ALI-ABA Course of Study
Consolidated Tax Return Regulations

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ACQUISITION AND SEPARATION ISSUES IN CONSOLIDATION

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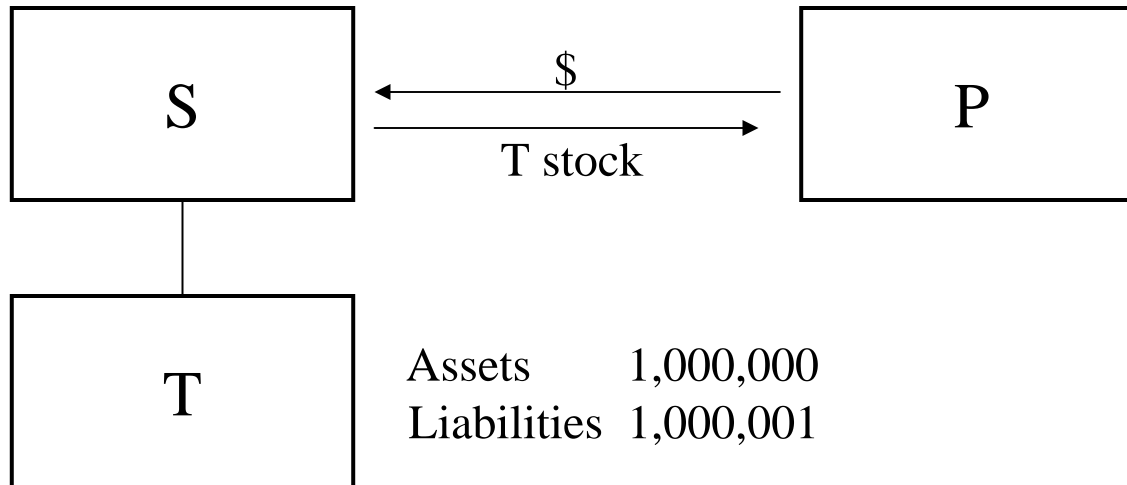
Example 1(a): Qualification as Section 332



Facts

Corporation T owns assets with a value of $1,000,000 and has liabilities of $1,000,001. P purchases all the stock of T from S for $1 and attempts to make a Section 338(h)(10) election with respect to T.

