

ALI-ABA Course of Study  
**Consolidated Tax Return Regulations**  
Cosponsored by the ABA Section of Taxation

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**Acquisitions and Separation Issues in  
Consolidation**

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**Continuity of Interest**

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Continuity of Interest – In General

- To be treated as a tax-free reorganization under section 368, a transaction must satisfy the continuity of interest ("COI") requirement, as well as other statutory requirements.
- COI requires that, in substance, a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. See Treas. Reg. § 1.368-1(e).
- A proprietary interest is generally preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation (i.e., the acquiring corporation or the parent of the acquiring corporation in a triangular reorganization).
- However, a proprietary interest in the target corporation is not preserved if it is acquired by the issuing corporation (or a related party) for consideration other than stock of the issuing corporation, or if stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed.
- The IRS considers the continuity of interest requirement as satisfied if, following the transaction, historic shareholders of the target corporation hold stock of the issuing corporation (as a result of prior ownership of target stock) representing at least 40% of the value of the stock of the target corporation. See Temp. Treas. Reg. § 1.368-1T(e)(2)(v), Ex. 1
- Cases have, however, approved reorganizations with lower percentages of stock consideration. See e.g., John A. Nelson Co. v. Helvering, 296 U.S. 374 (1934) (38 percent stock); Miller v. Commissioner, 84 F.2d 415 (6th Cir. 1936) (25 percent stock).

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Measuring Continuity of Interest

- On August 10, 2004, Treasury and the IRS published proposed regulations under section 368 to address concerns that the fluctuation in the value of the issuing corporation stock between the date the parties agree to the terms of the transaction and the date the transaction closes may cause a transaction to fail the COI requirement.
  - In general, the proposed regulations provided for a "binding contract" rule under which the consideration to be exchanged for target corporation stock is valued as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization (i.e., the signing date), provided that such consideration is fixed.
  - The signing date rule is based on the principle that, where a binding contract provides for fixed consideration, the target corporation shareholders can generally be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date.
- On September 16, 2005, Treasury and the IRS published final regulations ("2005 final regulations") that retained the general framework of the proposed regulations, but contained several modifications.
- On March 20, 2007, Treasury and the IRS published proposed and temporary regulations (the "2007 temporary regulations") that amend the final regulations in several significant respects.
- In general, the 2007 temporary regulations retain the signing date rule, but provide taxpayers with greater flexibility in structuring transactions so as to satisfy the COI requirement (or, if tax-free treatment is not desired, to find the COI requirement).

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2007 Temporary Regulations – Effective Date

- The 2007 temporary regulations apply to transactions occurring pursuant to binding contracts entered into after September 16, 2005.
- For transactions occurring pursuant to binding contracts entered into after September 16, 2005, and on or before March 20, 2007, the parties to the transaction may elect to apply the 2005 final regulations instead of the 2007 temporary regulations.
  - The election by any party to the transaction is contingent upon all parties making the election.
  - The parties to the transaction would include the target corporation, issuing corporation, controlling corporation (if parent stock is transferred), and any indirect transferee of transferred basis property.
  - The 2007 temporary regulations provide that the election requirement will be satisfied if none of the parties adopt inconsistent treatment.

See Temp Treas. Reg. 1-368-1T(8)(ii).

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## Contract Modifications

- The 2007 temporary regulations continue to apply the signing date rule, which values consideration transferred in a potential reorganization on the last business day before the first date a contract is a binding contract (i.e., the signing date).
- In general, contract modifications result in a new signing date (*i.e.*, the last business day before the first date a modification is a binding contract).
- Certain modifications do not result in a new signing date if the COI requirement would have been satisfied in the absence of the modification.
  - The 2005 final regulations contained an exception for modifications that have the sole effect of providing for the issuance of additional shares of issuing corporation stock.
  - The 2007 temporary regulations add an exception for modifications that have the sole effect of decreasing the amount of money (or other property) to be transferred to target shareholders (as well as for modifications that both decrease cash (or other property) and increase stock).
- The 2007 temporary regulations also provide for a similar rule for modifications of contracts that would have failed the COI requirement in the absence of the modification.

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## Fixed Consideration

- The signing date rule only applies if the binding contract provides for fixed consideration.
- A contract provides for fixed consideration if it provides the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property to be exchanged for all of the proprietary interests of the target corporation.
- Under the 2005 final regulations, binding contracts that provide for a shareholder election to receive stock or cash (or other property) generally are treated as providing for fixed consideration if that contract also specifies --
  - the minimum number of issuing corporation shares and maximum amount of cash (or other property) transferred to target shareholders,
  - The minimum % of number of shares of each class of proprietary interests in the target corporation exchanged for issuing corporation shares, or
  - The minimum % by value of proprietary interests in the target corporation exchanged for issuing corporation shares.
- The 2007 temporary regulations treat a shareholder election as providing for fixed consideration so long as the amount of stock to be received is determined using its value on the signing date.

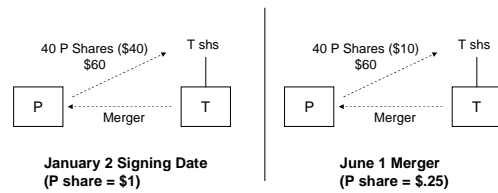
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## Contingent Consideration

- The 2005 final regulations generally provide that the presence of contingent consideration will cause a binding contract to fail to provide for fixed consideration.
- The 2007 temporary regulations adopt a more lenient standard whereby binding contracts providing for contingent consideration will be treated as providing for fixed consideration unless the contingent adjustments prevent (to any extent) the target shareholders from being subject to the economic benefits and burdens of ownership of the issuing corporation as of the signing date.
- The 2007 temporary regulations cite as examples of contingent consideration causing a binding contract not to be treated as providing for fixed consideration --
  - Adjustments to the consideration in the event that the value of issuing corporation stock or its assets (or any surrogate of either) increases or decreases after the signing date, and
  - Adjustments to the number of issuing corporation shares computed using a share value as of a date after the signing date.

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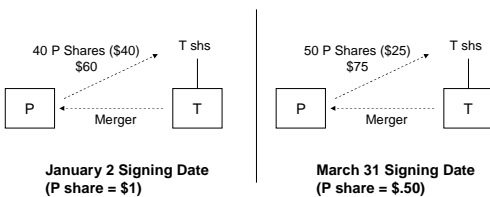
## Measuring COI – Example 1: Signing Date Rule



**Facts:** On January 3, P and T sign a binding contract pursuant to which T will merge with and into P on June 1 of that year. The contract provides that T shareholders will receive 40 P shares and \$60 in exchange for all of T stock. On January 2, a P share is worth \$1. On June 1, T merges with and into P. On that date, a P share is worth \$25.

**Result:** There is a binding contract providing for fixed consideration because the contract provides for the number of P shares and cash transferred in exchange for all of the proprietary interests in T. Thus, the value of P shares on the signing date (\$1 per share) is used to determine whether the COI requirement has been satisfied. Using that share value (\$1), the 40 P shares constitute 40% of the total consideration transferred to T shareholders. The COI requirement is satisfied. See Treas. Reg. § 1.368-1T(e)(2)(v), ex. 1.

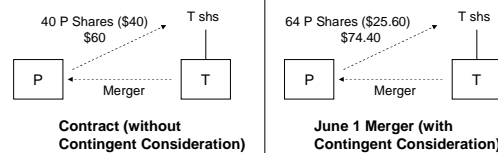
## Measuring COI – Example 2: Contract Modification



**Facts:** The facts are the same as in Example 1, except that the parties modify the binding contract on April 1 to provide that the T shareholders will receive 50 P shares and \$75. The modified contract is also a binding contract. On March 31, a P share is worth \$50.

**Result:** Because the modification provides for additional P shares and cash to be exchanged for all of the proprietary interests of T, the modification results in a new signing date (March 31). Thus, the value of P shares on March 31 is used to determine whether the COI requirement has been satisfied. Using that share value (\$50), the 50 P shares constitute 25% of the total consideration received by T shareholders. As a result, the COI requirement is not satisfied. Note that the COI requirement would have been satisfied if the modification only provided for additional P shares.<sup>11</sup> See Treas. Reg. § 1.368-1T(e)(2)(v), ex. 4 and 5.

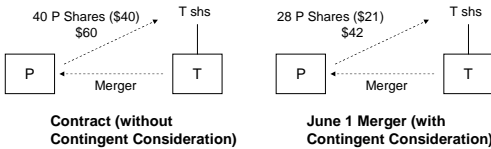
## Measuring COI -- Example 3: Contingent Consideration



**Facts:** On January 3, P and T sign a binding contract pursuant to which T will merge with and into P on June 1 of that year. On January 2, a P share is worth \$1. The contract provides that T shareholders will receive 40 P shares and \$60 in exchange for all of the T stock. The contract also provides that the T shareholders will receive \$16 of additional P shares and \$.24 for every \$.01 decrease in the value of a P share after January 2. On June 1, T merges with and into P. On that date, a P share is worth \$40. As a result of the provision for contingent consideration, T shareholders receive 64 P shares (worth \$25.60) and \$74.40 in the merger.

**Result:** The signing date rule does not apply because the binding contract does not provide for fixed consideration. The additional consideration received by T shareholders is contingent upon a decrease in the value of a P share after the signing date (January 2). As a result, the T shareholders are not subject to the economic benefits and burdens of P after that date. Because the signing date rule does not apply, the value of P shares as of January 2 is not used to determine whether the COI requirement is satisfied, but rather the value on the date of the merger (June 1). Using that share value (\$40), the value of the P shares (\$25.60) constitutes approximately 25% of the total consideration<sup>12</sup> and the COI requirement is not satisfied. See Treas. Reg. § 1.368-1T(e)(2), ex. 10.

### Measuring COI -- Example 4: Contingent Consideration



**Facts:** On January 3, P and T sign a binding contract pursuant to which T will merge with and into P on June 1 of that year. On January 2, a P share is worth \$1 and a T share is worth \$1. The contract provides that T shareholders will receive 40 P shares and \$60 in exchange for all of the T stock. The contract also provides that the T shareholders will receive \$.40 less P shares and \$.60 less for every \$.01 decrease in the value of a T share after January 3. On June 1, T merges with and into P. On that date, a P share is worth \$.75 and a T share is worth \$.70. As a result of the provision for contingent consideration, T shareholders receive 28 P shares (\$21) and \$42 in the merger.

**Result:** The signing date rule applies because the binding contract provides for fixed consideration. The additional consideration received by T shareholders is contingent upon a decrease in the value of a T share (and not a P share). Thus, the T shareholders are subject to the economic benefits and burdens of P. Because the signing date rule applies, the value of P shares on January 2 is used to determine whether the COI requirement is satisfied. Using that share value (\$1), the value of the P shares (\$28) constitutes 40% of the total consideration and the COI requirement is satisfied. See Treas. Reg. § 1.368-1T(e)(2), ex. 12.

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## Section 362(e)(2) Regulations

### Section 362(e) Overview

- Section 362(e) limits the ability of taxpayers to duplicate built-in loss in connection with nonrecognition transactions.
- Section 362(e)(1) provides that if there is an importation of a built-in loss in a transaction described in section 362(a) or (b), then the basis of certain property acquired in the transaction will be its fair market value immediately after the transaction.
- Section 362(e)(2) applies if property is transferred in a transaction described in section 362(a) (and not covered by section 362(e)(1)), and if the transferee's aggregate adjusted basis in the transferred property would exceed its fair market value.
  - In such a case, section 362(e)(2) limits the transferee's aggregate basis in the properties to the aggregate fair market value of the transferred property.
  - Any required basis reduction is allocated among the transferred properties in proportion to their built-in loss immediately before the transaction.
  - Transferor and transferee may elect to limit the basis in the stock received by the transferee to the aggregate fair market value of the transferred property, in lieu of limiting the basis in the assets transferred.
  - Such election shall be included with the tax returns of the transferor and transferee for the taxable year in which the transaction occurs and, once made, shall be irrevocable.

