Bloomberg BNA

Tax Management Memorandum™

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Section 355: A Flood of Guidance After a Long Drought

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The last year or so has seen a number of significant legislative, regulatory, and administrative developments affecting tax-free spin-offs under §355.[1] It has also seen the removal of a number of no-rules. This article provides an overview of these recent developments and the changes to the Internal Revenue Service's (the ''IRS'') ruling policy regarding §355. In particular, this article discusses temporary regulations providing guidance on determining whether a corporation is a predecessor or successor, which effectuate regulations proposed in 2004. This article also discusses guidance issued in response to no-rules adopted in 2013 on the application of the step-transaction doctrine to ''north-south'' transactions and on so-called recapitalizations into control; guidance issued in response to no-rules adopted in 2015 on spin-offs of small businesses and significant investment assets; and legislative and regulatory changes affecting spin-offs involving real estate investment trusts (REITs). Finally, this article discusses changes to the IRS's no-rule policy regarding the device and business purpose requirements of §355.

I. OVERVIEW OF §355

A. Basic Requirements Under §355

Since 1986, distributions of appreciated assets (including stock of a subsidiary) by a corporation to its shareholders generally have been subject to two levels of tax (one at the corporate level and one at the shareholder level). This foundational principal of corporate income taxation arose from the repeal of the so-called *General Utilities* doctrine, under which corporations were generally able to distribute appreciated property to their shareholders tax-free.[2]

Section 355, however, remains as a key exception to the repeal of the *General Utilities* doctrine. Section 355 permits a corporation (''Distributing'') to distribute the stock of its controlled subsidiary (''Controlled'') to Distributing's shareholders tax-free to both Distributing and its shareholders if certain requirements are met. In general, in order for a spin-off to qualify as a tax-free transaction under §355:

(a) Distributing must **control** Controlled immediately before the transaction;[3]

(b) The transaction must not be used principally as a **device** for the distribution of the earnings and

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[1] Unless otherwise indicated, all section references are to sections of the Internal Revenue Code, as amended (the ''Code''), and the regulations promulgated thereunder.

[2] The *General Utilities* doctrine is named after the Supreme Court case establishing this principle, *General Utilities and Operating Co. v. Helvering*, 296 U.S. 200 (1936), which was codified by Congress in 1954. *See* Revenue Act of 1954, Pub. L. No. 83-591 (1954). The Tax Reform Act of 1986 effectively repealed the doctrine by adding §311(b) to the Code. Pub. L. No. 99-514, §631(c), 100 Stat. 2085, 2272 (1986). Under §311(b), if a corporation distributes appreciated property to its shareholders, the corporation must recognize gain as if such property were sold at its fair market value.

[3] §355(a)(1)(A). A corporation is considered to control another corporation for purposes of §355 if it owns stock possessing 80% of the total combined voting power of all classes of stock entitled to vote in the second corporation and at least 80% of the total number of shares of each of the other classes of stock of that corporation. §368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.

profits (i.e., it cannot be used to convert what would otherwise be treated as dividends into capital gains or the recovery of basis);[4]

(c) Distributing and Controlled must each be engaged in the conduct of an **active trade or business** immediately after the transaction that has been actively conducted throughout the five-year period ending on the date of the distribution and was not acquired within that five-year period in a taxable transaction (a ''five-year ATB'');[5]

(d) Distributing must **distribute all** of its stock and securities of Controlled in the transaction or an amount constituting control (and retention of any Controlled stock or securities must not be in pursuance of a plan with a principal purpose of tax avoidance);[6]

(e) The distribution must be motivated by a **corporate business purpose**;[7]

(f) The historic shareholders must maintain a **continuity of interest** in Distributing and Controlled;[8]

(g) In a split-off, the value of **investment-type assets** held by Distributing and Controlled generally must be less than 2/3 of the value of all of the assets of Distributing and Controlled, respectively;[9]

(h) With certain exceptions, neither Distributing nor Controlled may be a **real estate investment trust** (REIT);[10] and

(i) No person may have **purchased stock** of Distributing or Controlled **within five years** prior to the distribution that results in that person owning 50% or more of the stock in either Distributing or Controlled immediately after the distribution.[11] If such a purchase is made, it triggers a corporate-level tax only; it does not disqualify the transaction from §355 at the shareholder level.

B. Section 355(e): Anti-*Morris Trust* Provision

In addition to the basic requirements described above, §355(e), often referred to as an anti-*Morris Trust* provision,[12] imposes limitations on certain acquisitions occurring in connection with a spin-off. Specifically, §355(e) provides that Distributing will recognize gain if one or more persons acquire, directly or indirectly, 50% or more of the stock (measured by vote or value) of Distributing or Controlled as ''part of a plan (or series of related transactions)'' that was in place at the time of the distribution. The transaction otherwise qualifies as a §355 transaction and, accordingly, the recipient shareholders do not recognize gain.

1. Plan Guidance

Regulations under §355(e) provide guidance as to what constitutes a ''plan (or series of related transactions)'' referred to hereafter as a ''Plan'' (and an acquisition of a 50% or greater interest as part of a plan is referred to as a ''Planned 50% acquisition'').[13] In general, whether a distribution and an acquisition are part of a Plan is determined based on all the facts and circumstances.[14] However, the regulations provide a series of safe harbors that provide circumstances under which a distribution and acquisition will not be treated as part of a Plan.[15]

2. Application of §355(e) to "Predecessors" and "Successors"

Section 355(e)(4)(D) provides that, for purposes of §355(e), any reference to Distributing or Controlled includes a reference to any predecessor or successor

[4] §355(a)(1)(B).

[5] §355(a)(1)(C), (b).

[6] §355(a)(1)(D).

[7] Reg. §1.355-2(b)(1). A corporate business purpose is defined as ''a real and substantial non Federal tax purpose germane to the business [Distributing], [Controlled], or the affiliated group to which [Distributing] belongs.'' Reg. §1.355-2(b)(2).

[8] Reg. §1.355-2(c). The regulations under §355 also appear to include a continuity of business enterprise requirement, stating that §355 ''contemplates the continued operation of the business or businesses existing prior to the separation.'' Reg. §1.355-1(b).

[9] §355(g).

[10] §355(h).

[11] §355(d).

[12] Transactions in which a target company spins off unwanted assets to its shareholders to facilitate an acquisition became known as ''Morris Trust'' transactions after the favorable tax treatment of such a transaction was upheld in *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966), *acq.*, Rev. Rul. 68-603, 1968-2 C.B. 148. Such transactions were blessed as tax free under §355 for more than 30 years until the enactment of §355(e) in 1997. *See, e.g.,* Rev. Rul. 78-251, 1978-1 C.B. 89; Rev. Rul. 75-406, 1975-2 C.B. 125; Rev. Rul. 72-530, 1972-2 C.B. 212; Rev. Rul. 70-434, 1970-2 C.B. 83.

[13] Reg. §1.355-7.

[14] Reg. §1.355-7(b)(1).