Question

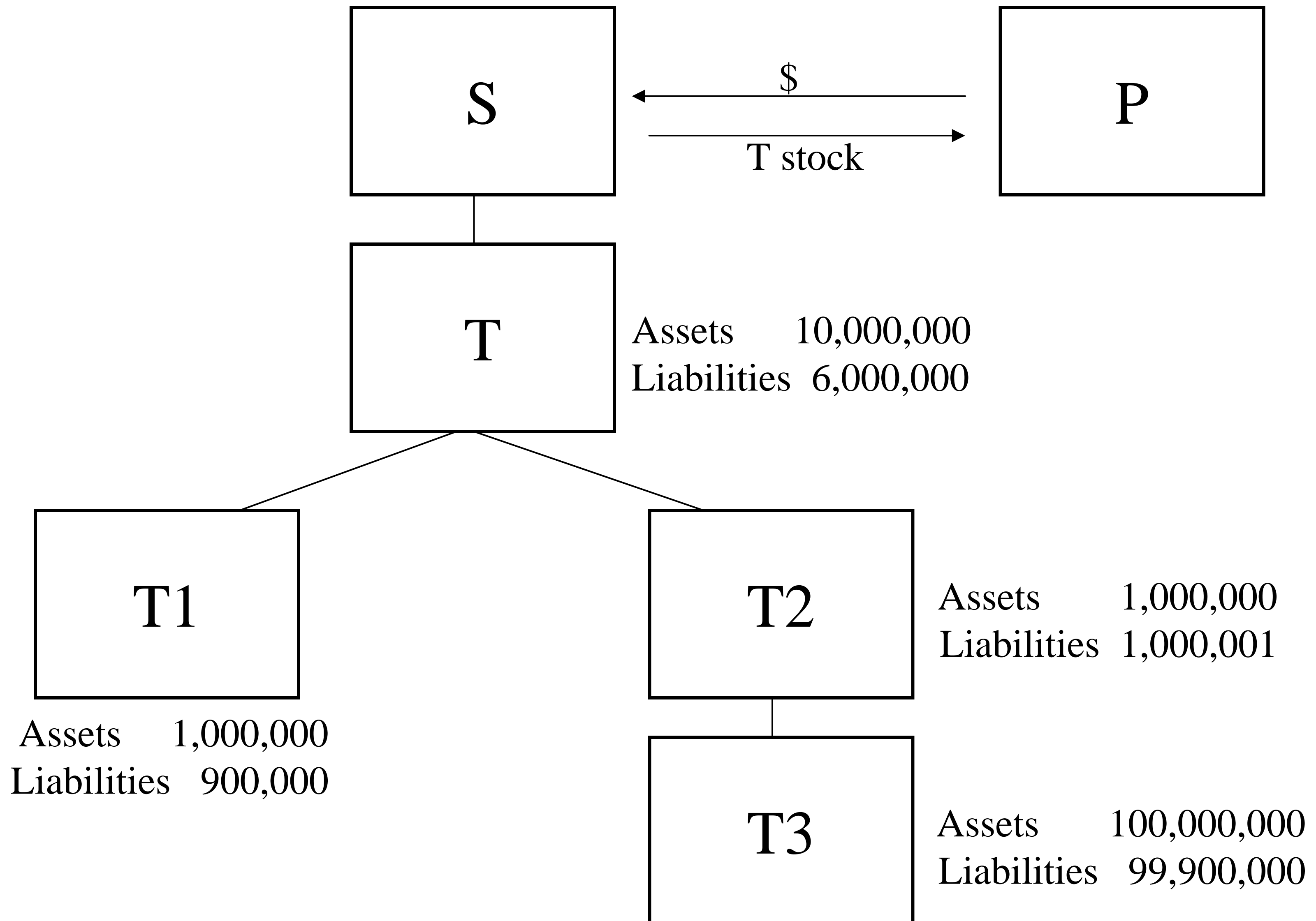
What are the results of this election?

Example 1(a): Qualification as Section 332 Continued

References

Section 338(h)(3)(A)
Treas. Reg. § 1.332-2(b)
Former Temp. Treas. Reg. § 1.338-3T(b)(2)(ii)
Treas. Reg. § 1.338-3(b)(2)
Rev. Rul. 56-387, 1956-2 C.B. 189

Example 1(b): Qualification as Section 332



Example 1(b): Qualification as Section 332 Continued

Facts

Corporation T owns assets with a value of $10 million and has liabilities of $6 million. Among the assets of T are all of the stock of T1 and T2. The assets of T1 have a value of $1 million and T1 has liabilities of $900,000. The assets of T2 have a value of $1 million and T2 has liabilities of $1,000,001. Among the assets of T2 is all of the stock of T3. The assets of T3 have a value of $100 million and T3 has liabilities of $99,900,000.

P purchases all the stock of T from S and attempts to join with S in a Section 338(h)(10) election with respect to T, T1, T2 and T3.

Questions

1. What are the results of this election?

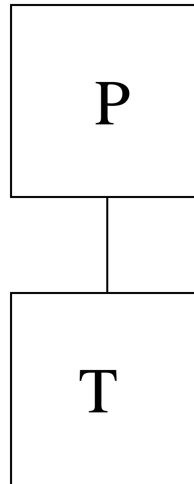
2. Would the result be different if T2 had no liabilities, but rather had outstanding both common and preferred stock, both held by T, with the preferred stock having a liquidating preference of $1,100,000?

Example 1(b): Qualification as Section 332 Continued

References

Treas. Reg. § 1.332-2(b)
Treas. Reg. § 1.338-3(b)(2)
Former Treas. Reg. § 1.338(h)(10)-1(e)(2)(ii)
Former Temp. Treas. Reg. § 1.338-3T(b)(2)(ii)
Rev. Rul. 56-387, 1956-2 C.B. 189
Comm'r v. Spaulding Bakeries, Inc., 252 F.2d 693 (2nd Cir. 1958)
H.K. Porter Co. v. Comm'r, 87 T.C. 689 (1986).