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### Proposed Section 362(e)(2) Regulations

- The IRS published proposed regulations under section 362(e)(2) on October 23, 2006.
- The proposed regulations do not address the application of section 362(e)(2) to transfers between members of a consolidated group and do not address the application of section 362(e)(1).
  - Treasury and the IRS published proposed regulations on January 23, 2007 that address the application of section 362(e)(2) in the consolidated context. See Prop. Treas. Reg. § 1.1502-13(e)(4).
- The proposed regulations clarify that section 362(e)(2) applies separately to each transferor where multiple transferors transfer property to a single transferee. See Prop. Treas. Reg. § 1.362-4(b)(2).
- The proposed regulations clarify that section 362(e)(2) will not apply to certain transfers of property where the net-built in loss is eliminated (e.g., a transaction described in sections 351 and 368(a)(1)(D)). See Prop. Treas. Reg. § 1.362-4(b)(6).
- The proposed regulations clarify that section 362(e)(2) can apply to transfers wholly outside the U.S. tax system, but will not apply if (i) neither party to the transfer was a U.S. person, (ii) neither party was required to file a return (including an information return), (iii) neither party was a CFC, (iv) the transfer occurred more than two years before the assets enter into the U.S. tax system and (v) neither the transferor nor the later importation of the assets was entered into with a view of reducing Federal income tax liability. See Prop. Treas. Reg. § 1.362-4(b)(7).

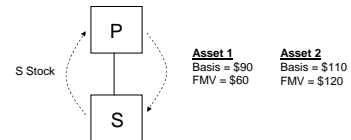
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### Proposed Section 362(e)(2) Regulations (Continued)

- The proposed regulations clarify that for purposes of determining whether the transferred property has a net built-in loss in the hands of the transferee, the bases of such property first must be increased under section 362(a) or (b) for any gain recognized by the transferor on the transfer of such property. See Prop. Treas. Reg. § 1.362-4(b)(ii).
- The proposed regulations detail the process by which the transferor and transferee make a joint election to reduce the transferor's basis in the transferee stock in lieu of reducing the transferee's basis in the property received in the transfer. See Prop. Treas. Reg. § 1.362-4(c).
- The proposed regulations contain an example demonstrating how section 362(e)(2) applies to a deemed section 351 transaction occurring by reason of section 304.
- The Preamble to the proposed regulations states that section 336(d) and section 362(e)(2) are fully compatible where the parties do not make an election to reduce the transferor's basis in the transferee stock received. However, the Preamble notes that if an election had been made, sections 336(d) and 362(e)(2) may operate to deny part or all of an economic loss and invite comments regarding this issue.

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### Proposed Section 362(e)(2) Regulations -- Example 1

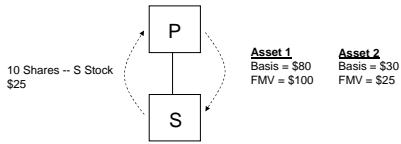


**Facts:** P contributes: (i) Asset 1 with a fair market value of \$60 and an adjusted basis of \$90 and (ii) Asset 2 with a fair market value of \$120 and a basis of \$110 to S in exchange for S stock in a section 351 exchange.

**Analysis:** Unless P and S elect otherwise, P's basis in its S shares is \$200. There is an aggregate built-in loss of \$20 in Assets 1 and 2. Thus, S's aggregate basis in Assets 1 and 2 equals \$180 (i.e., the aggregate fair market value of Assets 1 and 2). S's basis in Asset 1 is reduced to \$70 [\$90 - (\$20 x \$30/\$30)] (i.e., the proportionate share of built-in loss allocable to Asset 1). S's basis in Asset 2 remains \$110 [\$110 - (\$20 x \$0/\$30)]. See section 362(e)(2); Prop. Treas. Reg. § 1.362-4(d), ex. 1.

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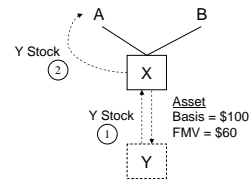
**Proposed Section 362(e)(2) Regulations – Example 2:  
Boot in Section 351 Exchange**



**Facts:** P contributes: (i) Asset 1 with a fair market value of \$100 and an adjusted basis of \$80 and (ii) Asset 2 with a fair market value of \$25 and a basis of \$30 to S in exchange for 10 shares of S stock and \$25 in a section 351 exchange.

**Analysis:** The proposed regulations require that the built-in loss in the hands of S, if any, be adjusted to reflect the gain recognized by P in the exchange. P is required to recognize gain (but not loss) under section 351(b) to the extent P receives boot in addition to the S stock received. For purposes of computing the amount of gain required under section 351(b), the amount of boot (\$25) is allocated to Asset 1 and Asset 2 in proportion to their relative fair market values. Thus, P is treated as having received 8 shares of S stock and \$20 in exchange for Asset 1 and 2 shares of S stock and \$5 in exchange for Asset 2. P must recognize \$20 of gain, and the basis of Asset 1 is increased by \$20 to \$100. The aggregate basis of Assets 1 and 2 (\$130) exceeds their aggregate fair market value (\$125), and thus section 362(e)(2) applies to reduce S's basis in Asset 2 to \$25. Prop. Treas. Reg. § 1.362-4(d), ex. 6.

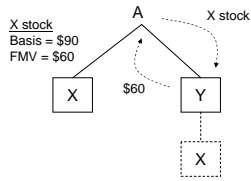
**Proposed Section 362(e)(2) Regulations – Example 3:  
'D' Reorganization & Split-Off**



**Facts:** A and B are individuals that each own 50 percent of corporation X. X owns Asset with a basis of \$100 and a fair market value of \$60. In a transaction described under section 351 and qualifying as a 'D' reorganization, X contributes Asset to a newly formed corporation, Y, in exchange for Y stock, and then distributes all of the Y stock to A in exchange for all of A's X stock in a transaction described in section 355. A has no plan to dispose of his Y stock. B has no plan to dispose of his X stock. No election is made under section 362(e)(2)(C). X stays in business after the contribution and distribution.

**Analysis:** Although Asset has a built-in loss, the proposed regulations provide that section 362(e)(2) will not apply because X distributes all of the Y stock received in the exchange without recognizing gain or loss under section 361(e), and, upon completion of the transaction, no person holds Y stock or any other asset with a basis determined in whole or in part by reference to X's basis in the Y stock received in the exchange. See Prop. Treas. Reg. § 1.362-4(d), ex. 4.

**Proposed Section 362(e)(2) Regulations – Example 4:  
Section 304 Transactions**



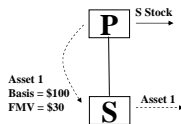
**Facts:** A is an individual who owns all of the stock of both corporation X and Y. A has a basis of \$90 in his X stock. A sells all of his X stock to Y for \$60. Pursuant to section 304, A is treated as if he transferred his X stock to Y in exchange for Y stock in a section 351 transaction and then as if his Y stock was redeemed. No election is made pursuant to section 362(e)(2)(C).

**Analysis:** Under section 362(a), Y would otherwise receive a \$90 basis in the X stock. Section 362(e)(2) operates to reduce Y's basis in X stock to \$60. Prop. Treas. Reg. § 1.362-4(d), ex. 8.

**Proposed Consolidated Section 362(e)(2) Regulations**

- Treasury and the IRS addressed the interaction between section 362(e)(2) and the consolidated return rules in connection with issuing proposed LDR regulations on January 23, 2007.
- In general, under section 362(e)(2), a transfer of loss property pursuant to a section 351 transaction will result in a decrease of the transferee's aggregate basis in the transferred assets. See section 362(e)(2).
- The transferor may elect to reduce its stock basis in the transferee in lieu of the reduction in the transferee's aggregate basis in the transferred assets.
- Thus, in the consolidated return context, the election under section 362(e)(2) may provide for the same results as those under the basis adjustment rules and the current loss duplication or proposed unified rules.

**Proposed Consolidated Section 362(e)(2) Regulations –  
Basic Fact Pattern**



**Facts:** P owns Asset 1, which has a basis of \$100 and a FMV of \$30. P transfers Asset 1 to S in exchange for stock in a transaction described in section 351. In Case 1, P and S are not consolidated and P makes no election to reduce its basis in S Stock. In Case 2, P and S are not consolidated and P makes an election to reduce its basis in S Stock. In Case 3, P and S are consolidated. In each case, S sells Asset 1, and P subsequently disposes of S stock.

**Result:** In Case 1, S must reduce the basis in Asset 1 to \$30 so it realizes no gain. When P sells its S stock, it recognizes a \$70 loss. In Case 2, S realizes a \$70 loss on the asset sale, but P realizes no loss on the stock disposition. In Case 3, P reduces its basis in S when S sells Asset 1 under the investment basis adjustment rules. Thus, the result would be the same as in Case 2. In each case, only one loss is recognized.

**Proposed Consolidated Section 362(e)(2) Regulations**

- The Preamble to the proposed section 362(e)(2) regulations indicates that the Service and Treasury recognize that loss duplication may effectively be precluded under consolidated return rules, but that they remain concerned that, if section 362(e)(2) did not apply, members of a consolidated group may be able to reduce gain under circumstances that separate taxpayers could not.
- The Service and Treasury are also mindful that the maintenance of dual regimes would add significant complexity and an increased administrative burden.
- The proposed regulations attempt to strike an appropriate balance by suspending the application of section 362(e)(2) so long as duplicated loss can be eliminated under the consolidated return provisions.
- Under the proposed rules, the suspension lasts until the occurrence of a "section 362(e)(2) application event" AND only thereafter to the extent the investment adjustment system has not and can no longer effectively eliminate any remaining duplication.

Proposed Consolidated Section 362(e)(2) Regulations

- The proposed regulations require that the amount and location of the loss duplication be tracked while in the consolidated group. See Prop. Treas. Reg. § 1.1502-13(e)(4)(i).
- In particular, the consolidated group must track the “section 362(e)(2) amount,” which is equal to the amount by which the transferee’s (“B’s”) basis in the assets received in a transaction to which section 362(e)(2) applies (an “intercompany section 362(e)(2) transaction”) would have been eliminated under section 362(e)(2). See Prop. Treas. Reg. § 1.1502-13(e)(4)(ii).
- A consolidated group must track the section 362(e)(2) amount (or any portion thereof) until it is eliminated. The remaining portion is referred to as the “remaining section 362(e)(2) amount.”
- The section 362(e)(2) amount can be eliminated in one of two ways –
  - As B’s attributes that reflect the section 362(e)(2) amount are taken into account by the group.
  - To the extent the basis in B stock that reflects the section 362(e)(2) amount is reduced by a shareholder election, by operation of the proposed unified rule, or otherwise without gain or loss (except as under the investment basis adjustment rules).

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Proposed Consolidated Section 362(e)(2) Regulations

- Under the proposed regulations, the section 362(e)(2) amount is tracked, but does not reduce B’s attributes reflecting the amount until the occurrence of a “section 362(e)(2) application event.” See Prop. Treas. Reg. § 1.1502-13(e)(4)(iii) and (iv).
- The proposed regulations define the term “section 362(e)(2) application event” to include any event or transaction that results in –
  - A transfer (within the meaning of Treas. Reg. § 1.1502-36(f)(11)) of any of the B stock received in the intercompany section 362(e)(2) transaction,
  - Any satisfaction of a security received in an intercompany section 362(e)(2) transaction without gain or loss recognition,
  - Any nonmember holding an asset with a substituted basis that reflects all or a portion of the remaining section 362(e)(2) amount (or succeeding to an attribute that does), and
  - Any other transaction the result of which prevents all or a portion of any remaining section 362(e)(2) amount reflected in stock basis or attributes from being effectively eliminated by the operation of the investment adjustment provisions when taken into account.

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Proposed Consolidated Section 362(e)(2) Regulations – Election to Reduce Share Basis

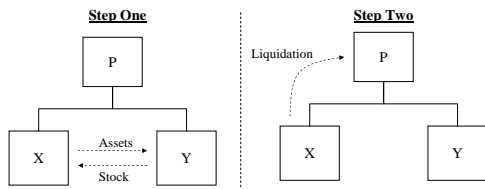
- Upon a section 362(e)(2) application event, S and B may avoid reduction of B’s attributes by electing to reduce S’s basis in B stock received in the intercompany section 362(e)(2) transaction. See Prop. Treas. Reg. § 1.1502-13(e)(4)(v).
- The amount of the reduction is equal to the amount B would otherwise be required to reduce its attributes.
- The election is similar to that available outside of the consolidated return context.
- The election is made in the manner described in regulations issued under section 362(e)(2).

