)(5), Example (8). The only alternatives that need to be considered in this particular context would appear to relate to the selling entity (the stock should be issued by the company, not sold by the shareholders). Regulation section 1.355-2(d)(4), Example (1).

In addition, judging from the number of section 355 rulings sanctioning stock issuances to employees, I cannot believe the Service will begin examining whether a phantom stock plan, SAR, or stock option plan would meet the same employee/company goals. If we are supposed to begin doing this, let us let the Service tell us so.

Very truly yours,

Robert W. Wood
Steeffel, Levitt & Weiss
San Francisco, Calif.
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