Example 1(c): Intercompany Debt – Rev. Rul. 68-602 and Treas. Reg. § 1.1502-13(g)



Assets FMV = $50
Intercompany debt = $75

Alternative 1: T liquidates into P.

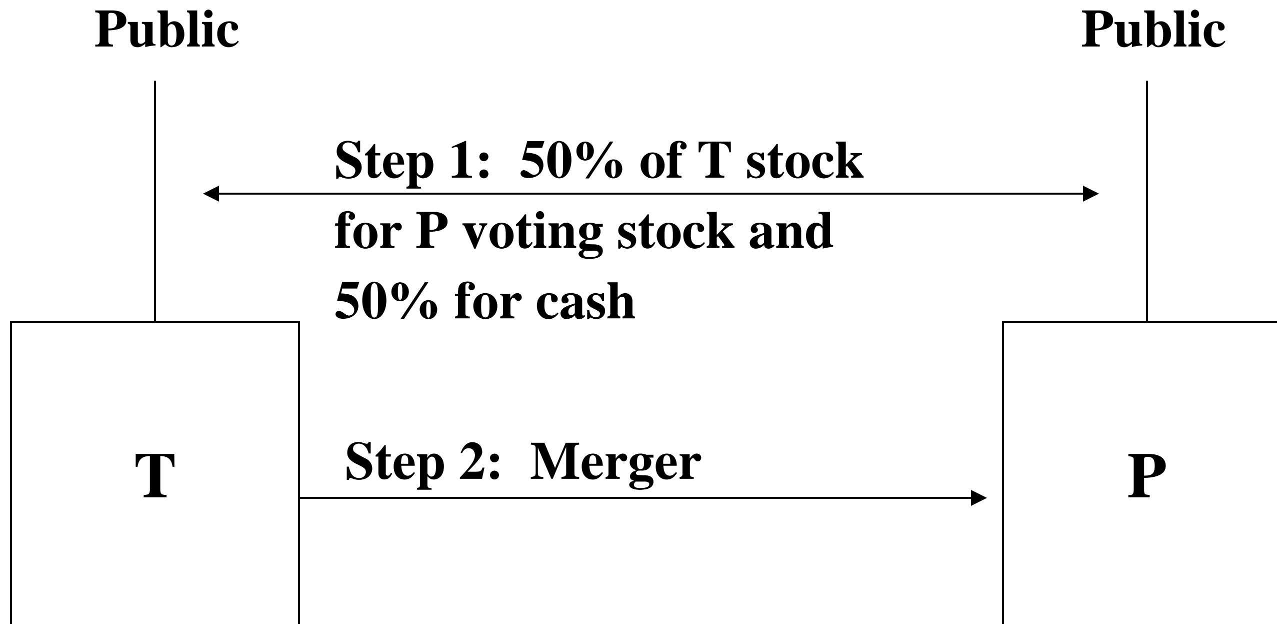
Alternative 2: P contributes the intercompany debt to capital and T liquidates.

Alternative 3: Same as Alternative 2 except that after contributing the intercompany debt to capital, P sells T stock to X, and P and X make a joint 338(h)(10) election.

Alternative 4: Without contributing the intercompany debt to capital, P sells T stock to X for $1, and P and X make a joint 338(h)(10) election.