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All Cash “D” Reorganizations

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‘D’ Reorganizations – Stock

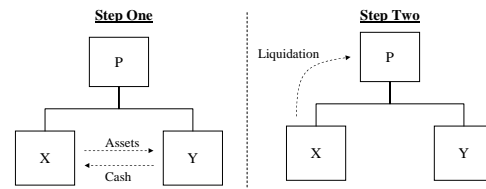


**Facts:** P, X, and Y are corporations. P owns all of the stock of X and Y. X transfers all of its assets to Y in exchange for stock. X then liquidates into P.

**Result:** This transaction qualifies as a tax-free ‘D’ reorganization under section 368(a)(1)(D). A transfer by one corporation (X) substantially all of its assets to another corporation (Y) qualifies as a reorganization described in section 368(a)(1)(D) if, immediately after the transfer, one or more of its shareholders (P) is in control of the acquiring corporation (Y), and if stock or securities of the acquiring corporation (Y) are distributed in a transaction which qualifies under section 354, 355, or 356. See Section 354(b)(1).

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‘D’ Reorganizations – Cash – Rev. Rul. 70-240

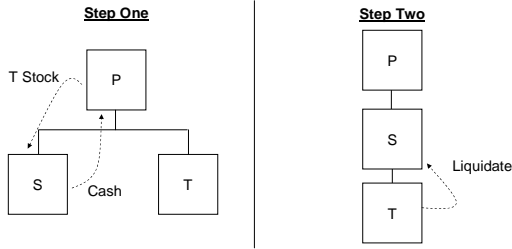


**Facts:** P, X, and Y are corporations. P owns all of the stock of X and Y. X transfers all of its assets to Y in exchange for cash. X then liquidates into P.

**Result:** This transaction qualifies as a tax-free ‘D’ reorganization under section 368(a)(1)(D). In the transaction, X distributes substantially all of its assets to D and its shareholder (P) is in control of Y after the exchange. However, the requirement that stock or securities of the acquiring corporation (Y) be distributed is not technically satisfied. This requirement is treated as satisfied because a distribution of Y stock in this example would be a meaningless gesture. See Rev. Rul. 70-240; see also Rev. Rul. 2004-83.

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**Rev. Rul. 2004-83**



**Facts:** Corporation P owns all the stock of Corporation S and Corporation T. P, S, and T are members of a consolidated group. As part of an integrated plan, S purchases all the stock of T from P for cash and T completely liquidates into S. Assume that if T had sold its assets directly to S and T had completely liquidated into P, the transaction would have qualified as a reorganization under section 368(a)(1)(D).

**Issue:** In Rev. Rul. 2004-83, the Service ruled that step transaction principles apply to treat this transaction as a merger of T into S under section 368(a)(1)(D). In addition, Rev. Rul. 2004-83 provides that the result would be no different if P, S, and T were not members of a consolidated group. In the Service's view, no policy exists that would require section 304 to apply where section 368(a)(1)(D) would otherwise apply.

**'D' Reorganizations -- Temporary & Proposed Regulations**

- On December 18, 2006, the IRS issued temporary and proposed regulations under sections 368(a)(1)(D) and 354(b)(1)(B) in response to requests for immediate guidance regarding whether certain all-cash acquisitive transactions can qualify as a 'D' reorganization. See Temp. Treas. Reg. § 1.368-2T(l).
- The Preamble to the recent temporary regulations states that the IRS and Treasury contemplate that the proposed regulations may change upon completion of a broader study and the comments received regarding the proposed regulations.
- On March 1, 2007, the IRS amended the temporary regulations so that certain related party triangular regulations that qualify as tax-free triangular regulations under section 368 would not be treated as 'D' reorganizations with boot under the temporary regulations.

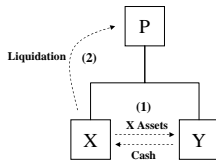
**'D' Reorganizations -- Temporary & Proposed Regulations**

- The temporary and proposed regulations provide that a transaction otherwise described in section 368(a)(1)(D) will be treated as satisfying the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) notwithstanding the fact there is no actual issuance of stock and / or securities of the transferee corporation if the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporation in identical proportions.
- In such cases, the transferee corporation will be deemed to issue a nominal share of stock to the transferor corporation in addition to the actual consideration exchanged for the transferor corporation's assets.
- The nominal share of stock in the transferee corporation will then be deemed distributed by the transferor corporation to its shareholders and, where appropriate, further transferred through chains of ownership to the extent necessary to reflect the actual ownership of the transferor and transferee corporations.

**'D' Reorganizations -- Temporary & Proposed Regulations**

- The constructive ownership rules of section 318(a)(1) apply such that an individual and all members of his or her family described in section 318(a)(1) will be treated as one individual.
- The constructive ownership rules of section 318(a)(2) apply without regard to the 50-percent limitation in section 318(a)(2)(C).
- The same person or persons will be treated as owning all of the stock of the transferor and transferee corporation in identical proportions notwithstanding the fact that there is a de minimis variation in shareholder identity or proportionality of ownership.
  - The temporary and proposed regulations do not define what level of variation would be treated as de minimis, although an example does conclude that a 1% ownership in the stock of the transferee by an individual who owns no stock in the transferor is de minimis variation in identity and proportionality where the other three shareholders own 34%, 33%, and 33% of the stock of the transferor and each owns 33% of the stock of the transferee. See Temp. Treas. Reg. § 1.368-2T(l)(3), ex. 4.
- Additionally, section 1504(a)(4) stock is not taken into account.

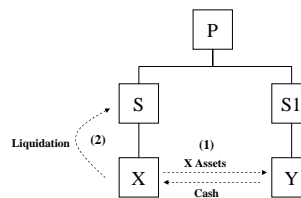
**'D' Reorganizations -- Direct Ownership**



**Facts:** P owns all of the stock of X and Y. X transfers its assets to Y in exchange for cash and immediately thereafter liquidates into Y.

**Result:** The transaction will be treated as a 'D' reorganization because the distribution of Y stock would constitute a meaningless gesture. See Rev. Rul. 70-240. Note that the same result would obtain if P transferred X stock to Y in exchange for cash and, immediately thereafter, X liquidated into Y. See Rev. Rul. 2004-83. The result does not change under the temporary or proposed regulations because there is complete shareholder identity and proportionality of ownership in X and Y. See Temp. Treas. Reg. § 1.368-2T(l)(2); Cf. Temp. Treas. Reg. § 1.368-2T(l)(3), ex. 1.

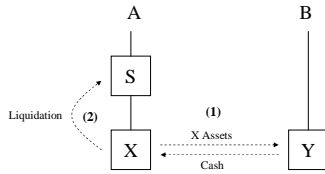
**'D' Reorganizations -- Indirect Ownership**



**Facts:** P owns all of the stock of S and S1. S owns the stock of X and S1 owns the stock of Y. X transfers its assets to Y in exchange for cash and immediately thereafter liquidates into Y.

**Result:** The transaction should qualify as a 'D' reorganization because Y stock is treated as being distributed up the chain to P and then back down. See PLR 8911067; PLR 9229026. In the consolidated return context, the following events are deemed to occur: (i) Y is treated as issuing its stock to X in exchange for X's assets; (ii) X is treated as distributing Y stock to S in a liquidation; and (iii) Y is treated as redeeming its stock from S for cash. See Treas. Reg. section 1.1502-13(f) and (f)(7), ex. 3. The same result would obtain under the new temporary regulations. Cf. Temp. Treas. Reg. § 1.368-2T(l)(3), ex. 4.

### 'D' Reorganizations -- Constructive Ownership

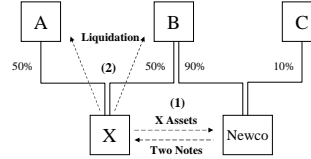


**Facts:** A and B are mother and son. A owns the stock of S which owns the stock of X. B owns the stock of Y. X transfers its assets to Y and immediately thereafter liquidates into S.

**Result:** Has there been a 'D' reorganization? Does S control Y after the transaction? Would a distribution of Y stock be a meaningless gesture? See PLR 9111055. What is the result under the new temporary regulations? See Temp. Treas. Reg. § 1.368-2T(l)(3), ex. 2.

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### 'D' Reorganizations -- PLR 200551018

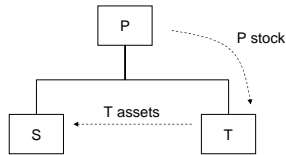


**Facts:** A and B own 50 percent of the stock of X. B and C own Newco, with B owning 90 percent and C owning 10 percent of the stock, respectively. X Corporation transfers its assets to Newco in exchange for two notes. Immediately thereafter, X liquidates, distributing one note to each A and B.

**Result:** PLR 200551018 assumes that the transaction does not qualify as a 'D' reorganization in holding that Newco is entitled to amortize the cost of goodwill acquired as a result of the purchase of X assets. What is the result under the new temporary regulations? Is there identity and proportionality of ownership in X and Newco? See Temp. Treas. Reg. § 1.368-2T(l)(3), ex. 6.

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### Acquisitive Triangular Reorganizations



**Facts:** P owns all of the stock of S and T. T transfers substantially all of its assets to S solely in exchange for P stock and T liquidates.

**Result:** This transaction satisfies the technical requirements of a 'C' reorganization. Prior to the March 2007 amendment to the temporary regulations, this transaction was also treated as a valid 'D' reorganization, even though no stock of the acquiring corporation, S, is transferred in exchange for T's assets. Because section 368(a)(2)(A) precludes the transaction from being treated as a 'C' reorganization if it also a 'D' reorganization, the temporary regulations would have treated the transfer of P stock as boot in a 'D' reorganization. The March 2007 amendment prevents this transaction from being treated as a 'D' reorganization under the temporary regulations. See Temp. Treas. Reg. 1.368-2T(l)(2)(iv).

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### Section 355: Active Trade or Business

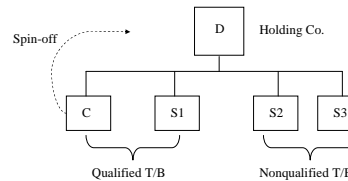
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### Active Trade or Business Requirement – SAG Rule

- Sections 355(a)(1)(C) and (b)(1) generally require that Distributing and Controlled must each be engaged in the active conduct of a trade or business (an "ATB") immediately after the distribution.
- Section 355(b)(2)(A) provided that a corporation satisfies the ATB requirement if and only if (i) it is engaged in an ATB or (ii) substantially all of its assets consist of stock of a corporation controlled by it (immediately after the distribution) which is so engaged.
- The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") amended section 355(b) to provide that a corporation can meet the ATB requirement only if it conducts an ATB. However, for such purposes, all members of such corporation's separate affiliated group (a "SAG") shall be treated as one corporation. See section 355(b)(3).
- A SAG is defined as the affiliated group which would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply.
- The TIPRA change applies to distributions occurring after the date of enactment (May 17, 2006).
  - Under TIPRA, section 355(b)(3) was to sunset with respect to transactions occurring before December 31, 2010.
  - On December 9, 2006, Congress enacted the Tax Relief and Health Care Act of 2006, which contained a provision that made the TIPRA amendment to section 355(b)(3) permanent.

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### Section 355(b)(3) — Example



**Facts:** D is a holding company that wholly owns C, S1, S2, and S3, each of which is of equal value. C and S1 each engage in a qualifying 5-year active trade or business, but S2 and S3, having been acquired in taxable transactions within the past 5 years, do not. D wants to spin-off C to its shareholders.

**Analysis:** Under prior law, D would not have satisfied the active trade or business requirement, because substantially all of its assets are not stock or securities in subsidiaries that are so engaged. See Section 355(b)(2). However, under section 355(b)(3)(B), D, S1, S2, and S3 will now be treated as one corporation engaged in S1's qualifying active trade or business.

Would the answer change if S1 were a foreign corporation?

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### Section 355(b) – Proposed Legislative Change

- The Tax Technical Corrections Act of 2006 (the "Proposed Corrections Act") was introduced in the Senate (S. 4026) and the House (H.R. 6264) on September 29, 2006.
- The Proposed Corrections Act would modify the affiliated group ATB in TIPRA, enacted as section 355(b)(3).
  - As discussed above, section 355(b)(3) provides that all members of a corporation's separate affiliated group (determined under section 1504(a) as if section 1504(b) did not apply) are treated as one corporation for purposes of applying the ATB requirement of section 355(b).
  - The Proposed Corrections Act would redefine the term "separated affiliated group" not to include those corporations which became a member of such separate affiliated group (or of any other separate affiliated group to which the active business rule of the provision applies with respect to the same distribution) during the 5-year period ending on the date of distribution by reason of one or more transactions in which gain or loss was recognized in whole or in part.
  - Also, a business conducted by such a corporation at the time it became an otherwise qualifying member would not be included.
- The legislative change to section 355(b) proposed by the Proposed Corrections Act would apply as if it had been included in TIPRA.
- The proposed legislative change has not been enacted.