[15] Under the so-called ''super safe harbor,'' in the case of an acquisition (other than involving a public offering) after a distribution, a distribution and an acquisition can be part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the two-year period ending on the date of the distribution. Reg. §1.355-7(b)(2). If this super safe harbor is not satisfied, the regulations provide nine other safe harbors that may be satisfied. Reg. §1.355-7(d)(1)–§1.355-7(d)(9). If no safe harbor is met, then the regulations provide non-exclusive factors to be considered as part of the facts and circumstances test. *See* Reg. §1.355-7(b)(3), §1.355-7(b)(4).

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of Distributing or Controlled, respectively. As a result, in general, if there is a Planned 50% acquisition of the stock of a precededecessor or successor of Distributing or Controlled, then Distributing will recognize gain in the transaction to the same extent that it would have if there were a Planned 50% acquisition of Distributing or Controlled under §355(e).

3. Intragroup Spin-Offs: §355(e)(2)(C) and §355(f)

Special rules apply to intragroup spin-offs. First, §355(e)(2)(C) provides an exception to §355(e) when, immediately after completion of the Plan, Distributing and Controlled are each members of a single expanded affiliated group.[16]

Second, in the case of an intragroup spin-off where the exception in §355(e)(2)(C) does not apply because the intragroup spin-off is part of a Plan that results in Distributing and Controlled no longer being members of a single expanded affiliated group, §355(f) may serve to turn off §355 with respect to the intragroup spin-off. Section 355(f) generally serves to prevent the duplication of gain (and, in some cases, of loss) in the context of a multi-step transaction where an intragroup spin-off is followed by an external spin-off.

Consider, for example, a structure in which the common parent of an affiliated group under §1504(a) (''Higher-Tier Distributing'') wholly owns a subsidiary member (''Lower-Tier Distributing'') which in turn wholly owns Controlled. Under a Plan, Lower-Tier Distributing spins off Controlled to Higher-Tier Distributing, and Higher-Tier Distributing then spins-off Controlled to its shareholders. Section 355(e)(2)(C) does not apply because immediately after completion of the Plan, Controlled is not a member of an expanded affiliated group with Higher-Tier Distributing or Lower-Tier Distributing. In the absence of §355(f), Lower-Tier Distributing would recognize gain, under §355(e), in the intragroup spin-off, but Higher-Tier Distributing would be afforded nonrecognition treatment under §355(a) and, as a result, would not take a fair market value basis in the Controlled stock. Higher-Tier Distributing then could recognize additional gain, under §355(e), as part of the external spin-off. However, under §355(f), §355 would not apply to intragoup spin-off and, consequently, the built-in gain in the Controlled stock should only be recognized once.

II. TEMPORARY PREDECESSOR/ SUCCESSOR REGULATIONS

Section 355(e) does not provide a definition of a predecessor or successor of Distributing or Controlled. On December 19, 2016, the IRS and the Treasury Department (''Treasury'') published temporary regulations providing guidance in determining whether a corporation is a predecessor or successor of Distributing or Controlled for purposes of the anti-*Morris Trust* provisions of §355(e).[17] The temporary regulations also provide limitations on the recognition of gain in certain cases involving a predecessor of Distributing, including some changes to the rules under §355(f) to ensure that the policy behind the gain limitation rules works. The temporary regulations adopt proposed regulations issued in 2004 (the ''2004 Proposed Regulations''), with a few significant modifications.

A. Purpose of the Temporary Regulations

The temporary regulations describe two ''principal purposes'' that motivated the adoption of the rules:[18]

- Ensuring that §355(e) applies to a §355 distribution if, as part of a Plan, some of the assets of a predecessor of Distributing (a ''Predecessor of Distributing'' or ''POD'') are transferred directly or indirectly to Controlled without full recognition of gain, and the distribution accomplishes a division of the assets of the POD.
- Ensuring that §355(e) applies when there is a Planned 50% acquisition of the stock of a successor of Distributing or successor of Controlled.

The temporary regulations expressly provide that they ''must be interpreted and applied in a manner that is consistent with and reasonably carries out'' these purposes.[19]

B. Identifying a Predecessor of Distributing

The POD rules of the temporary regulations are complex, but, in essence, look to see whether the assets of any corporation other than Distributing or Controlled (a ''Potential Predecessor'') are divided as part of a Plan (because some, but not all, of the assets are transferred to Controlled) without recognizing all of the built-in gain that existed in such assets before the distribution. Specifically, the definition of a POD requires the satisfaction of two pre-distribution requirements — the Relevant Property requirement and

[16] An ''expanded affiliated group'' means an affiliated group as defined in §1504 without regard to §1504(b). §355(e)(2)(C).

[17] Reg. §1.355-8T, T.D. 9805, 82 Fed. Reg. 91,738 (Dec. 19, 2016), *as corrected by* 82 Fed. Reg. 8811 (Jan. 31, 2017).

[18] Reg. §1.355-8T(a)(2).

[19] *Id.*

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the reflection of basis requirement — and one post-distribution requirement — a division of Relevant Property between Controlled and Distributing or the Potential Predecessor.[20] In order to accomplish this, the temporary regulations contain a number of defined terms.

The Relevant Property requirement is satisfied if, before the distribution and as part of a Plan, Distributing directly or indirectly acquires Controlled stock in exchange for a direct or indirect interest in Relevant Property.[21] The temporary regulations define ''Relevant Property'' as ''any property that was held, directly or indirectly, by the Potential Predecessor during the Plan Period.''[22] Relevant Property can include Controlled stock, but only to the extent that it was transferred directly or indirectly to Distributing during the Plan Period, and it was Relevant Property of the Potential Predecessor before the direct or indirect transfers.[23] The temporary regulations define the ''Plan Period'' as:

> the period that ends immediately after the distribution and begins on the earliest date on which any pre-distribution step that is part of the Plan is agreed to or understood, arranged, or substantially negotiated by one or more officers or directors acting on behalf of Distributing or Controlled, by controlling shareholders of Distributing or Controlled, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders.[24]

The reflection of basis requirement is satisfied only if any Controlled stock distributed in the distribution reflects the basis of any Separated Property.[25] ''Separated Property'' generally is defined to include: (i) Relevant Property that is Controlled stock distributed in the distribution, the gain on which was not recognized in full as part of the Plan; and (ii) Relevant Property that is held directly or indirectly by Controlled immediately before the distribution, the gain on which was not recognized in full as part of the Plan.[26]

The post-distribution requirement is that, immediately after the distribution, direct or indirect ownership of Relevant Property must have been divided between Controlled on the one hand and Distributing or the Potential Predecessor on the other hand.[27]

The basics of the POD rules are best understood by considering a couple of examples. Under the first example,[28] X owns all of the stock of P, which holds multiple assets. Y owns all of the stock of Distributing. The following steps occur as part of a Plan: P merges into Distributing in a type A reorganization (merger). Immediately after the merger, X and Y own 10% and 90%, respectively, of the stock of Distributing. Distributing then contributes to Controlled one of the assets with built-in gain (Asset 1) acquired from P in the merger. In exchange for Asset 1, Distributing receives additional Controlled stock (and possibly some boot). Distributing distributes the stock of Controlled to X and Y, pro rata. The contribution and distribution constitute a type D reorganization.