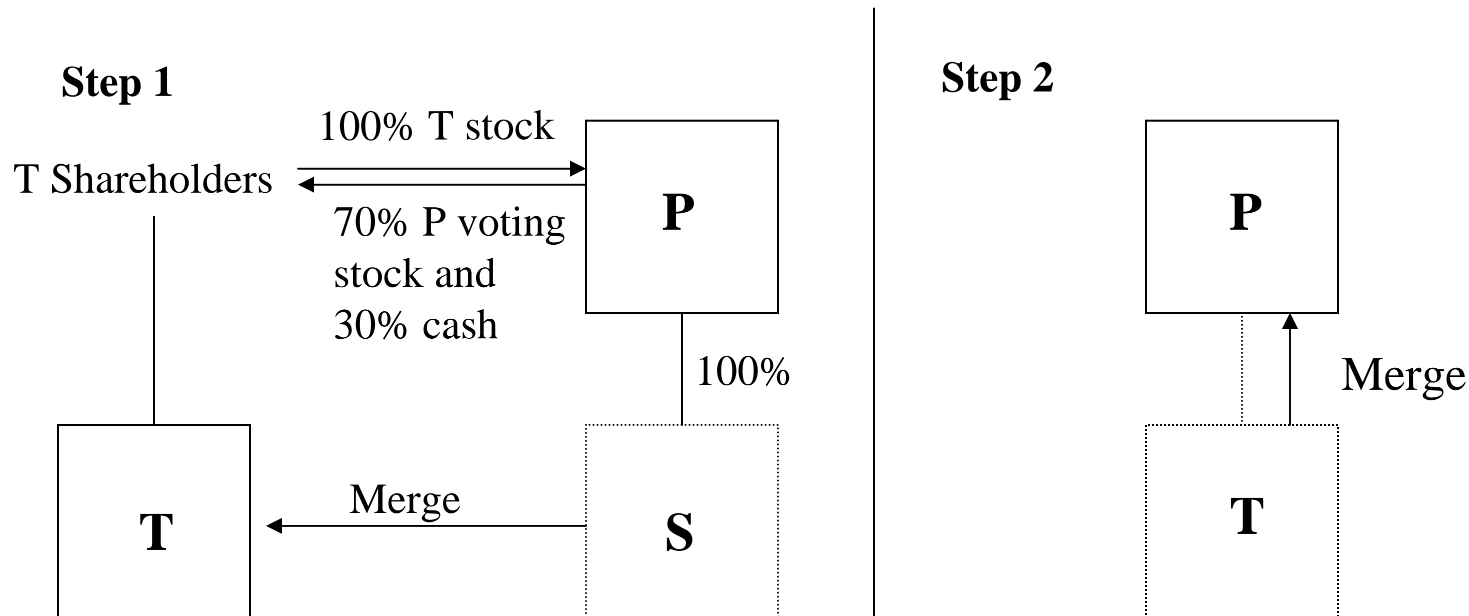
Alternative 5: Same as Alternative 4 except that T's debt is third party debt. What is new T's basis in the assets if the debt is recourse or non-recourse?

<u>Example 2(a): *King Enterprises* Transaction</u>



<u>Facts</u>: The shareholders of T exchange all of their T stock for consideration consisting of 50% P voting stock and 50% cash. Immediately following the exchange, and as part of the overall plan, P causes T to merge upstream into P. The transaction should qualify as an "A" reorganization. <u>See</u> <u>King Enterprises, Inc. v. United States</u>, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-26, 2001-1 C.B. 1297.

Example 2(b): Rev. Rul. 2001-46 - Situation 1



Facts: P owns all of the stock of S, a newly formed wholly owned subsidiary. Pursuant to an integrated plan, P acquires all of the stock of T, an unrelated corporation, in a statutory merger of S into T, with T surviving. In the merger, the T shareholders exchange their stock for consideration of 70% P voting stock and 30% cash. Immediately thereafter, T merges upstream into P.

Result: If the acquisition were viewed independently from the upstream merger of T into P, the result should be a QSP of T stock followed by a section 332 liquidation. See Rev. Rul. 90-95, 1990-2 C.B. 67. However, because step transaction principles apply, see King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969), the transaction is treated as a single statutory merger of T into P under section 368(a)(1)(A). P acquires the T assets with a carry-over basis under section 362, and P may not make a section 338 election for T.

Note: On July 8, 2003, the Service issued new final and temporary regulations that permit taxpayers to turn off the step transaction doctrine and to make a section 338(h)(10) election in the transaction described above. See Treas. Reg. § 1.338-3(c)(1)(i), (2) and Temp. Treas. Reg. § 1.338(h)(10)-1T.

New Temp. Treas. Reg. § 1.338(h)(10)-1T(c)(2), (e)

• The new temporary regulations provide that "a section 338(h)(10) election may be made for T where P's acquisition of T stock, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P) . . . " Temp. Treas. Reg. § 1.338(h)(10)-1T(c)(2).

