CC:DOM:FS:CORP May 5, 1997
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ACTION ON DECISION

Subject: The Edna Louise Dunn Trust, Morgan Guaranty Trust Company, Trustee v. Commissioner, 86 T.C. 745 (1986), T.C. Dkt. No. 32031-85.

Issue: Whether a portion of the stock of a subsidiary distributed to petitioner in a spinoff constituted taxable "other property" under I.R.C. § 355(a)(3)(B).

Discussion: Petitioner owned 400 shares of American Telephone and Telegraph Company ("ATT"). ATT owned all of the stock of many subsidiaries and most of the stock of other subsidiaries, including Pacific Telephone and Telegraph Company ("Pacific").

More specifically, prior to the transaction described below, ATT owned 91.5% of the voting common stock and 78.2% of the voting preferred stock of Pacific, but none of the Pacific nonvoting preferred stock.

In 1982, ATT caused a newly-formed wholly-owned subsidiary to merge into Pacific, thus acquiring all of the Pacific voting stock (both common and preferred) in exchange for ATT stock and cash, respectively. However, because ATT did not own the Pacific nonvoting preferred stock, ATT did not control Pacific under I.R.C. § 368(c) so that the exchange was taxable to the shareholders of Pacific voting stock who received ATT stock and cash.

In 1983, in settlement of an antitrust suit, ATT transferred all of its Pacific stock, along with other assets, to Pacific Telesis Group ("PacTel"), a holding company, in a nontaxable exchange for all of the PacTel stock. In 1984, ATT distributed its PacTel stock, as well as stock of other subsidiaries, to its shareholders, including petitioner.

ATT argued that the entire distribution was tax-free under I.R.C. § 355(a)(1). The Service argued that the distribution of the PacTel stock was taxable as "other property" under I.R.C. § 355(a)(3)(B), to the extent of the value of the minority voting interest in Pacific acquired in 1982. The issue in this case was whether the limitations of I.R.C. § 355(a)(3)(B) applied.

I.R.C. § 355(a)(3)(B) provides that stock of a controlled corporation acquired by the distributing corporation by reason of any transaction: (i) which occurs within 5 years of the distribution of such stock, and (ii) in which gain or loss was recognized in whole or in part (i.e., "purchased stock"), shall not be treated as stock of such controlled corporation, but as taxable "other property."

Petitioner argued that this provision did not apply because ATT did not distribute the "purchased stock" of Pacific, but rather the stock of PacTel (which held the Pacific stock). The Service argued that the "by reason of any transaction" language of I.R.C. § 355(a)(3)(B) included not only direct distributions of the "purchased stock" of Pacific, but also indirect distributions (i.e., the portion of the PacTel stock equal in value to the value of the Pacific "purchased stock").

The Tax Court held that no portion of the PacTel stock distributed to ATT's shareholders constituted taxable "other property" under I.R.C. § 355(a)(3)(B). The Court cited a number of reasons for its conclusion. It noted that I.R.C. § 355(a)(3)(B) read literally would only apply to purchased PacTel stock. The Court also examined the legislative history of I.R.C. § 355(a)(3)(B) and concluded that the "by reason of any transaction" language was intended to prevent the indirect acquisition of controlled corporation stock (e.g., through a purchase by a related entity) rather than the acquisition of the underlying active subsidiary which was not actually distributed. The Court also noted that not taxing the distribution in this case did not offend the overall statutory framework of I.R.C. § 355, because ATT acquired the purchased Pacific stock mostly in exchange for its own stock and because the Pacific stock remained in corporate solution in the hands of PacTel.

In accordance with an agreement between the Service and ATT, the Service did not appeal this decision. Therefore, this decision disposed of this issue with regard to ATT shareholders.

Having reconsidered its original litigating position, the Service believes that the Tax Court correctly decided that I.R.C. § 355(a)(3)(B) did not apply in this case. In this case, ATT distributed the stock of PacTel, a corporation much larger than and different from Pacific. Moreover, it is clear that ATT had good business and economic reasons for incorporating PacTel and distributing PacTel stock rather than Pacific stock.

Nevertheless, the Service believes that the Tax Court's interpretation of I.R.C. § 355(a)(3)(B) is unduly limited, and may challenge a transaction in which the facts differ from those of this case. For example, the Service may challenge a transaction in which purchased stock is transferred to a holding company in order to avoid the application of I.R.C. § 355(a)(3)(B).

Recommendation: Acquiescence in result only.

Reviewers: /s/

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/s/

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