In this example, P is a Potential Predecessor. Asset 1 is an item of Relevant Property because it was held by P during the Plan Period. Asset 1 is also an item of Separated Property because it is held by Controlled immediately before the distribution and the built-in gain on Asset 1 is not recognized as part of the Plan. The basis of Asset 1 is reflected in the basis of Controlled stock as a consequence of the type D reorganization. The remainder of the Relevant Property (other than Asset 1) remains with Distributing. As a result of the Plan, some of the assets of P (Asset 1) have been separated from the other assets of P and built-in gain on this Separated Property has not been recognized. Therefore, P is a POD.

A second example shows how these rules apply when the Separated Property is Controlled stock itself. Under the second example,[29] X owns all of the stock of P, which holds multiple assets, including Asset 2. Y owns all of the stock of Distributing. P owns 35% of the stock of Controlled (Block 1), and Distributing owns the remaining 65% of the Controlled stock (Block 2). The following steps occur as part of a Plan: P merges into Distributing in a type A reorganization, and Distributing immediately thereafter distributes all of the Controlled stock to X and Y, pro rata. Distributing continues to hold Asset 2.

In this example, P is a Potential Predecessor. Block 1 and Asset 2 are both items of Relevant Property.

[20] Reg. §1.355-8T(b)(1)(i).

[21] Reg. §1.355-8T(b)(i)(ii)(A).

[22] Reg. §1.355-8T(b)(2)(iv)(A). Special rules apply in determining whether property held directly or indirectly by Distributing (including Controlled stock) is Relevant Property. Reg. §1.355-8T(b)(2)(iv)(B), §1.355-8T(b)(2)(iv)(C).

[23] *See* Reg. §1.355-8T(b)(2)(iv)(B), §1.355-8T(b)(2)(iv)(C).

[24] Reg. §1.355-8T(a)(4)(iii).

[25] Reg. §1.355-8T(b)(1)(ii)(B).

[26] *See* Reg. §1.355-8T(b)(1)(ii)(A), §1.355-8T(b)(2)(vii). However, the definition of Separated Property does not look-through stock that is Relevant Property. *Id.*

[27] Reg. §1.355-8T(b)(1)(iii).

[28] *See* Reg. §1.355-8T(h) *Ex.* 1.

[29] *See* Reg. §1.355-8T(h) *Ex.* 3.

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Block 1 is also an item of Separated Property because it is Controlled stock distributed in the distribution, the gain on which was not recognized in full as part of the Plan. Asset 2 remains with Distributing. As a result of the Plan, some of the assets of P (the Controlled stock represented by Block 1) have been separated from the other assets of P and built-in gain on this Separated Property has not been recognized. Therefore, P is a POD.

C. Significant Changes from Proposed Regulations

The temporary regulations make two major changes to the proposed regulations in response to comments.[30] First, the temporary regulations tie the definition of POD to the existence of a Plan. Because the proposed regulations were not so limited, taxpayers would have had to track the assets of any Potential Predecessor received by Distributing in a combining transfer indefinitely to see if they were separated in the distribution. Treasury and the IRS incorporated the Plan rules of Reg. §1.355-7 for purposes of determining whether a corporation is a POD.[31]

Second, the temporary regulations broaden the scope of transactions that can give rise to a POD to include not only §381 transactions but also other tax-free transactions (what the preamble refers to as synthetic spin-offs). A commenter pointed out that similar results to a §381 transaction between a POD and Distributing followed by a separation of some of the POD's assets in a spin-off of Controlled could be achieved through an acquisition of POD stock by the parent of Distributing followed by a §351 transfer of some of the POD's assets to Distributing and the separation of some of those assets in a spin-off of Controlled. As a result, the temporary regulations eliminate the requirements of a combining transfer (i.e., a §381 transaction) followed by a separating transfer and more generally define as a POD any corporation some of whose assets are transferred to Controlled tax free as part of Plan and thereby divided.[32] This modification adds complexity, as it requires tracing of assets while the POD can still be in existence. Nonetheless, Treasury and the IRS believe these cases will be in the minority and that the Plan limitation mitigates this complexity.[33]

D. Gain Limitation Rules

The temporary regulations also include three gain limitation rules.[34] In the absence of these gain limitation rules, if there were a Planned 50% acquisition of of Distributing, Controlled, or a POD, Distributing would recognize the full amount of built-in gain on stock or securities of Controlled under §355(c)(2) or §361(c)(2) (the ''Statutory Recognition Amount''). The gain limitation rules try to limit the gain to those assets that are separated in the spin-off. The first two gain limitation rules are applied to each corporation with respect to which there is a Planned 50% acquisition of such corporation's stock to which §355(e) applies. The final gain limitation rule provides an overall limitation for a given distribution. In general, the gain limitation rules are intended to implement a policy that the regulations should apply §355(e) only to the assets that are separated through a distribution of Controlled.[35]

The first gain limitation rule applies if there is a Planned 50% acquisition of the stock of a POD. It uses a hypothetical type D/§355(e) reorganization to determine the amount of gain that is recognized. Specifically, if there is a Planned 50% acquisition of the stock of a POD, the amount of gain recognized by Distributing by reason of §355(e) is limited to the amount of gain, if any, that Distributing would have recognized if, immediately before the distribution, Distributing had engaged in the following transaction:

> Distributing transferred all Separated Property received from the POD to a newly-formed corporation in exchange solely for stock of such corporation in a type D reorganization and then distributed the stock of such corporation to the shareholders of Distributing in a transaction to which section 355(e) applied.[36]

This was modified from the proposed regulations, which used a hypothetical §351 construct. Commenters were concerned that incorporating §351 was too complicated due to §351's ancillary rules, such as the

[30] For a detailed discussion of the proposed regulations, see Lisa M. Zarlenga & Kevin Spencer, *Who Preceeds and Who Succeeds: New Anti-Morris Trust Proposed Regulations*, 107 TAX NOTES 351 (Apr. 18, 2005).

[31] *See* preamble to T.D. 9805, 81 Fed. Reg. at 91,742 (3.A.i.).

[32] *See* preamble to T.D. 9805, 81 Fed. Reg. at 91,741-91,743 (3.A.i-ii.).

[33] *See* preamble to T.D. 9805, 81 Fed. Reg. at 91,744 (3.A.ii.b.). Note that this broadening was not extended to the definition of successor, which continues to be limited to §381 transactions.

[34] *See* Reg. §1.355-8T(e).

[35] *See* preamble to T.D. 9805, 81 Fed. Reg. at 91,745 (3.B.).

[36] Reg. §1.355-8T(e)(2)(i). An anti-duplication rule applies to prevent duplication of gain where Separated Property was held, directly or indirectly, by multiple PODs. Reg. §1.355-8T(e)(2)(ii)(C).

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loss importation rules of §351(e). Although Treasury and the IRS were not willing to discard any hypothetical construct, they believed that a D/§355 construct would more closely reflect the policies underlying the regulations.[37]

The second gain limitation rule applies where a Planned 50% acquisition of Distributing occurs as the result of a §381 transfer from the POD to Distributing.[38] In that case, the amount of gain recognized by Distributing by reason of §355(e) as a result of the acquisition is the excess, if any, of the Statutory Recognition Amount over the amount of gain, if any, that Distributing would have been required to recognize under the first gain limitation rule if there had been a Planned 50% acquisition of the POD, but not of Distributing, in the §381 transaction.