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### Active Trade or Business Requirement -- Sections 355(b)(2)(C) & (D)

- Sections 355(b)(2)(B) requires that the ATB be conducted throughout the five-year period ending on the date of distribution (the pre-distribution period)
- Section 355(b)(2)(C) provides that the ATB must not have been acquired in a transaction in which gain or loss was recognized, in whole or in part, during the pre-distribution period.
- Section 355 (b)(2)(D) provides that control over a corporation which (at the time of acquisition) was conducting an ATB must not have been directly or indirectly acquired by any distributee corporation or distributing corporation during the pre-distribution period in a transaction in which gain or loss was recognized, in whole or in part.
- The IRS published proposed regulations on May 8, 2007 that provide guidance on the application of the SAG rule of section 355(b)(3) to the acquisition rules of sections 355(b)(2)(C) and (D).
- In general, these proposed regulations follow the basic principle of section 355(b)(3) that all members of a SAG are to be treated as divisions of a single corporation. In this regard, the proposed regulations further the legislative policy of section 355(b)(3) to minimize pre-section 355 restructurings in order to satisfy the tax-free requirements of section 355.

### Proposed Regulations -- Sections 355(b)(2)(C) & (D)

- The proposed regulations introduce the terms "DSAG" and "CSAG", which refer to the SAG of Distributing and Controlled, respectively.
- The members of DSAG and CSAG may overlap and members of a CSAG may be included in the DSAG, as appropriate.
- The proposed regulations clarify that the SAG rule applies throughout the pre-distribution period. Accordingly, Distributing or Controlled may satisfy the ATB requirement if a member of the DSAG or CSAG satisfied the requirement.
- The proposed regulations confirm that asset transfers between SAG members are disregarded for purposes of determining whether there has been an impermissible acquisition under section 355(b)(2)(C).
- The proposed regulations generally treat stock acquisitions that result in the acquired corporation becoming a SAG member as asset acquisitions, thereby limiting the effect of section 355(b)(2)(D). If the acquired corporation becomes a SAG member, then the applicable code provision is section 355(b)(2)(C) because the acquisition is treated as an asset acquisition.

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### Proposed Regulations -- Sections 355(b)(2)(C) & (D)

- The Preamble to the proposed regulations provides that sections 355(b)(2)(C) and (D) have been and should be applied in a manner consistent with the overall purposes of section 355. *See C.I.R. v. Gordon*, 382 F.2d 499 (2d Cir.1967), *rev'd on other grounds*, 391 US 83 (1968); Rev. Rul. 69-461 (1969-2 CB 52); Rev. Rul. 78-442 (1978-2 CB 143); §1.355-3(b)(4)(iii); §1.355-3(b)(4)(i).
- Accordingly, the proposed regulations may depart from the literal language of section 355(b)(2)(C) and (D) in order to carry out the common purpose underlying section 355(b)(2)(C) and (D).
- The common purpose of section 355(b)(2)(C) and (D) is to prevent the direct or indirect acquisition of the trade or business to be relied on by a corporation in exchange for assets in anticipation of a distribution to which section 355 would otherwise apply.
- The proposed regulations provide that --
  - certain transactions in which there is gain or loss actually recognized are not treated as recognition transactions because they do not violate the common purposes of sections 355(b)(2)(C) and (D).
  - certain tax-free acquisitions are treated as transactions in which gain or loss is recognized even though no gain or loss is actually recognized because they violate the common purpose of sections 355(b)(2)(C) and (D).

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### Proposed Regulations -- Sections 355(b)(2)(C) & (D)

- The proposed regulations provide that certain transactions made in exchange for DSAG's assets are treated as transactions in which gain or loss was recognized for purposes of sections 355(b)(2)(C) and (D).
- The proposed regulations explicitly provide that the following acquisitions constitute impermissible acquisitions under sections 355(b)(2)(C) and (D) --
  - The DSAG or CSAG acquires an interest in a partnership engaged in the trade or business to be relied on by contributing assets not constituting the trade or business to be relied on to the partnership. *See Prop. Reg. § 1.355-3(b)(4)(ii)(A).*
  - The DSAG or CSAG acquires stock of a corporation engaged in the trade or business to be relied on by transferring assets not constituting the trade or business to be relied on to such corporation in exchange for stock of such corporation. *See Prop. Reg. § 1.355-3(b)(4)(iii)(A).*
  - The DSAG or CSAG acquires stock of a corporation engaged in the trade or business in an exchange to which section 304(a)(1) applies. *See Prop. Reg. § 1.355-3(b)(4)(iii)(A).*
  - Distributing acquires a trade or business in exchange for its stock and assets in a transaction in which no loss is recognized by virtue of section 351(b). *See Prop. Reg. § 1.355-3(b)(4)(iii)(A).*
- Acquisitions consisting of a distribution from a partnership are generally treated as an acquisition paid for with DSAG assets. *See Prop. Reg. § 1.355-3(b)(4)(ii)(B).*

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### Proposed Regulations -- Sections 355(b)(2)(C) & (D)

- The proposed regulations provide that certain exchanges are not treated as made in exchange for DSAG assets and, accordingly, are not subject to recognized gain or loss treatment.
  - The assumption by the DSAG or CSAG of liabilities of a transferor shall not, in and of itself, be treated as the payment of assets if the assumption is not treated as the payment of money or other property under any other applicable provision. *See Prop. Treas. Reg. § 1.355-3(b)(4)(ii)(A).*
  - The following acquisitions are also not treated as made in exchange for DSAG assets --
    - An acquisition in which no gain or loss is recognized consisting of a pro rata distribution to which section 355 applies (to the extent the stock with respect to which the distribution is made was not acquired during the pre-distribution period in a transaction in which gain or loss was recognized).
    - A reorganization described in section 368(a)(1)(E) or (F).
    - An exchange to which section 1036 applies.
    - An acquisition consisting of a pro-rata distribution from a partnership of stock or an interest in a lower-tier partnership to the extent the distributee partner did not acquire the interest in the distributing partnership during the pre-distribution period in a transaction in which gain or loss was recognized and to the extent the distributing partnership did not acquire the distributed stock or partnership interest within such period.
- See Prop. Treas. Reg. § 1.355-3(b)(4)(ii)(A).*

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### Proposed Regulations -- Sections 355(b)(2)(C) & (D)

- The proposed regulations also disregard recognized gain or loss with respect to certain transactions for purposes of applying sections 355(b)(2)(C) and (D).
- The proposed regulations identify the following transactions as those in which any gain or loss will be disregarded –
  - An acquisition by the CSAG from the DSAG provided the DSAG controls the controlled corporation ("C") immediately after the acquisition. See Prop. Treas. Reg. § 1.355-3(b)(4)(iii)(A).
  - An acquisition that would be tax-free but for the payment of cash to shareholders for fractional shares in the transaction, provided that the cash paid represents a mere rounding off of the fractional shares in the exchange and is not separately bargained for consideration. See Prop. Treas. Reg. § 1.355-3(b)(4)(iii)(B).
  - A direct or indirect acquisition by a distributee corporation of control of the distributing corporation ("D"), in one or more transactions, where the basis of the acquired distributing stock in the hands of the distributee corporation is determined in whole by reference to the transferor's basis. However, this rule is only applicable with respect to a distribution by the acquired D, and does not apply for purposes of any subsequent distribution by any distributee corporation. See Prop. Treas. Reg. § 1.355-3(b)(4)(iii)(C).

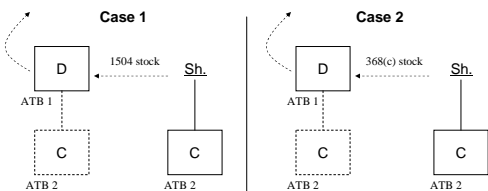
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### Sections 355(b)(2)(C) & (D) – Predecessors & Hot Stock

- The current regulations only take a "predecessor in interest" into account for purposes of applying section 355(b)(2)(D). See Treas. Reg. § 1.355-3(b)(4)(i).
- The proposed regulations provide that any reference to a corporation includes a reference to a predecessor of such corporation. A predecessor is defined as a corporation that transfers its assets to the acquirer in a transaction to which section 381 applies. See Prop. Treas. Reg. § 1.355-3(b)(4)(iv)(A).
- Section 355(a)(3)(B) provides that stock of controlled acquired by distribution during the pre-distribution period in which gain or loss is recognized is treated as boot.
- The Preamble to the proposed regulations requests comments concerning the application of section 355(a)(3)(B) to acquisitions of C stock in gain or loss transactions that, under these proposed regulations, are not treated as violating requirements of section 355(b).

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### Section 355(b)(2)(C) vs. 355(b)(2)(D)

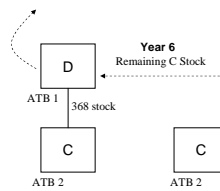


**Facts:** For five years, D has conducted ATB 1, and unrelated C has conducted ATB 2. In Year 6, D purchases C stock. In Year 8, D distributes all of the C stock in a section 355 transaction. In Case 1, D purchases C stock in Year 6 that satisfies the requirements of section 1504(a)(2). In Case 2, D purchases C stock in Year 6 that satisfies the requirements of section 368(c), but not section 1504(a)(2).

**Result:** In Case 1, D is treated as acquiring the assets of C in violation of section 355(b)(2)(C). In Case 2, D is treated as acquiring the stock of C in violation of section 355(b)(2)(D). See Prop. Reg. § 1.355-3(b)(1)(ii), -3(b)(4)(i)(B).

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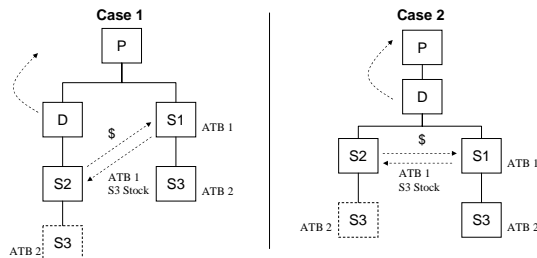
### Section 355(b)(2)(C) vs. 355(b)(2)(D)



**Facts:** For five years, D has conducted ATB 1 and C has conducted ATB 2. ATB 1 and ATB 2 are not in the same line of business. Throughout this period, D has owned C stock that satisfies the requirements of section 368(c), but not section 1504(a)(2). In Year 6, D purchases the remaining C stock in a taxable transaction. In Year 8, D distributes all of its C stock in a section 355 transaction.

**Result:** Under the proposed regulations, the Year 6 acquisition would be in violation of section 355(a)(2)(C) because D's acquisition of control under section 1504(a)(2) in Year 6 would be treated as an asset acquisition. Under existing regulations, however, the Service had taken the position that acquisitions between affiliated members would not implicate section 355(a)(2)(C) or (D). The Service has issued guidance stating that it will not challenge such transactions if effected prior to the date the proposed regulations are issued in temporary or final form. See Notice 2007-60.

### Affiliation – SAG vs. non-SAG Members

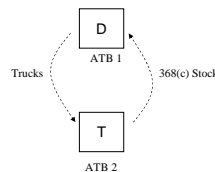


**Facts:** For five years, the P consolidated group has consisted of D, S1, S2, and S3. During this period, S1 and S3 have conducted ATB 1 and ATB 2, respectively. In Year 6, S2 purchases ATB 1 and the stock of S3 from S1. In Year 8, D spins-off S2. In Case 1, S1 is a brother-sister corporation of D. In Case 2, S1 is a wholly-owned subsidiary of D.

**Result:** In Case 1, S1 is not a member of D's separate affiliated group (the "DSAG"). Therefore, the acquisition of ATB 1 and ATB 2 violates section 355(b)(2)(C), and D cannot rely on ATB 1 or ATB 2 to satisfy the ATB requirement for the Year 8 spin-off. In Case 2, S1 is a member of the DSAG. Accordingly, the acquisition of ATB 1 and ATB 2 is disregarded. See Prop. Reg. § 1.355-3(b)(1)(ii), -3(d)(2), ex. 26.