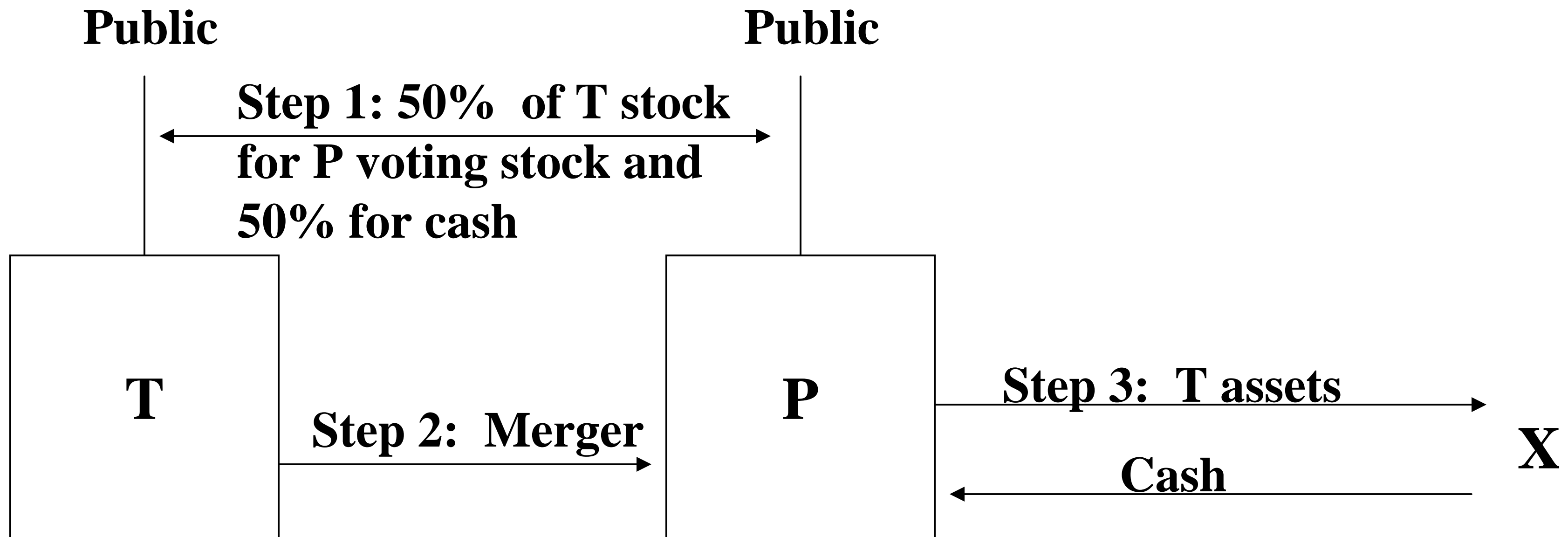
• This rule applies regardless of whether, under the step transaction doctrine, the acquisition of T stock and subsequent merger or liquidation of T into P (or P affiliate) qualifies as a reorganization under section 368(a). Id.

• If a section 338(h)(10) election is made under these facts, P's acquisition of T stock will be treated as a QSP for all Federal tax purposes and will not be treated as a reorganization under section 368(a). See Temp. Treas. Reg. § 1.338(h)(10)-1T(e), Ex. 12 & 13.

• However, if taxpayers do not make a section 338(h)(10) election, Rev. Rul. 2001-46 will continue to apply so as to recharacterize the transaction as a reorganization under section 368(a). See id. at Ex. 11.

• The regulations are effective for stock acquisitions occurring on or after July 8, 2003.