The final gain limitation rule puts an overall cap on the amount of gain recognized under §355(e) with respect to a single distribution equal to the Statutory Recognition Amount.[39]

E. Identifying a Predecessor of Controlled

The temporary regulations provide rules for identifying a predecessor of Controlled only in very limited circumstances. The temporary regulations provide that, for purposes of §355(e)(2)(C) (described above), if a corporation transfers its assets to a member of the same expanded affiliated group in a §381 transaction, the transferor will be treated as continuing in existence within the same affiliated group.[40] Solely for the purpose of applying this rule, a corporation is a predecessor of Controlled if, before the distribution, it transfers property to Controlled in a §381 transaction as part of a Plan.[41] Other than for this limited purpose, no corporation can be a predecessor of Controlled.[42]

F. Identifying a Successor of Distributing or Controlled

The successor rules of the temporary regulations are considerably simpler that the rules for identifying a POD. A successor of Distributing or Controlled is defined to be a corporation to which Distributing or Controlled, respectively, transfers property in a §381 transaction after the distribution.[43] This definition is consistent with other definitions of successor in other contexts.[44]

G. Limitations on §355(f)

The temporary regulations also impose limitations on the applicability of §355(f).[45] These rules were included because Treasury and the IRS determined that the application of §355(f) may frustrate the policy underlying the first and second gain limitation rules of the temporary regulations in certain cases.[46] Using the example of §355(f) described above,[47] if there is a Planned 50% acquisition of the stock of only a predecessor of the Lower-Tier Distributing (and not of Controlled or the Higher-Tier Distributing), then §355(f) would be expected to apply to the intragroup spin-off. If §355(f) were to apply, no part of §355 would apply (including the gain limitation rules under the temporary regulations). Without application of the first and second gain limitation rules, the full amount of built-in gain in the Controlled stock or securities would be recognized by the Lower-Tier Distributing under §311 on its distribution of Controlled stock.

The temporary regulations provide, however, that §355(f) does not apply to an intragroup spin-off if there is a Planned acquisition of 50% of the stock of a POD but not of Distributing, Controlled, or their successors.[48] As a result, §355(e), including the first and second gain limitation rules in the temporary regulations, would apply to the intragroup spin-off by Lower-Tier Distributing in the example described above. Taxpayers may instead elect to apply §355(f) without any gain limitation rules, subject to a consistency requirement.[49]

[37] *See* preamble to T.D. 9805, 81 Fed. Reg. at 91,744–91,745 (3.B.).

[38] Reg. §1.355-8T(e)(3).

[39] Reg. §1.355-8T(e)(4).

[40] Reg. §1.355-8T(f).

[41] Reg. §1.355-8T(c)(1).

[42] *Id.*

[43] Reg. §1.355-8T(c)(2).

[44] *See, e.g.,* Reg. §1.1275-6(g) (integration of qualifying debt instrument with a hedge), §1.1502-79(c)(1), §1.1502-79(d)(1), §1.1502-79(e)(1) (apportioning tax attributes to separate return year of departing member), §1.1502-77A(e)(4) (agent for consolidated group).

[45] *See* I.B.3., above.

[46] Preamble T.D. 9805, 3.E.

[47] *See* I.B.3., above

[48] Reg. §1.355-8T(g)(1).

[49] Reg. §1.355-8T(g)(2).

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III. GUIDANCE IN RESPONSE TO 2013 NO-RULES

A. Rev. Proc. 2013-3

In Rev. Proc. 2013-3,[50] the IRS added several issues under §355 as areas under study with respect to which letter rulings will no longer be issued pending the issuance of formal guidance:

- *Control Requirement* — ‘‘Whether a corporation is a ‘controlled corporation' within the meaning of section 355(a)(1)(A) if, in anticipation of a distribution of the stock of the corporation, a distributing corporation acquires putative control of the controlled corporation (directly or through one or more corporations) in any transaction (including a recapitalization) in which stock or securities were exchanged for stock having a greater voting power than the stock or securities relinquished in the exchange, or if, in anticipation of a distribution of the stock of the putative controlled corporation, such corporation issues stock to another person having different voting power per share than the stock held by the distributing corporation.''
- *North-South Transactions* — ‘‘Whether transfers of stock, money, or property by a person to a corporation and transfers of stock, money, or property by that corporation to that person (or a person related to such person) in what are ostensibly two separate transactions (so-called ‘north-south' transactions), at least one of which is a distribution with respect to the corporation's stock, a contribution to the corporation's capital, or an acquisition of stock, are respected as separate transactions for Federal income tax purposes.''
- *Use of Controlled Stock/Securities to Satisfy Distributing Debt* — ‘‘Whether either section 355 or section 361 applies to a distributing corporation's distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if such distributing corporation debt is issued in anticipation of the distribution.''

B. Guidance Issued in Response to 2013 No-Rules

1. Guidance on Recapitalizations into Control

As described above, in a §355 transaction, Distributing must have ‘‘control'' of Controlled within the meaning of §368(c) immediately prior to the transaction. That is, Distributing must own Controlled stock with at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of each class of nonvoting stock.

Historically, the IRS has permitted Distributing to acquire control through a recapitalization preceding the spin-off in some circumstances — a so-called ‘‘recapitalization into control.'' In Rev. Rul. 69-407,[51] the IRS permitted Distributing to use a recapitalization under §368(a)(1)(E) to acquire control of Controlled to spin-off under §355. The transaction was distinguished from another recapitalization into control described in Rev. Rul. 63-260,[52] because the recapitalization in Rev. Rul. 69-407 ‘‘resulted in a permanent realignment of voting control'' while the recapitalization in Rev. Rul. 63-260 resulted in control only in a ‘‘transitory and illusory sense.''

In a series of private letter rulings in recent years, the IRS appeared to gradually relax, but not eliminate, the requirement that the realignment of voting control be permanent.[53] Specifically, the IRS permitted unwinds of the recapitalization following the spin-off, as long as the taxpayer represented that there was no legally binding obligation to change the capital structure of Controlled or to proceed with the remainder of the proposed transaction.

On July 15, 2016, the IRS issued Rev. Proc. 2016-40.[54] Rev. Proc. 2016-40 provides two safe harbors under which the IRS will not assert that Distributing lacks control of Controlled within the meaning of §355(a)(1)(A), despite the presence of a transaction that ‘‘unwinds'' the recapitalized structure after the spin-off.

The first safe harbor covers transactions in which no action is taken (including the adoption of any plan or policy), at any time prior to 24 months after the distribution, by Controlled's board of directors, Controlled's management, or any of Controlled's controlling shareholders that would (if implemented) actually or effectively result in an unwind.[55]

The second safe harbor covers unanticipated third-party transactions where Controlled engages in a transaction with one or more persons that results in an unwind, regardless of whether the transaction takes place more or less than 24 months after the distribution, provided that:

[50] 2013-1 I.R.B. 122.

[51] 1969-2 C.B. 50.

[52] 1963-2 C.B. 147.

[53] *See, e.g.,* PLR 200139011, PLR 200347013, PLR 200403041, PLR 200837027, PLR 201007050.