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### Use of Assets Test: Transfer of Non-ATB Assets



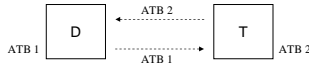
**Facts:** For five years, unrelated D and T have engaged in ATB 1 and ATB 2, respectively. In Year 6, D transfers trucks to be used in T's ATB 2 in exchange for section 368(c) stock of T in a section 351 transaction in which no gain or loss is recognized.

**Result:** D cannot rely on ATB 2 to satisfy the ATB requirement unless D's acquisition of T stock is not within the pre-distribution period, because D acquired control of T in exchange for assets not constituting the ATB in violation of section 355(b)(2)(D). See Prop. Reg. § 1.355-3(d)(2), ex. 30.

Does the result change if D acquires section 1504(a)(2) stock in the transaction? What if D transfers ATB 1 to T? What if ATB 1 is then sold by T prior to the spin-off? See Prop. Reg. § 1.355-3(d)(2), ex. 37.

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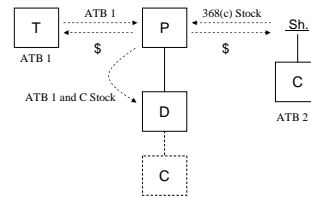
### Use of Assets Test: Section 1031



**Facts:** For five years, D and T have engaged in ATB 1 and ATB 2, respectively. In Year 6, D exchanges ATB 1 for ATB 2 in a tax-free section 1031 transaction.

**Result:** Can D rely on ATB 2 to satisfy the ATB requirement without waiting until the section 1031 exchange is no longer within the pre-distribution period?

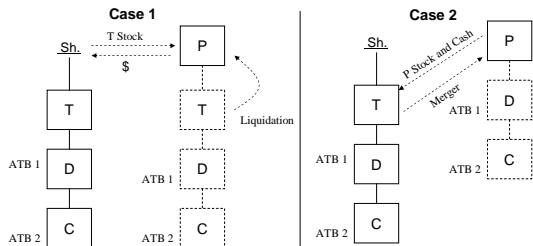
### Use of Assets Test: Non-DSAG Assets



**Facts:** For five years, P has owned all of the stock of D, and T and C have engaged in ATB 1 and ATB 2, respectively. In Year 6, P purchases ATB 1 from T and section 368(c) stock from C's shareholders. In that same year, P contributes ATB 1 and the C stock to D in a section 351 transaction.

**Result:** D can rely on ATB 1 and C can rely on ATB 2 for purposes of satisfying the ATB requirement, because neither ATB 1 nor control of C were acquired in exchange for assets of the DSAG. See Prop. Reg. § 1.355-3(d)(2), ex. 32. Would the result change if P recognized section 357(c) gain on the transfer? See Prop. Reg. § 1.355-3(d)(2), ex. 33.

### Use of Assets Test: Acquisition of Distributing



**Facts:** For five years, T has owned all of the stock of D, and D has owned the stock of C. During that period, D and C have engaged in ATB 1 and ATB 2, respectively. In Case 1, P purchases T stock in a taxable transaction in Year 6. In Year 7, P liquidates T in a transaction in which no gain or loss was recognized. P's adjusted basis in the D stock after the liquidation is determined by reference to T's adjusted basis in the D stock. In Case 2, P acquires all of the assets of T in exchange for P stock and cash in an A reorganization in Year 6. In Year 8, D distributes C stock to P.

**Result:** D can rely on ATB 1 and C can rely on ATB 2 for purposes of satisfying the ATB requirement. See Prop. Reg. § 1.355-3(b)(4)(iii)(C). However, P cannot rely on ATB 1 or ATB 2 if it were to distribute D or C, unless the Year 6 acquisition is not in the pre-distribution period. See Prop. Reg. § 1.355-3(d)(2), ex. 40.

### Section 355: Expansion

#### ATB Requirement -- Business Expansion

- Bricks and clicks**
  - A corporation that previously only sold to customers through retail stores begins to sell over the internet
    - Do the products have to be identical with those in the stores?
    - What if the sales are conducted through an auction process?
- Clicks and clicks**
  - A corporation that manufactures computer parts develops/acquires software or know-how that enhances the performance of its (and similar) products
  - A corporation that develops software applications develops/acquires applications that are utilizable in new ways (or by new industries)
  - A corporation that develops software applications develops/acquires a consulting business with respect to its or similar products
- Results of Product Innovation/Industry Expansion**
  - A corporation that owns and operates cable systems acquires stations or begins to produce content to show over the network.
  - A corporation that manufactures televisions begins to manufacture DVD players.
  - A corporation that provides long distance telephone service begins also to provide local service. Thereafter, it begins to provide wireless service. That wireless service becomes integrated with the internet and then, in turn, with hand-held devices. In addition, the company begins to manufacture telephones that incorporate its recently developed technology for delivery to customers.

#### Expansion Doctrine - General

- Treas. Reg. § 1.355-3(b)(3)(ii):

The fact that a trade or business underwent change during the five-year period preceding the distribution (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded, provided that the changes are not of such a character as to constitute the acquisition of a new or different business. In particular, if a corporation engaged in the active conduct of one trade or business during that five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such a character as to constitute a new or different business.

### Expansion Doctrine - General

• **Preamble to section 355 Regulations (T.D. 8238) (Jan. 5, 1989):**

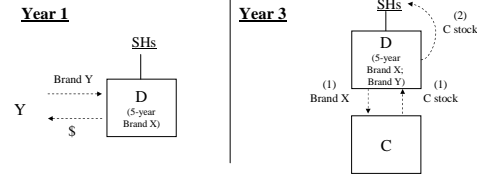
In reexamining the active business requirements, Treasury and the Internal Revenue Service recognized that it is often difficult to determine whether a corporation is conducting a single business, which may be separated under section 355 if it has been actively conducted for five years, or multiple businesses, which may be separated under section 355 only if each has been actively conducted for five years. Correlatively, they recognized that it is difficult to determine whether a corporate expenditure for a new activity constitutes the acquisition or creation of a new business or the expansion of an existing business. Accordingly, it is considered to be appropriate to simplify these determinations.

As in *Estate of Lockwood v. Commissioner*, 350 F.2d 712 (8<sup>th</sup> Cir. 1965), the final regulations provide that, for purposes of the five-year active conduct requirement, a new activity in the same line of business as an activity that has been actively conducted by the distributing corporation for the five-year period preceding the distribution ordinarily will not be considered a separate business. As a result, the distribution of a new activity will more easily satisfy the five-year active conduct requirement.

### Expansion Doctrine – Examples

- A corporation that owns and operates a department store downtown may acquire a parcel of land in the suburbs and construct a new department store. Treas. Reg. § 1.355-3(c), Example 7.
- A corporation that owns and operates hardware stores in several states may purchase the assets of a hardware store in a state where it had not previously conducted business. Treas. Reg. § 1.355-3(c), Example 8; See also *Estate of Lockwood v. Commissioner*, 350 F.2d 712 (8<sup>th</sup> Cir. 1965).
- A corporation that manufactures a product may acquire assets related to the installation or distribution of that product. P.L.R. 199937014 (June 15, 1999); P.L.R. 9621030 (Feb. 23, 1996).
- A corporation may introduce a new product line that complements and advances its current products by incorporating new technological developments. P.L.R. 9646019 (Aug. 16, 1996).

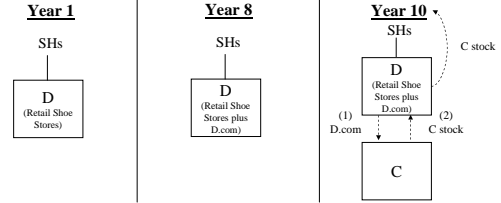
### Rev. Rul. 2003-18



**Facts:** D has been engaged as an automobile dealer of brand X automobiles for over five years. In Year 1, D acquired a franchise for the sale of brand Y automobiles and purchased the inventories, equipment, and leasehold of a former brand Y automobile dealer. D operated the brand Y business through D's employees. In Year 3, D transferred all of the assets with respect to the brand X business to C in exchange for the stock of C, and distributed the C stock pro rata to its shareholders.

**Result:** The Service ruled that the acquisition of the brand Y business in Year 1 constituted an expansion, because (i) the product of the brand X business is similar to the product of the brand Y business, (ii) the business activities associated with the brand X business are the same as the business activities associated with the brand Y business, and (iii) the operation of the brand Y business involves the use of the experience and know-how that D developed in the brand X business. See Treas. Reg. § 1.355-3(c), Exs. 7, 8; see also P.L.R. 9241033 (July 13, 1992). This ruling obsoletes Rev. Rul. 57,190, 1957-1 CB, 121, which came to a contrary result under the same facts, effective as of January 5, 1989, the effective date of Treas. Reg. § 1.355-3.

### Rev. Rul. 2003-38



**Facts:** D has operated a retail shoe store business under the name "D" since Year 1. D's business enjoys favorable name recognition, customer loyalty, and other elements of goodwill. In Year 8, D created an Internet web site, which it named D.com to take advantage of its goodwill, and began selling shoes at retail on the web site. In Year 10, D transferred all of the assets with respect to the web site to C in exchange for the stock of C, and distributed the C stock pro rata to its shareholders.

**Result:** The Service ruled that the creation of the web site in Year 8 constituted an expansion, because (i) the product of the retail shoe store and the web site are the same, (ii) the business activities associated with the retail shoe store are the same as those of the web site, and (iii) the operation of the web site draws to a significant extent on D's existing experience and know-how, and the web site's success will depend in large measure on the goodwill associated with D's name, even though the web site's operation requires some know-how not associated with operating a retail store. See Treas. Reg. § 1.355-3(c), Exs. 7, 8. What if the web site offered specialized shoes or other products that were not offered in the stores? What if the web site sold shoes through an auction process?

### Rev. Rul. 2003-18 v. Rev. Rul. 2003-38

Factors Considered	Rev. Rul. 2003-18	Rev. Rul. 2003-38
1. Similar Products Sold	Present	Present
2. Same Business Activities	Present	Present
3. Use of Experience and Know-How of Existing Business	Present	Partially Present (web site's operation differs from retail store)
4. Goodwill Associated with Name of Existing Business	Not Considered	Present

### Expansion Doctrine – Proposed Regulations

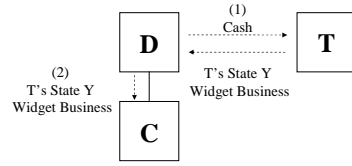
- The Service published proposed regulations on May 8, 2007 to provide guidance on issues involving the ATB requirement, particularly the application of section 355(b)(3).
- The proposed regulations provide for certain facts and circumstances to be considered when applying the expansion doctrine.
- The Preamble to the proposed regulations indicates that the inclusion of these non-exclusive facts and circumstances was not intended to be a substantive change, but rather intended to clarify and restate the current law regarding expansions.
- The proposed regulations provide that in determining whether an acquired business is in the same line of business as the original business, all facts and circumstances shall be considered, including the following –
  - Similarity of products of the businesses,
  - Similarity of activities associated with operation of the businesses, and
  - Whether operation of acquired business involves use of experience and know-how developed in original business, or, draws to a significant extent on experience and know-how of the owner of the original business and success of the acquired business will depend on large measure on goodwill associated with the original business.

### Expansion Doctrine – Proposed Regulations

- Because a stock acquisition resulting in the acquired corporation becoming part of a separate affiliated group (a "SAG") is treated as an asset acquisition, the Preamble to the proposed regulations provides that a corporation should be able to expand its existing business by acquiring the stock of a corporation engaged in a trade or business in the same line of business, provided that the acquired corporation becomes a subsidiary SAG member. See Prop. Treas. Reg. § 1.355-3(b)(3)(ii).
- The Preamble states that the Service and Treasury believe that section 355(b)(3) provides the exclusive means by which a corporation is attributed the assets (or activities) owned (or conducted) by another corporation.
- Accordingly, the Preamble states that a stock acquisition that does not result in the acquired corporation becoming a subsidiary SAG member should not be an expansion of the SAG's original business.