[54] 2016-32 I.R.B. 228.

[55] Rev. Proc. 2016-40, §4.01.

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(1) There was no agreement, understanding, arrangement, substantial negotiations, or discussions concerning the transaction or a similar transaction at any time during the 24-month period ending on the date of the distribution; and

(2) No more than 20% of the interest in the other party, in vote or value, is owned by the same persons that own more than 20% in vote or value of the stock of Controlled (as determined under ownership rules provided in the revenue procedure).[56]

The safe harbors only apply to determine whether an acquisition of control has substance for purposes of §355(a)(1)(A).[57] If a transaction is not described in one of the safe harbors, the determination of whether an acquisition of control has substance will be made under general federal tax principles without regard to the provisions of the revenue procedure.[58] Rev. Proc. 2016-40 deletes the no-rule on the control requirement that was introduced by the IRS in Rev. Proc. 2013-3, so if the safe harbors do not apply, a taxpayer may be able to get a ruling.

2. Guidance on North-South Transactions

On May 3, 2017, the IRS issued Rev. Rul. 2017-9.[59] The revenue ruling provides guidance on ''north-south'' transactions under two factual scenarios — one involving north-south transfers between Distributing and its parent and one involving north-south transfers between Distributing and Controlled. The revenue ruling also eliminates the prior no-rule position on north-south transactions that was introduced in Rev. Proc. 2013-3, although the IRS may still decline to issue a ruling in the interest of sound tax administration, because the issues are inherently factual, or for other reasons.[60]

a. Situation 1

In Situation 1, Parent owns all the stock of Distributing, which owns all of the stock of Controlled. The fair market value of the Controlled stock is $100X. Parent has been engaged in Business A for more than 5 years, and Controlled has been engaged in Business B for more than 5 years. Business A and Business B each constitute a five-year ATB. Distributing is not engaged in an ATB, directly or through any member of its SAG other than Controlled. On Date 1, Parent transfers Business A, having a fair market value of $25X, to Distributing in exchange for additional shares of Distributing stock. On Date 2, Distributing distributes all the Controlled stock to Parent for a valid corporate business purpose. The purpose of Parent's transfer of Business A to Distributing is to allow Distributing to satisfy the five-year ATB requirement.

The tax treatment of Situation 1 depends on whether the transactions occurring on Date 1 and on Date 2 are treated as separate transactions for tax purposes. If the Date 1 and Date 2 transfers are respected as separate transactions, Parent would be treated as transferring property to Distributing on Date 1 in a §351 transaction, and Distributing would be treated as distributing the stock of Controlled to Parent on Date 2 in §355 spin-off (assuming the requirements under those Code sections are otherwise satisfied). In contrast, if the Date 1 and Date 2 transfers are integrated into a single exchange, Parent would be treated as transferring its Business A property to Distributing in exchange for a portion of the Controlled stock in a taxable exchange under §1001. In addition, §355 would not apply to any part of the distribution of Controlled stock because Distributing would not have distributed stock constituting control of Controlled.

The revenue ruling concludes that, in Situation 1, the transactions on Date 1 and on Date 2 will be respected as separate transactions for tax purposes, regardless of whether the purpose of the transfer on Date 1 is to qualify the distribution on Date 2 under §355. The revenue ruling explains that back-to-back nonrecognition transfers are generally respected when consistent with the underlying intent of the applicable Code provisions and there is no compelling alternative policy. In Situation 1, each step provides for continued ownership in modified corporate form. Additionally, the steps do not resemble a sale, and none of the interests are liquidated or otherwise redeemed.

The ruling notes that the result would be the same if Distributing had acquired the ATB from a subsidiary of Parent in a cross-chain reorganization under §368(a)(1). Note that prior rulings required the taxpayer to represent that there is no regulatory, legal, or economic compulsion or requirement that the contribution be made as a condition of the distribution of controlled stock.[61] It appears that this representation is no longer required to avoid exchange treatment.

b. Situation 2

The corporate structure addressed in Situation 2 is similar to the structure addressed in Situation 1. However, in Situation 2, Distributing (rather than Parent) has been engaged in Business A for more than 5 years.

[56] Rev. Proc. 2016-40, §4.02.

[57] Rev. Proc. 2016-40, §5.01.

[58] Rev. Proc. 2016-40, §5.02.

[59] 2017-21 I.R.B. 1244.

[60] Rev. Rul. 2017-9 (''Effect on Other Documents'').

[61] *See, e.g.,* PLR 201149012, PLR 201033007, PLR 201007050.

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As in Situation 1, Controlled has been engaged in Business B for more than five years. On Date 1, Controlled distributes $15X of money and property having a fair market value of $10X to Distributing, and Distributing retains the money and property. On Date 2, Distributing transfers to Controlled property having a basis of $20X and a fair market value of $100X, and Distributing distributes all the Controlled stock to Parent, in a transaction that would otherwise qualify as a D reorganization and a tax-free spin-off. Controlled and Distributing planned and executed the Date 1 transfer in pursuance of the plan of reorganization that included the Date 2 transfers.

In Situation 2, if the distribution by Controlled of money and other property on Date 1 were treated as separate from the distribution of Controlled stock, §301 would apply to Distributing's receipt of the money and other property from Controlled, and no gain would be recognized to Distributing upon the transfer of property to Controlled. In contrast, if the Date 1 distribution is treated as made in pursuance of the plan of reorganization that includes the Date 2 distribution of Controlled stock, the money and other property distributed by Controlled to Distributing would constitute boot to Distributing, and, under §361(b)(1)(B), gain would be recognized to Distributing on its transfer of property to Controlled to the extent of the amount of the money and the fair market value of the property. Section 361(b) requires gain recognition to Distributing if boot is distributed to Distributing and not further distributed by Distributing to its shareholders or creditors in pursuance of the plan of reorganization unless the facts establish that the distribution is in substance a separate transaction.

Because the facts of Situation 2 assume that Controlled and Distributing planned and executed the Date 1 transfer in pursuance of the plan of reorganization, the revenue ruling concludes that, in Situation 2, the distribution of money and property by Controlled to Distributing will constitute a distribution of boot under §361(b). The ruling provides no guidance on when a distribution will be treated as part of a plan of reorganization.

3. Lifting of No-Rule on Debt Exchanges

In Rev. Proc. 2017-38,[62] the IRS eliminated its no-rule position for transactions where Controlled stock or securities are used to retire Distributing debt issued in anticipation of the distribution.

This prior no-rule position generally was intended to cover certain leveraged spin-off transactions. In a typical transaction, Distributing would raise cash by issuing debt securities to unrelated investors (''Distributing Securities''). Distributing would then contribute assets to Controlled in exchange for a combination of Controlled stock and Controlled debt securities (''Controlled Securities''). Distributing would distribute all of the Controlled stock to its shareholders in a §355 transaction. After the distribution, Distributing would exchange the Controlled Securities it received with the Distributing Securities held by the unrelated investors, thus retiring the debt that it had incurred prior to the spin-off.[63]

Under the rulings provided by the IRS, this kind of leveraged spin-off transaction could permit Distributing to monetize some of the value of the separated assets without triggering gain under §355 and §361. Distributing generally must recognize gain under §361(b) on any boot received from Controlled in a divisive type D reorganization, but can avoid such gain by distributing the boot to its shareholders or, in certain circumstances, its creditors. Under §361(b)(3), the amount of money plus the fair market value of boot that Distributing can distribute to its creditors without gain recognition under §361(b) is limited to the amount of the basis of the assets contributed to Controlled. That limitation does not apply, however, to Controlled securities.