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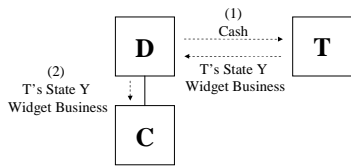
### Example 1: Direct Acquisition of T Assets by D



- Facts:** D owns a 5-year Widget business operating in State X. D acquires T's 5-year Widget business operating in State Y for cash. D operates in States X and Y for two years. D contributes T's business to C, and immediately thereafter spins-off C.
- Result:** See Treas. Reg. § 1.355-3(b)(3)(ii) (acquisition of trade or business by corporation engaged in same line of business ordinarily treated as an expansion of the original business); Treas. Reg. § 1.355-3(c), Ex.(7) (acquisition by distributing through purchase and construction of new retail location, followed by transfer of new store to controlled, satisfies active business requirement); Treas. Reg. § 1.355-3(c), Ex. (8) (purchase by distributing of new retail store in state where corporation had not previously conducted any business, followed by transfer of newly acquired assets to controlled; controlled satisfies active business requirements); Prop. Treas. Reg. § 1.355-3(c), Ex. 18; *Estate of Lockwood v. Comm'r*, 350 F.2d 712 (8th Cir. 1965) (expansion of distributing's business into new geographical area by controlled is a good 5-year business; relying on Conf. Rep. No. 2543, at 38 (1954)).

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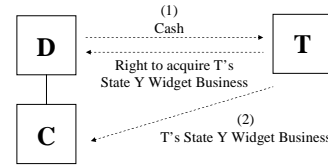
### Example 2: Acquisition of T Assets by D/Transitory Ownership



- Facts:** Same facts as Example 1, except the following:
  - D contributes T's State Y Widget business to C immediately after its acquisition.
  - D spins-off C two years after acquiring T's State Y Widget business.
- Issue:** Is D's transitory ownership of T's business disregarded?

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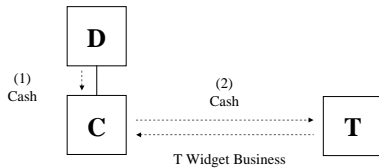
### Example 3: Acquisition of T Assets/Cause to be Directed Transfer



- Facts:** Same facts as Example 2, except D directs the T assets to be transferred directly from T to C.
- Result:** The directed transfer presumably is treated as a transfer to D, followed by a contribution of the assets from D to C. See Rev. Rul. 70-224, 1970-1 C.B. 79.
  - See PLR 199937014 (June 15, 1999) (contract for acquisition of assets by parent of distributing corporation and immediate transfer of those assets to newly formed subsidiaries of distributing corporation constitutes expansion of distributing's business).

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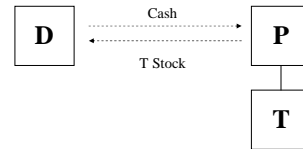
### Example 4: Acquisition of T Assets Directly by C



- Facts:** Same facts as Example 2, except D contributes cash to C; C contracts directly with T for the cash acquisition of T's 5-year Widget business operating in State Y.
- Issue:** Should the lack of any transitory actual or constructive ownership by D of the T assets, as in the previous examples, preclude satisfaction of the active trade or business analysis? See *Athanasios v. Comm'r*, T.C. Memo 1995-72 (in litigation, IRS appears to have conceded that controlled's acquisition of new restaurant constitutes expansion of distributing's active business).

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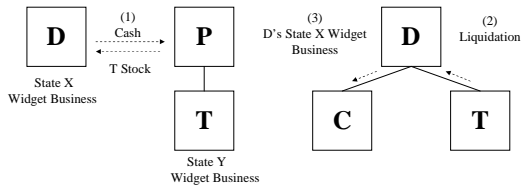
### Example 5: Expansion of Business through Stock Acquisition; Spin-Off of Newly Acquired Corporation



- Facts:** Same historic facts as Example 1 regarding D's and T's respective Widget Business. D acquires all of the stock of T from P in a qualified stock purchase; no Section 338 election is made. D spins off T two years after its acquisition.
- Issue:** Should the expansion of business principle trump section 355(b)(2)(D) as it does section 355(b)(2)(C)? Does structure of section 355 and language of section 355(a)(3)(B) suggest that the latter provision is inapplicable with respect to stock acquisitions that precede or give rise to Distributing owning an amount of stock satisfying section 368(c) control? See Prop. Treas. Reg. § 1.355-3(b)(c), exs. 20-21 (concluding that stock acquisition can result in expansion if acquired corporation treated as member of D's separate affiliated group); see also PLR 200109027 (Nov. 30, 2000) (suggesting that expansion of business requirements not met with respect to a stock acquisition).

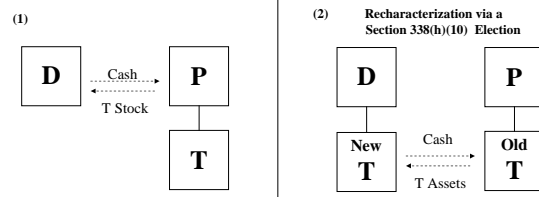
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**Example 6: Indirect Expansion of D's Business through Acquisition of T Stock**



- **Facts:** Same historic facts as Example 1 regarding D's and T's respective Widget businesses. D acquires all of the stock of T from P in a qualified stock purchase; no Section 338 election is made. Two years after its acquisition, T is liquidated. Immediately thereafter, D contributes its historic State X Widget Business to C and spins off C.
- **Issue:** Should the expansion of business principle apply to D's acquisition of the State Y Widget business via the liquidation of T? See Prop. Treas. Reg. §1.355-3(b)(c), exs. 20-21 (concluding that stock acquisition can result in expansion if acquired corporation treated as member of D's separate affiliated group); See PLR 200109027 (Nov. 30, 2000); cf. *Commissioner v. Gordon*, 382 F.2d 499 (2d Cir. 1967), *rev'd on other grounds*, 391 U.S. 83 (1968) (implying that a single-entity approach applies to active trade or business analysis); Treas. Reg. §1.355-3(b)(4)(iii) (same, applicable prior to 1987 legislation); Rev. Rul. 78-442, 1978-2 C.B. 143 (transaction qualifies under Section 355 despite recognition of gain upon distributing's transfer of assets to controlled).

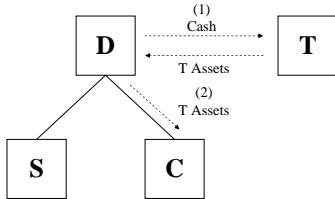
**Example 7: Acquisition of T Stock by D with Section 338(h)(10) Election**



- **Facts:** Same historic facts as Example 1 regarding D's and T's respective Widget businesses. D acquires all of the stock of T from P in a qualified stock purchase. D and P make a Section 338(h)(10) election.
- **Result/Issue:** Acquisition is treated as purchase by New T of all of the Old T Assets. Should this transaction be treated the same as Example 4?

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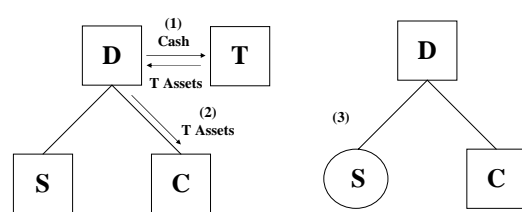
**Example 8: Acquisition of T Assets by Holding Company D**



- **Facts:** S owns a 5-year Widget business operating in State X. D is a holding company and satisfies the active trade or business requirement through its ownership of the stock of S. D acquires all of the assets of T's 5-year Widget business operating in State Y. D immediately contributes the T assets to the newly formed C. D spins off C two years following the acquisition of the T assets.
- **Issue:** Should the fact that D is not directly engaged in an active trade or business change the outcome of Example 2? See section 355(b)(3).

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**Example 9: Acquisition of T Assets by Holding Company D**



- **Facts:** Same facts as Example 8, except 10 days following acquisition of T assets, D makes a retroactive check-the-box election for S effective as of the day before the acquisition.
- **Result:** See Treas. Reg. §301.7701-3(c)(1) (regarding retroactive effectiveness dates for check-the-box elections); PLR 200109027 (Nov. 30, 2000) (merger of existing subsidiaries into disregarded entities satisfies expansion of business test as well as 5% gross assets test).

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**Section 355: Partnerships**

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**Partnership Attribution – Proposed Regulations**

- The IRS published proposed regulations on May 8, 2007 which provide guidance as to whether a corporation is engaged in an ATB through the attribution of trade or business assets and activities from a partnership.
- The proposed regulations generally are consistent with the principles of Rev. Rul. 92-17 and Rev. Rul. 2002-49.
- The proposed regulations expand the principle of Rev. Rul. 92-17 to provide that a partner owning a "significant interest" can be attributed a partnership's business irrespective of whether the partner conducts active and substantial management functions.
- In addition, the proposed regulations do not differentiate between the nature of a partnership interest and an LLC interest.
- The proposed regulations will apply to distributions that occur after the date the regulations are published as final regulations.
- Query whether the Service will entertain ruling requests on the basis of the proposed regulations where doing so would be inconsistent with the Service's current position.
  - Note that the Service has recently issued Rev. Rul. 2007-42 which concludes that a "significant interest" in a partnership can satisfy the ATB requirement.

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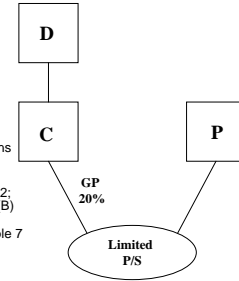
**Partnership Attribution – Proposed Regulations**

- In general, the proposed regulations provide that a corporation is required itself to perform active and substantial management or operational functions, although employees of affiliates may perform such functions.
  - The proposed regulations provide that a partner will be attributed the trade or business assets and activities of a partnership if either –
    - The partner (or its SAG) has a “significant interest” in the partnership, or
    - The partner (or its affiliates) perform active and substantial management functions with respect to the partnership’s business, and the partner (or its SAG) has a “meaningful interest” in the partnership.
- See Prop. Treas. Reg. § 1.355-3(b); see also Treas. Reg. § 1.368-1(d)(4)(iii)(B) (COBE requirements)
- The Service considers a “significant interest” to be 33 1/3% and a “meaningful interest” to be 20%, although it is unclear whether lower percentages would also be treated as such. Rev. Rul. 2007-42 clarifies that a 20% interest would not be a significant interest.

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**Section 355 and the Use of Partnerships**  
**Example 1: 20% Managing General Partner**  
 (Revenue Ruling 92-17)

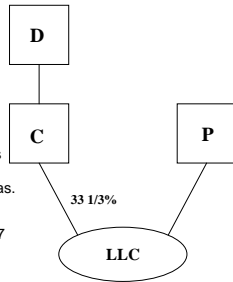
- C is 20% general partner in limited partnership.
- C provides managerial services.
  - C’s officers perform active and substantial management functions including decision making and employee supervision.
- See Rev. Rul. 92-17, 1992-1 C.B. 142; Prop. Treas. Reg. § 1.355-3(b)(2)(v)(B)
- Compare Treas. Reg. §§ 1.368-1(d)(4)(iii)(B) & 1.368-1(d)(5), Example 7 (COBE satisfied).



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**Section 355 and the Use of Partnerships**  
**Example 2: 33 1/3% Member**  
 (Revenue Ruling 2007-42)

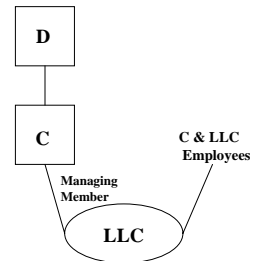
- C has a 33 1/3% interest in a LLC taxable as a partnership.
- Employees of the LLC perform all management and operational functions with respect to the LLC’s business operations.
- See Rev. Rul. 2007-42; Prop. Treas. Reg. § 1.355-3(b)(2).
- Compare Treas. Reg. §§ 1.368-1(d)(4)(iii)(B) & 1.368-1(d)(5), ex. 7 (COBE satisfied).



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**Section 355 and the Use of Partnerships**  
**Example 3: Managing Member in Limited Liability Company**

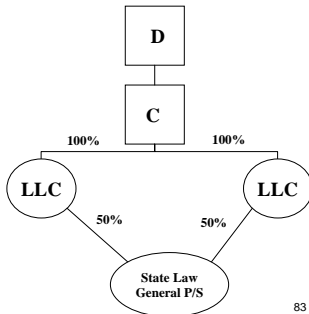
- C is sole managing member.
  - C performs all active and substantial management functions for LLC.
- See PLR 200025001 (July 9, 1999).
- Are standards for percentage ownership or management higher for LLC interests than GP interests?
  - For example, what if C is not the sole managing member and has a less than 50% interest in the LLC?
- The proposed regulations do not make a distinction.



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**Section 355 and the Use of Partnerships**  
**Example 4: Business Held through Disregarded Entities**

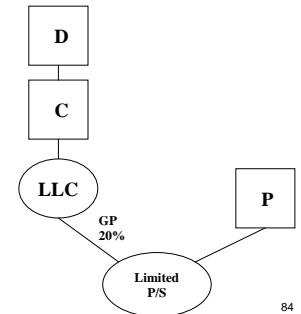
- C owns captive state law general partnership through disregarded LLCs.
- See PLR 200007005 (Nov. 1, 1999); PLR 9722018 (Feb. 26, 1997).



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**Section 355 and the Use of Partnerships**  
**Example 5: 20% Managing General Partner Held Through SM LLC**

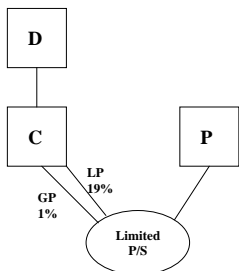
- C is 20% general partner in limited partnership.
- C’s partnership interest is held through disregarded LLC.
- C provides managerial services as per Rev. Rul. 92-17.
- Does liability shield alter the result? See PLR 20025001.



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**Section 355 and the Use of Partnerships**  
**Example 6: 1% Managing General Partner & 19% Limited Partner**

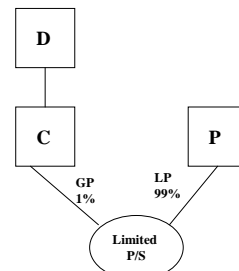
- C is 1% general partner & 19% limited partner.
- C provides managerial services as per Revenue Ruling 92-17.
- Bifurcated GP/LP established as a liability shield.



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**Section 355 and the Use of Partnerships**  
**Example 7: 1% Managing General Partner**

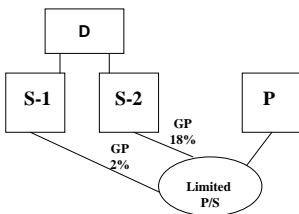
- C is 1% general partner in limited partnership.
- C provides managerial services as per Revenue Ruling 92-17.
- Compare Treas. Reg. §§ 1.368-1(d)(4)(iii)(B) & 1.368-1(d)(5), Example 8 (COBE failed under similar facts).
- The proposed regulations do not clarify what would be treated as meaningful interest.



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**Section 355 and the Use of Partnerships**  
**Example 8: 2% Partner; Affiliate Holds 18% and Management**

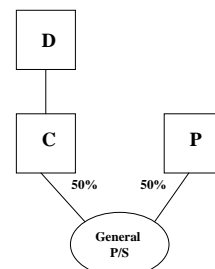
- S-1 is 2% general partner.
- S-2 is 18% general partner and provides managerial services as per Revenue Ruling 92-17.
- Can S-2's interest and/or management activities be considered in testing S-1?
- The proposed regulations provide that S-2's management would be, but not its interest. See Prop. Treas. Reg. § 1.355-3(b)(2)(v). Cf. Rev. Rul. 79-394, 1979-2 C.B. 141 & Rev. Rul. 80-181, 1980-2 C.B. 121 (Services performed by officers & employees of affiliate count).
- Treas. Reg. §§ 1.368-1(d)(4)(i) & (ii) & 1.368-1(d)(5), Example 11 (Interest of qualified group counted for COBE).



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**Section 355 and the Use of Partnerships**  
**Example 9: 50% Partner in General Partnership with Shared Management**

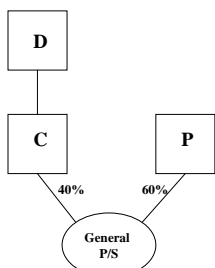
- C is 50% partner in general partnership.
- C & P both provide managerial services.
- Can more than one partner treat partnership as a qualifying active business?
- See Prop. Treas. Reg. § 1.355-3(d), ex. 24 (three partners attributed partnership's assets and activities); Cf. PLR 200044017.



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**Section 355 and the Use of Partnerships**  
**Example 10: 40% Partner in General Partnership with Blocking Rights**

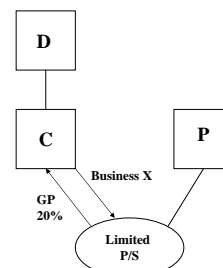
- C is 40% partner in general partnership.
- P has controlling interest.
- C has blocking rights with respect to material decisions.
- Proposed regulations would treat C as having a significant interest and, thus, would be attributed partnership's business, irrespective of whether C exercised active and substantial management functions. See Prop. Treas. Reg. § 1.355-3(d), ex. 23.
- Cf. Treas. Reg. §§ 1.368-1(d)(4)(iii)(B) & 1.368-1(d)(5), Examples 9, 10, 11 & 12 (COBE satisfied with 33% interest and no management).
- See Rev. Rul. 2007-42.



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**Section 355 and the Use of Partnerships**  
**Example 11: Business Contributed to Partnership during 5-Year Period**

- Until six months prior to spin-off, Business X was operated directly by C.
- Six months prior to spin-off, C contributes Business X to Partnership.
- C receives 20% managing general partner interest that satisfies standards of Revenue Ruling 92-17 and the proposed regulations.
- Is C in the same active business before and after the contribution?
- See PLR 200025001 (July 9, 1999).
- What if C recognizes gain when Business X is contributed to P/S?



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### Section 355 and the Use of Partnerships

#### Example 12: Section 355 Active Trade or Business

**Facts:**  
 P contributes a five year business to P/S that meets the requirements of 355(b) in exchange for an 80% interest in P/S. C contributes a three year business to P/S that does not meet the requirements of 355(b) in exchange for a 20% interest in P/S. C is the managing general partner of P/S.  
 D wants to spin off C under section 355. Does C satisfy the active trade or business requirement?

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### Section 355 and the Use of Partnerships

#### Revenue Ruling 92-17: Variation

**Facts:** C is a wholly-owned subsidiary of D. D and C have each actively conducted five-year trades or businesses. C then transfers its business into a newly-formed general partnership, GP, and takes a 50% general partnership interest in GP. X, an unrelated corporation, transfers assets into GP and also takes a 50% general partnership interest in GP. Both C and X retain employees and perform activities on behalf of GP as general partners. May D distribute the stock of C tax-free under section 355? See Plus 200044017; 200025001; cf. Rev. Rul. 2002-49; Prop. Treas. Reg. § 1.355-3(d), ex. 24.

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### Section 355 and the Use of Partnerships

#### Revenue Ruling 2002-49: Situation 1

**Facts:**

- D and X jointly perform all active and substantial management functions for LLC through Year 2.
- D purchases the LLC interests of X and Y on the first day of Year 3.
- D exclusively manages LLC from Year 3 through Year 6.
- D causes LLC to distribute 40 percent of the value of its rental properties on the first day of Year 6.
- D then transfers those properties to C, a newly formed subsidiary, and distributes the stock of C.

**Holding:** The active trade or business requirement is satisfied. In Years 1-2, D satisfies the requirements of Rev. Rul. 92-17, and the acquisition of X and Y's interests in Year 3 constitutes an expansion.

### Section 355 and the Use of Partnerships

#### Revenue Ruling 2002-49: Situation 2

**Facts:**

- D acquires its interest in LLC on the first day of Year 2 by contributing appreciated securities to LLC in a transaction described in Section 721.
- D and X jointly perform all active and substantial management functions for LLC through Year 2.
- D exclusively manages LLC from Year 3 through Year 6.
- D causes LLC to distribute 40 percent of the value of its rental properties on the first day of Year 6.
- D then transfers those properties to C, a newly formed subsidiary, and distributes the stock of C.

**Holding:** The active trade or business requirement is not satisfied because D will be treated as having acquired the business of LLC in a transaction in which gain or loss was recognized.

### Section 355 and the Use of Partnerships

#### Revenue Ruling 2002-49: Variation

**Facts:**

- Corporation X has been actively engaged in Business X throughout Years 1-5. Corporation Y has been actively engaged in Business Y throughout Years 1-5.
- On January 1 of Year 6, X and Y form LLC and contribute Businesses X and Y to LLC in exchange for 80% and 20% membership interests in LLC, respectively.
- LLC is treated as a partnership for federal income tax purposes. The exchanges qualify as tax-free under section 721. X and Y have no other assets other than their interests in LLC. X and Y have equal say in making policy decisions and in the overall supervision of LLC (i.e., X and Y both perform management functions with respect to LLC's businesses described in Rev. Rul. 92-17).
- In Year 8, for valid business reasons, LLC sells Business Y for cash to a person unrelated to X and Y. LLC thereafter continues to operate Business X. LLC uses the cash proceeds from the sale in the operation of Business X.

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### Section 355 and the Use of Partnerships

#### Revenue Ruling 2002-49: Variation (Cont.)

**Facts:** In Year 9, Y's Parent, D, distributes the stock of Y to D's shareholders in a transaction intended to qualify as tax-free under section 355.

**Issues:** Does Y satisfy the active trade or business requirement of section 355?

- Immediately after the distribution Y performs management functions described in Rev. Rul. 92-17.
- Business X is actively conducted throughout the 5-year period ending on the date of the distribution.
- Y acquired its interest in Business X in a transaction in which gain or loss was not recognized.

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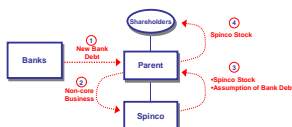
## Section 355: Extracting Value

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### Extracting Value in Section 355 Transactions

- Section 355 transactions separate two businesses of Parent -- often "Core" and "Non-core"
- In many current transactions, value is extracted from the Non-core Business
- Extraction of value up to basis of Non-core Business is relatively straightforward:
  - Spincor assumption of newly-incurred Parent debt (§ 357(a), (c))
  - Spincor incurrence of new debt and distribution of proceeds to Parent, which "purges" boot by distribution to Parent creditors or shareholders (§ 361(b))
- Extraction of value beyond basis of Non-core Business is more complex:
  - Debt-for-Debt Exchange using Spincor Securities to retire Parent debt (§ 361(c))
  - Stock-for-Debt Exchange using Spincor Stock to retire Parent debt (§ 361(c))
  - Sponsored Spinoff or Sponsored Splitoff
  - Cash-Rich Splitoff

### Extracting Value up to Basis -- Spincor Assumption of New Parent Debt

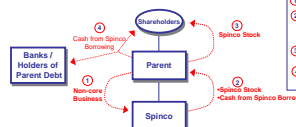


- Parent incurs new Bank Debt
- Parent Transfers Non-core Business to Spincor
  - Parent retains proceeds of Bank Debt
- Parent receives in exchange for Non-core Business:
  - Spincor Stock
  - Assumption of new Bank Debt
- Parent spins off Spincor to Shareholders

- Transfer of Non-core Business to Spincor for Spincor Stock and assumption of Bank Debt = D Reorganization
- No tax to Parent on receipt of Spincor Stock
  - § 361(a)
- No tax to Parent on assumption of Bank Debt, up to Parent's basis in Non-core Business
  - § 357(a), (c)
  - Must consider anti-avoidance rule of § 357(b). Good reasons for assumption include:
    - replaces non-assumable Parent debt associated with Non-core Business (Rev. Rul. 79-258)
    - creates appropriate capital structure (PLRs 200217006, 200146019)
- No tax to Parent on spinoff of Spincor Stock to shareholders
  - §§ 361(c)(1), 361(c)(2)(B)(ii)
- No tax to shareholders on receipt of Spincor Stock
  - § 355(a)(1)

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### Extracting Value up to Basis -- Purging the Taint of Boot by Distribution to Creditors or Shareholders

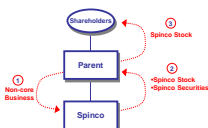


- Parent Transfers Non-core Business to Spincor
- Parent receives in exchange for Non-core Business:
  - Spincor Stock
  - Cash from Spincor Borrowing (boot)
- Parent spins off Spincor to Shareholders
- Parent uses cash to repay creditors or distribute to shareholders