While earlier rulings generally were limited to ''old and cold'' debt of Distributing,[64] the IRS began to rule on transactions where Distributing debt was issued only shortly before the §355 transaction.[65] In these cases, the IRS would generally require representations to ensure that the creditors were real creditors (i.e., that they had event and credit risk) and that Distributing was not loading up on debt in anticipation of the spin-off. For event and credit risk, the IRS has required a so-called ''5-14 representation'': that the creditor holds the Distributing debt for at least 5 days before entering into the exchange agreement and holds the Distributing debt for at least 14 days before executing the exchange of Distributing for Controlled debt.[66] To ensure Distributing was not loading up on debt, the IRS has required a representation that the Distributing debt exchanged for Controlled debt will not exceed the daily average outstanding third-party

[62] 2017-22 I.R.B. 1258.

[63] *Compare, e.g.,* PLR 201029007. In other cases, an investment bank purchases Distributing debt (on the open market or directly from Distributing) and enters into an exchange agreement with Distributing for the Controlled securities. *See, e.g.,* PLR 201138021.

[64] *See, e.g.,* PLR 200137011, PLR 200345050, PLR 200716024.

[65] *See, e.g.,* PLR 200802009, PLR 200936022, PLR 201232014.

[66] *See, e.g.,* PLR 201232014, PLR 201138021.

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indebtedness of Distributing for a period before the spin-off.[67]

Although the IRS issued no substantive guidance to accompany this change in ruling position, we understand that the IRS is still working on substantive guidance.

IV. GUIDANCE IN RESPONSE TO 2015 NO-RULES

A. Rev. Proc. 2015-43 and Notice 2015-59

On September 14, 2015, the IRS relased Rev. Proc. 2015-43[68] and Notice 2015-59[69] in response to concerns relating to spin-off transactions involving relatively small active businesses, substantial amounts of investment assets (particularly when there is a significant difference between Distributing's ratio and Controlled's ratio of investment to non-investment assets), and regulated investment companies (''RICs'') or real estate investment trusts (''REITs''). For purposes of the guidance, investment assets were generally defined as cash, corporate stock or securities, foreign currency, and similar assets.[70]

The revenue procedure expanded the IRS's no-rule policy in these areas of concern, while the notice stated that such transactions were under study and that such transactions may present evidence of device for the distribution of earnings and profits or may lack an adequate business purpose or a qualifying business.

B. Proposed Device and ATB Regulations

As described above, a §355 transaction must not be used principally as a device for the distribution of the earnings and profits. Existing regulations provide for a series of nonexclusive ''device factors'' and ''nondevice'' factors that are used in determining whether, under all the facts and circumstances, a transaction is used principally as a device.[71]

Although the existing regulations contain all the rules necessary to address the transactions that concerned Treasury and the IRS, they thought more objective guidance was needed. On July 14, 2016, Treasury and the IRS proposed regulations that would make several changes to the existing regulations:

- Modify the device factor relating to nature and use of assets and the nondevice factor relating to corporate business purpose;
- Add a per-se device rule; and
- Add a new minimum size for a business to qualify as a five-year ATB.[72]

This section provides an overview of some of the key changes.

1. Shift to Nonbusiness Assets

Under the current regulations, the existence of assets that are not used in a five-year ATB (''Non-ATB Assets'') is evidence of device.[73] Furthermore, the strength of the evidence of device increases as the ratio of the value of Non-ATB Assets to the value of five-year ATB assets increases.

The proposed regulations, in contrast, would focus on assets used in a ''Business,'' rather than assets used in five-year ATB.[74] In general, Business would have the same meaning as a five-year ATB, but without regard to whether the business has been operated or owned for at least five years prior to the date of the distribution or whether the collection of income requirement in Treas. Reg. §1.355-3(b)(2)(ii) is satisfied. Business assets would be defined as gross assets used in a Business, including reasonable amounts of cash and cash equivalents held for working capital and assets required to be held to provide for exigencies related to a Business or for regulatory purposes with respect to a Business.

The focus on Business vs. nonbusiness assets is in contrast to the focus of Notice 2015-59 and Rev. Proc. 2015-43, which looked at investment vs. noninvestment assets. Although business vs. nonbusiness assets may more precisely target the types of assets that concern Treasury and the IRS,[75] it introduces a level of uncertainty by introducing concepts such as reasonable needs of the business and business exigency.

The proposed regulations contain some operating rules for purposes of determining business and nonbusiness assets. First, all members of a separate affiliated group (''SAG'')[76] with respect to which Distributing or Controlled is the common parent would be

[67] *See, e.g.,* PLR 201232014, PLR 201029007.

[68] 2015-40 I.R.B. 467.

[69] 2015-40 I.R.B. 459.

[70] *See* §355(g)(2)(B).

[71] Reg. §1.355-2(d).

[72] REG-134016-15, 81 Fed. Reg. 46,004 (July 15, 2016).

[73] Reg. §1.355-2(d)(2)(iv).

[74] Prop. Reg. §1.355-2(d)(2)(iv)(C).

[75] Preamble to REG-134016-15, 81 Fed. Reg. 46,004, 46,009–10.

[76] A corporation's SAG consists of the corporation (the common parent) and any other corporation that is either 80% owned by the parent corporation or is linked to the parent in a chain by stock ownership of at least 80% at each level. §355(b)(3)(B), §1504(a).

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treated as a single corporation.[77] Second, the proposed regulations contain a look-through rule for partnership interests if Distributing or Controlled would be considered engaged in the ATB of a partnership[78] and for stock of 50% owned subsidiaries.[79] If the look-through rule applies, the partnership interest or stock will be allocated between business and nonbusiness assets in the same proportion as the assets of the partnership or corporate subsidiary. Otherwise, the partnership interest or stock will be treated as a nonbusiness asset.[80]

Furthermore, the proposed regulations would provide thresholds for determining whether the ownership of nonbusiness assets and/or differences in the proportions of nonbusiness assets held by Distributing and Controlled are evidence of device, which act as safe harbors. If neither Distributing nor Controlled has nonbusiness assets that comprise 20% or more of its total assets, the ownership of nonbusiness assets ordinarily would not be evidence of device. Additionally, a difference in the proportion of nonbusiness assets held by Distributing and Controlled ordinarily would not be evidence of device if the difference is less than 10 percentage points (or is attributable to a need to equalize value in a non-pro rata distribution).[81] Although these safe harbors would provide greater objectivity to the nature and use of assets factor, they would add significant burden by requiring taxpayers to value all their assets.

2. Corporate Business Purpose

Under existing final regulations, the corporate business purpose for the transaction is evidence of nondevice, and the stronger the evidence of device provided by other factors, the stronger the corporate business purpose required to prevent the determination that the transaction was used principally as a device.[82] The proposed regulations would clarify that a corporate business purpose that relates to a separation of nonbusiness assets from one or more businesses or from business assets would not be evidence of nondevice, unless the business purpose involves an exigency that requires an investment or other use of the nonbusiness assets in a business.[83]

3. Per Se Device Test

The proposed regulations would also add a per se device test, which is a significant departure from the current facts-and-circumstances analysis.[84] If both prongs of this test are met, than the transaction will be treated as a device. The first prong would be satisfied if the nonbusiness assets of Distributing or Controlled represent two-thirds or more of the total assets of Distributing or Controlled, respectively. The second prong uses a sliding scale. In the first band, if one corporation's nonbusiness assets are 66⅔% of its total assets or more, but less than 80%, the distribution would fall within the band if the other corporation's nonbusiness assets are less than 30% of its total assets. In the second band, if one corporation's nonbusiness assets are 80% or more, but less than 90%, of its total assets the distribution would fall within the band if the other corporation's nonbusiness assets are less than 40% of its total assets. In the third band, if one corporation's nonbusiness assets are 90% or more of its total assets, the distribution would fall within the band if the other corporation's nonbusiness assets are less than 50% of its total assets.

The per se rule does not apply to a distribution entitled to a dividends-received deduction or to transactions ordinarily not considered to be a device.[85]

4. Minimum Size ATB Requirement

Section 355(b) does not provide on its face for a minimum absolute or relative size requirement for an ATB to qualify under §355(b).[86] However, the preamble to the proposed regulations states that "that Congress intended that section 355(b) would require that distributions have substance and that a distribution involving only a relatively de minimis active business should not qualify under section 355 because such a distribution is not a separation of businesses as

[77] Prop. Reg. §1.355-2(d)(2)(iv)(D)(2).

[78] Prop. Reg. §1.355-2(d)(2)(iv)(D)(6)(ii). Generally, a corporation is treated as engaged in the active conduct of a partnership's business for §355(b) purposes if (i) it owns a "significant" (generally 33.33% or greater) interest in the partnership, or (ii) it owns at least a 20% interest in the partnership and performs active and substantial management functions for the partnership. *See* Rev. Rul. 2007-42, 2007-28 I.R.B. 44; Rev. Rul. 2002-49, 2002-32 I.R.B. 288; Rev. Rul. 92-17, 1992-1 C.B. 142.

[79] Prop. Reg. §1.355-2(d)(2)(iv)(D)(7)(ii).

[80] Prop. Reg. §1.355-2(d)(2)(iv)(D)(6)(i), §1.355-2(d)(2)(iv)(D)(7)(i).

[81] *Id.*

[82] Reg. §1.355-2(d)(3)(ii).

[83] Prop. Reg. §1.355-2(d)(3)(ii). Example 3 of the final regulations suggests that a strong corporate business purpose for the spin-off (i.e., the inability to own both a regulated and nonregulated business in an affiliated group) is not sufficient to justify transferring cash not related to the reasonable needs of the business to Controlled. Reg. §1.355-2(d)(4) *Ex.* 3. Thus, the proposed regulations essentially move the conclusion of this example into the operating rule.

[84] Prop. Reg. §1.355-2(d)(5).

[85] Prop. Reg. §1.355-2(d)(5)(i).

[86] In Rev. Proc. 96-43, 1996-2 C.B. 330, the IRS imposed a minimum five-percent threshold percentage for a qualifying business for ruling purposes only. However, a ruling might still be issued if the taxpayer could establish that the trade or business was not de minimis compared with the other assets or activities of the corporation. Rev. Proc. 2003-48, 2003-29 I.R.B. 86, eliminated this no-rule provision.

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contemplated by section 355."[87] Thus, the proposed regulations would adopt a new requirement that the percentage determined by dividing the fair market value of Distributing and each Controlled's five-year ATB assets by the fair market value of its respective total assets must be at least five percent.[88]

The five-percent ATB threshold would apply to "all distributions,"[89] including intragroup distributions. In addition, the look-through rule for corporate stock owned by Distributing or Controlled that applies to the device requirement would not apply to the ATB requirement.[90] This could mean that a reshuffling of assets within the group prior to an external spin-off may be necessary, even if the spin-off outside the group would meet the five-percent threshold.[91]

C. Restrictions on REIT Spin-Offs

A REIT is a tax-favored entity that facilitates investment in income-producing real estate. To qualify for the favorable tax treatment, the REIT must be taxable as a domestic corporation and have at least 100 shareholders.[92] In addition, the REIT must distribute at least 90% of its taxable income to shareholders.[93] Moreover, the REIT must satisfy a number of tests designed to ensure that REITs derive most of their income from passive real estate assets and that they facilitate investment in real estate.[94]

Historically, REITs could not participate in tax-free spin-offs because they could not, by definition, engage in an ATB.[95] Changes to the REIT requirements by the Tax Reform Act of 1986,[96] the Taxpayer Relief Act of 1997,[97] and the Tax Relief Extension Act of 1999,[98] however, expanded the permissible activities of REITs sufficiently for REITs to be able to satisfy the ATB requirement.[99]

Notice 2015-59 and Rev. Proc. 2015-43 announced that the IRS would not rule on REIT spin-offs pending further study. This appears to have been motivated by so-called "OpCo-PropCo" transactions involving the spin-off of real estate assets followed by a REIT election. In an OpCo-PropCo transaction, Distributing (the "OpCo") transfers a portion of its real estate assets to a new Controlled (the "PropCo") that it plans to spin off in a tax-free §355 transaction. PropCo then elects to be treated as a REIT and generally leases the real estate back to OpCo through a triple net lease, generating deductions.

1. PATH Act of 2015

Before Treasury and the IRS could act, however, Congress stepped in and severely restricted REIT spin-offs in the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act").[100] The PATH Act added §355(h) to the Code, which provides that §355 does not apply if either Distributing or Controlled is a REIT, subject to only two exceptions:

- The spin-off may qualify as tax-free if, immediately after the distribution, both Distributing and Controlled are REITs;[101] and
- A REIT may spin-off a "taxable REIT subsidiary" ("TRS") tax-free if: (i) Distributing has been a REIT for the three-year period ending on the date of the distribution; (ii) Controlled has been a TRS at all times during such period; and (iii) Distributing had control of Controlled, directly or indirectly, at all times during such period.[102] Controlled will satisfy requirements (ii) and (iii) if it was spun-off by a TRS that satisfies those requirements.[103]

The PATH Act also amended §856(c) to preclude a corporation from making a REIT election for the 10-year period following a §355 distribution in which it was Distributing or Controlled (or a successor corporation to either).

[87] Preamble to REG-134016-15, 81 Fed. Reg. 46,004, 46,011 (July 15, 2016).

[88] Prop. Reg. §1.355-9.

[89] Preamble to REG-134016-15, 81 Fed. Reg. 46,004, 46,012 (July 15, 2016).

[90] The preamble to the proposed regulations states that Treasury and the IRS believed that the §355(b)(3) SAG rules limit the ability to take into account assets held by subsidiaries for purposes of the active trade or business requirement. REG-135016-15, 81 Fed. Reg. 46,004, 46,011 (July 15, 2016).