- Transfer of Non-core Business to Spincor for Spincor Stock and cash = D Reorganization with boot (cash from Spincor Borrowing)
- No tax to Parent on receipt of Spincor Stock
  - § 361(a)
- No tax to Parent on receipt of boot (cash from Spincor borrowing) if its taint is purged by distribution of boot to Parent creditors or Parent shareholders:
  - § 361(b)(1)(A) (transfers to shareholders), § 361(b)(1)(A), 361(b)(3) (transfers to creditors)
- Amount of boot that may be purged limited to net basis of Non-core Business (minus liabilities assumed under § 357(a), (c))
  - 2004 amendment to § 361(b)(3) added explicit net basis limitation for purge by distribution to creditors
  - Similar net basis limitation for purge by distributions to shareholders (and pre-2004 to creditors) for consolidated Spincor because non-taxed boot in excess of basis creates ELA under § 358(a)(1)(A)(ii) and Treas. Reg. § 1.1502-19(a)(1)

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### Extracting Value in Excess of Basis -- External Debt-for-Debt Exchange

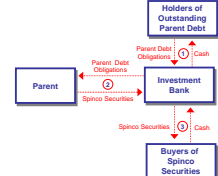


- Parent Transfers Non-core Business to Spincor
- Parent receives in exchange for Non-core Business:
  - Spincor Stock
  - Spincor Securities
- Parent spins off Spincor to Shareholders

- Transfer of Non-core Business to Spincor for Spincor Stock and Spincor Securities = D Reorganization
- Can be combined with other techniques to extract value up to basis without tax to Parent
  - Spincor assumption of Parent Debt (§ 357(a), (c))
  - Spincor distribution of cash from new borrowing, with boot purged by distribution to shareholders or creditors (§ 361(b)(1)(A) (transfers to shareholders), § 361(b)(1)(A), 361(b)(3) (transfers to creditors))
- No tax to Parent on receipt of Spincor Stock and Spincor Securities:
  - § 361(a)
- No tax to Parent on spinoff of Spincor Stock to shareholders
  - §§ 361(c)(1), 361(c)(2)(B)(ii)
- No tax to shareholders on receipt of Spincor Stock
  - § 355(a)(1)

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### Extracting Value in Excess of Basis -- External Debt-for-Debt Exchange (cont'd)



- External Debt-for-Debt Exchange
- Investment Bank (as a principal, not agent of Parent) acquires outstanding Parent debt obligations for cash
- Parent transfers Spincor Securities to Investment Bank in exchange for Parent debt obligations
- Investment Bank (as a principal, not agent of Parent) sells Spincor debt securities to new buyers for cash

- Spincor Securities exchanged for Parent Debt held by Investment Bank (as principal)
  - No tax to Parent, based on
    - §§ 361(c)(2)(B)(ii), 361(c)(3) (PLR 20031005), or
    - Treas. Reg. § 1.1502-13(g) (PLRs 200624001, 200629001, 200701010, 200702033)

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### Extracting Value in Excess of Basis -- Internal Debt-for-Debt Exchange and Repayment

① Opco Transfers Non-core Business to Spincor

② Opco receives in exchange for Non-core Business:

- Spincor Stock
- Spincor Debt Securities
- Cash from Spincor Borrowing (or Spincor assumes Opco debt)

- Transfer of Non-core Business to Spincor for Spincor Stock, Spincor Securities and Cash = D Reorganization with boot (cash from Spincor Borrowing)
- No tax to Opco on receipt of Spincor Stock and Spincor Securities:
  - § 361(a)
- No tax to Opco on receipt of boot (cash from Spincor borrowing):
  - §§ 361(b)(1)(A), 361(b)(3) (transfers to creditors)
  - Boot must be distributed by Opco to its shareholders or creditors
    - ◆ Finco is a creditor of Opco, even though they are related parties
  - Boot must be limited to net basis of Non-core Business assets (minus liabilities assumed under § 357(c))

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### Extracting Value in Excess of Basis -- Internal Debt-for-Debt Exchange and Repayment (cont'd)

③ Internal Spinoff

- Opco distributes Spincor Stock to Parent

④ External Spinoff

- Parent distributes Spincor Stock to Shareholders

⑤ Internal Debt Exchange

- Opco transfers Spincor Securities to Finco in exchange for Intercompany Debt

⑥ Internal Debt Repayment

- Opco transfers Cash from Spincor Borrowing to Finco in repayment of Intercompany Debt

- Spincor Stock distributed from Opco to Parent, then from Parent to Shareholders
  - No tax to Opco -- §§ 361(c)(1), 361(c)(2)(B)(i)
  - No tax to Parent -- § 355(a) (receipt of Spincor Stock), § 355(c) (distribution of Spincor stock)
  - No tax to Shareholders -- § 355(a)
- Spincor Securities exchanged for Intercompany Debt held by Finco
  - No tax to Opco -- § 361(c)(3)
  - § 1001 event to Finco, but it has full basis in exchanged Intercompany Debt
- Cash from Spincor Borrowing (boot) used to repay Intercompany Debt held by Finco
  - Payment of cash to Finco purges boot taint -- §§ 361(b)(1)(A), 361(b)(3)
  - § 1001 event to Finco, but it has full basis in repaid Intercompany Debt

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### Extracting Value in Excess of Basis -- Internal Debt-for-Debt Exchange and Repayment (cont'd)

⑦ Sale of Spincor Securities

- Parent sells Spincor Securities for cash in normal underwritten offering

⑧ External Debt Repayment

- Parent repays external debt with cash from Opco and proceeds of sale of Spincor Securities

- Finco sells Spincor Securities for cash
  - Treas. Reg. § 1.1502-13(g) creates fictional retirement/reissuance of Spincor Securities when they are sold by Finco
  - ◆ Finco generally has no gain/loss unless Spincor Securities have changed in value before sale
- Finco repays external debt with cash from Spincor Borrowing and cash from sale of Spincor Securities
  - Finco could exchange Spincor Securities for Finco external debt in debt-for-debt exchange, but sale of Spincor Securities is easier to execute
- Is repayment of external debt necessary for tax purposes?
  - Internal debt exchange/repayment satisfies §§ 361(b) (cash repayment), 361(c)(3) (Spincor Securities-for-debt exchange) even without external debt repayment or exchange.
  - In 2 PLRs involving internal debt exchange, however, taxpayer represented that it would use Spincor Securities to repay external debt.
  - ◆ PLRs: 20031005, 200624001

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### Extracting Value in Excess of Basis -- Sponsored Spinoff

- Sponsored Spinoff separates Core Business from Non-core Business
  - Core Business to be owned 100% by Old Parent Shareholders
  - Non-core Business to be >50% owned by Old Parent Shareholders, <50% owned by Sponsor, to comply with Sections 355(d), 355(e)
  - Cash to be extracted from Non-core Business and transferred to either Core Business or to Old Parent Shareholders
    - ◆ Since Non-core Business will remain in Old Parent, there is no basis limitation on amount of cash that can be extracted from Non-core Business

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### Extracting Value in Excess of Basis -- Sponsored Spinoff (cont'd)

- Old Parent transfers Core Business and cash to Spincor (renamed "New Parent")
- Cash may come from new borrowing by Old Parent
- Transfer of Core Business to Spincor/New Parent may involve complex steps to move assets and liabilities of Old Parent (other than Non-core Business) to Spincor/New Parent.

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### Extracting Value in Excess of Basis -- Sponsored Spinoff (cont'd)

- Old Parent distributes 100% of Spincor/New Parent Stock to its historic Shareholders in Spinoff
  - Old Parent may also distribute large cash dividend
- Concurrent with Spinoff, Sponsor invests in Old Parent in exchange for newly-issued Old Parent Stock
  - Sponsor must hold less than 50% of Old Parent Stock to comply with Sections 355(d), 355(e)

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### Extracting Value in Excess of Basis -- Sponsored Spinoff (cont'd)

- Final Structure -- Two Public Companies
  - Cash extracted from Non-core Business is in Splitco/New Parent or distributed directly to shareholders of Old Parent
- Agreements limit ability of Old Parent to issue equity or take other actions that could violate Section 355
- Since Non-core Business is in Old Parent rather than Splitco/New Parent, there is no basis limitation on amount of cash that can be extracted from Non-core Business
- Recent Transactions:
  - Alberto-Culver/Sally Beauty Products (November 2006)
  - Marshall & Isley/Metavante (Pending)

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### Extracting Value in Excess of Basis -- Sponsored Splitoff

- Old Parent will use Sponsored Splitoff to separate Core Business from Non-core Business
  - Core Business to be owned 100% by Public Shareholders of Old Parent
  - Non-core Business to be owned:
    - >50% by small group of historic Institutional Shareholders of Old Parent
    - <math><50\%</math> by Sponsor (to comply with Sections 355(d), 355(e))
  - Cash to be extracted from Non-core Business and transferred to either Continuing Business or to Old Parent Shareholders
    - Since Non-core Business will remain in Old Parent, there is no basis limitation on amount of cash that can be extracted from Non-core Business

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### Extracting Value in Excess of Basis -- Sponsored Splitoff (cont'd)

- Old Parent transfers Core Business and cash to Splitco (renamed "New Parent")
- Cash may come from Old Parent borrowing
- Transfer of Core Business to New Parent may involve complex steps to move assets and liabilities of Old Parent (other than Non-core Business) to Splitco/New Parent.

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### Extracting Value in Excess of Basis -- Sponsored Splitoff (cont'd)

- Old Parent distributes 100% of Splitco/New Parent Stock in Splitoff
- Concurrent with Splitoff, Sponsor invests in Old Parent in exchange for newly-issued Old Parent Stock
  - Sponsor must hold less than 50% of Old Parent Stock to comply with Sections 355(d), 355(e)

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### Extracting Value in Excess of Basis -- Sponsored Splitoff (cont'd)

- Final Structure -- Splitco/New Parent is public company, Old Parent is private company
  - Institutional Shareholders reduce or terminate ownership of Core Business in Splitco/New Parent
- Agreements limit equity issuance or other actions by Old Parent that could violate Section 355
- Section 355(d) issue: Are Institutional Shareholders and Sponsor aggregated into one shareholder because they are "acting pursuant to a plan or arrangement" (Section 355(d)(7)(B) aggregation rule)?
  - If so, then each must have owned Old Parent shares for more than 5 years or Old Parent recognizes gain on distribution of Splitco/New Parent stock
- Public Shareholders of Splitco/New Parent are not subject to Section 355(d) aggregation rule
  - Treas. Reg. § 1.355-6(c)(iv)(A) -- If shareholders acquire stock of first corporation (Old Parent) without a common plan, they will not be aggregated upon acquisition of stock in second corporation in substitute basis transaction (Splitco/New Parent)

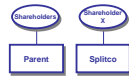
113

### Extracting Value in Excess of Basis -- Cash-Rich Splitoff

- Transfer of Cash and Non-core Business to Splitco for Splitco Stock = D Reorganization
  - No tax to Parent on receipt of Splitco Stock
    - § 361(a)
- § 355(g) limit on cash transferred to Splitco
  - Cash and FMV of other investment assets of Splitco must be less than 2x FMV of non-investment assets of Splitco
    - Measurement based on gross assets not net assets
      - as a result, Splitco's investment assets can be more or less than 2x net FMV of Non-core Business, depending on facts
- No tax to Parent on distribution of Splitco Stock to Shareholder X
  - §§ 361(c)(1), 361(c)(2)(B)(ii)
- No tax to Shareholder X on receipt of Splitco Stock
  - § 355(a)(1)

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Extracting Value in Excess of Basis --  
Cash-Rich Splitoff (cont'd)



- Effect of Cash-Rich Splitoff:
  - > Shareholder X owns all of Splitco, which holds the Non-core Business and cash
  - > Shareholder X's interest in Parent has been reduced or eliminated
  - > Parent has repurchased Parent Shares using Splitco Stock as currency
- Parent realizes *pre-tax* value of non-Core Business in the form of repurchased Parent Stock:
  - > Parent has repurchased an amount of Parent Stock equal to FMV of Splitco
  - > Splitco FMV includes *pre-tax* FMV of Non-core Business
- Tax consequences for Shareholder X:
  - > No tax on surrender of Parent Stock in exchange for Splitco Stock
  - > Shareholder X generally has low basis in Splitco Stock and in Non-core Business assets
    - Basis of Splitco Stock = basis of Parent Stock redeemed from Shareholder X
    - Basis of Non-core Business assets = same as in hands of Parent
  - > Shareholder X may not plan to remove cash from Splitco by dividend, liquidation, etc.

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