[91] This seems contrary to the legislative intent of the §355(b)(3) SAG rules, which was to minimize the amount of restructuring necessary within a consolidated group to prepare for an external spin-off. *See* H.R. Rep. No. 109-304, at 54 (2005).

[92] §856(a)(3), §856(a)(5).

[93] §857(a).

[94] §856(c)(2), §856(c)(3), §856(c)(4).

[95] *See* Rev. Rul. 73-236, 1973-1 C.B. 183 (holding that the requirements of §856 precluded a REIT from satisfying the ATB requirement).

[96] Pub. L. No. 99-514, §663(a), 100 Stat. 2085 (1986).

[97] Pub. L. No. 105-34, §1252(b) (1997).

[98] Pub. L. No. 106-170, §541(a) (1999).

[99] Rev. Rul. 2001-29, 2001-26 I.R.B. 1348.

[100] Pub. L. No. 114-113. For an in-depth discussion of these restrictions, the evolution of the law relating specifically to REIT spin-offs, and the remaining options to unlock the value of corporate real estate, *see* Robert Rizzi and Lisa M. Zarlenga, *Untrapping Real Estate From Corporate Solution after Changes in REIT Spin-Offs*, 43 Real Estate Tax'n 153 (3rd Quarter 2016).

[101] §355(h)(2)(A).

[102] §355(h)(2)(B).

[103] *Id.* (flush language).

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2. Temporary and Proposed Regulations Regarding REIT Conversions

Even after enactment of §355(h) and §856(c), Treasury and the IRS were concerned that taxpayers could still engage in certain transactions to circumvent the purposes of these PATH Act provisions.[104] For example, Distributing or Controlled could merge into a REIT instead of electing REIT status. As a result, on June 7, 2016, Treasury and the IRS issued temporary regulations under §337(d) that impose a corporate-level tax on certain transactions in which property of a C corporation becomes the property of a REIT.[105]

Existing regulations under §337(d) provide that if property of a C corporation becomes the property of a REIT in a conversion transaction, then the REIT will be subject to corporate-level tax on the net built-in gain in the converted property under the rules of §1374 and the underlying regulations as if the REIT were an S corporation.[106] A conversion transaction occurs when a C corporation: (i) qualifies to be taxed as a REIT; or (ii) transfers assets to a REIT in a carryover basis transaction.[107] The general §1374 rule does not apply if the C corporation transferor makes a ''deemed sale election'' to recognize gain or loss as if it sold the converted property to an unrelated person at fair market value at the time of the conversion.[108]

The temporary regulations provide that a C corporation engaging in a conversion transaction involving a REIT within the recognition period following a related §355 distribution will be treated as making the deemed sale election.[109] In addition, the temporary regulations provide that a REIT that is a party to a §355 distribution occurring within the recognition period following a conversion transaction for which a deemed sale election has not been made will recognize any remaining unrecognized built-in gains and losses resulting from the conversion transaction (after taking into account the impact of §1374 in the interim period).[110]

Consistent with the PATH Act provisions, the temporary regulations do not apply if both Distributing and Controlled are REITs immediately after the date of the §355 distribution. The temporary regulations go beyond the PATH Act by also requiring that Distributing and Controlled remain REITs at all times during the two years following the §355 distribution. In addition, the temporary regulations do not apply to certain §355 distributions in which Distributing is a REIT and Controlled is a TRS.[111]

V. CHANGES TO THE IRS'S RULING POLICY

In the past, the IRS generally would issue private letter rulings that addressed whether a transaction qualified as a §355 transaction as a whole, with relatively few caveats. In Rev. Proc. 86-41,[112] and later in Rev. Proc. 96-30,[113] the IRS provided a checklist of representations to be included in requests for rulings under §355.

However, starting with Rev. Proc. 2003-48, the IRS announced that it would ''adhere more closely to its general policies'' of not issuing rulings on issues that are primarily factual and not issuing ''comfort rulings.''[114] As a result, the IRS would no longer rule on whether a distribution of the stock of Controlled is being carried out for one or more corporate business purposes, whether the transaction is used principally as a device, or whether a distribution and acquisition are part of a plan for purposes of §355(e).[115] These issues remained on the IRS's ''no rule'' list unchanged until 2016.[116]

On August 26, 2016, the IRS issued Rev. Proc. 2016-45, which modified these no-rules to carve out legal issues relating to the business purpose and device issues.[117] As a result, the IRS may now issue a private letter ruling with respect to a significant issue under Reg. §1.355-2(b) pertaining to the corporate business purpose requirement, or a significant issue under Reg. §355(a)(1)(B) and Reg. §1.355-2(d) pertaining to device, provided that the issue is a legal issue and is not inherently factual in nature.[118]

Some examples of potential issues on which the IRS might rule include:

- Whether an alternative transaction (such as a tax-free liquidation/upstream merger-reincorporation within an affiliated group) is neither impractical nor unduly expensive for purposes of satisfying the business purpose requirement;
- The effect of continuing relationships between Distributing and Controlled on the business purpose requirement;

[104] Preamble to T.D. 9770, 81 Fed. Reg. 36,793, 36,796 (June 8, 2016).

[105] T.D. 9770, 81 Fed. Reg. 36,793 (June 8, 2016).

[106] Reg. §1.337(d)-7(a)(1).

[107] Reg. §1.337(d)-7(a)(2)(ii).

[108] Reg. §1.337(d)-7(c).

[109] Reg. §1.337(d)-7T(c)(6), §1.337(d)-7T(f)(1).

[110] Reg. §1.337(d)-7T(b)(4).

[111] Reg. §1.337(d)-7T(f)(3).

[112] 1986-2 C.B. 716.

[113] 1996-1 C.B. 696.

[114] Rev. Proc. 2003-48, §2.

[115] *Id.*, §4.

[116] *See* Rev. Proc. 2016-3, §3.01(53).

[117] Rev. Proc. 2016-45, §4.

[118] *Id.*, §3.02. For this purpose, a ''significant issue'' means ''an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction.'' Rev. Proc. 2016-3, §3.01(50).

ISSN 0148-8295

- Whether state tax savings meets the business purpose requirement;
- Whether the acquisition of Controlled by a foreign acquiror in a §367(a) transaction is a sale or exchange presenting evidence of device; and
- Whether a distribution within a consolidated group is not ''ordinarily'' a device.

VI. CONCLUSION

For over a decade, Treasury and the IRS have been trying to provide much-needed guidance in the §355 area, including guidance interpreting predecessors and successors for purposes of §355(e) and guidance implementing the SAG rules of §355(b)(3). Layered on top of this were issues identified for further study by Treasury and the IRS in Rev. Proc. 2013-3 (including recapitalizations into control, north-south transactions, and debt exchanges in connection with spin-offs) and Notice 2015-59/Rev. Proc. 2015-43 (spin-offs of small ATBs and REIT spin-offs). Pending further study, the IRS had indicated that it would not issue private letter rulings on these issues.

In the last year or so, Treasury and the IRS have been able to check many of these issues off of their priority guidance plan and, correspondingly, off the IRS's no-rule list. While practitioners still await guidance on the SAG rules and debt exchanges in connection with spin-offs, the guidance that has been issued and the re-opening of the rulings program for these transactions is welcome news.

ISSN 0148-8295