Example 2(c): *King Enterprises* Transaction - Variation

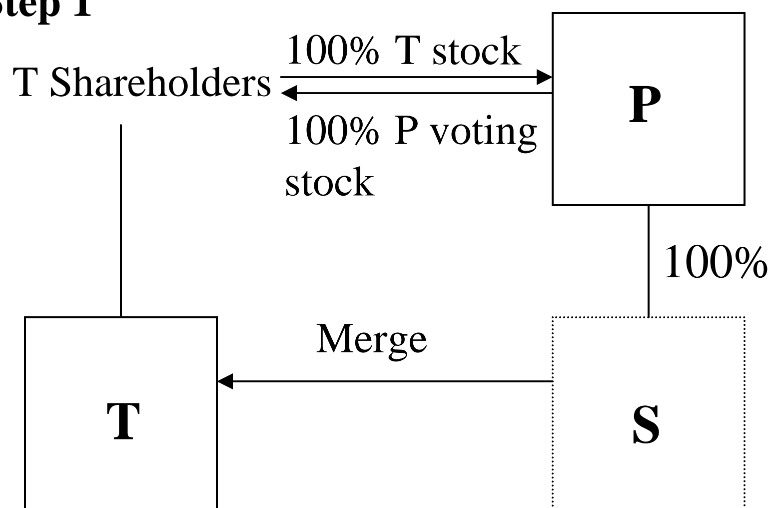


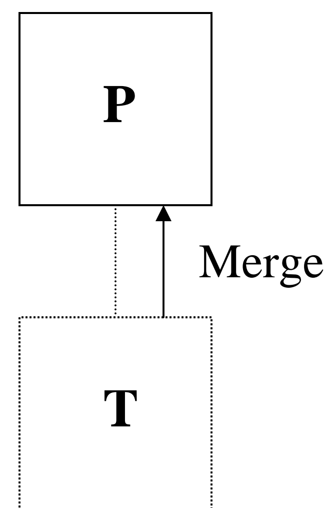
Facts: Same facts as in Variation 1, except P sells T's assets to X a third party immediately after the merger of T into P.

Questions: (1) Does the Step-Transaction Doctrine apply?

(2) What is the result of this transaction for Federal income tax purposes?

Example 2(d): Rev. Rul. 2001-46 - Situation 2





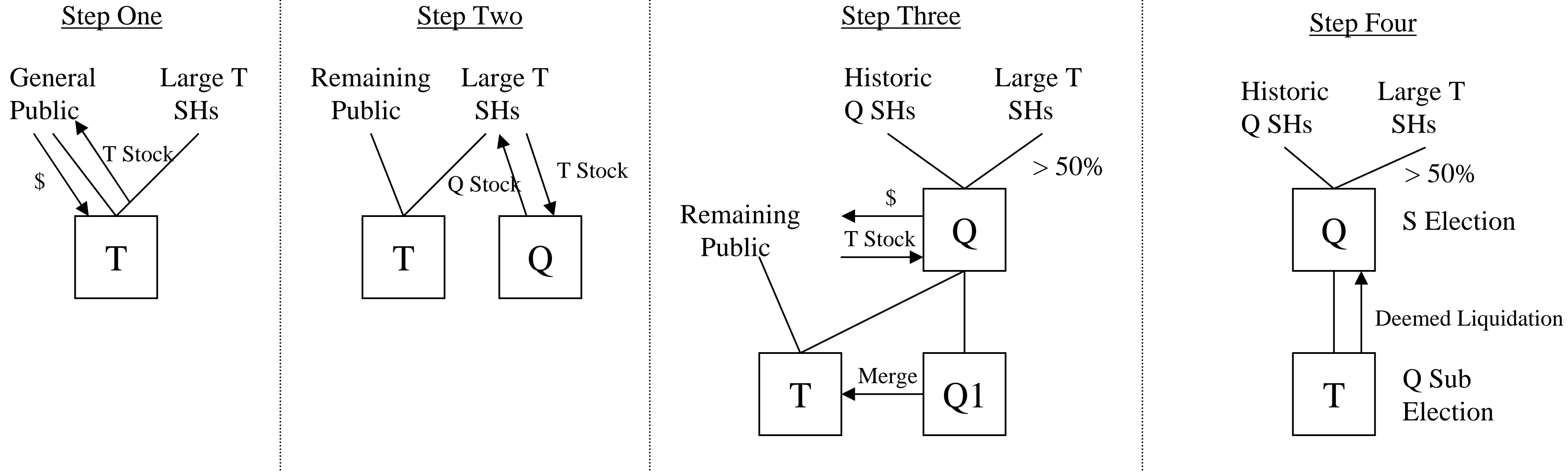
Facts: Same facts as in Situation 1, except that the T shareholders receive solely P stock in exchange for their T stock, so that the merger of S into T, if viewed independently of the upstream merger of T into P, would qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

Result: Step transaction principles apply to treat the transaction as a merger of T directly into P.

Note: The taxpayers cannot not change this result under the new section 338 regulations because, standing alone, P's acquisition of T does not constitute a qualified stock purchase.

Example 2(e): PLR 200141040

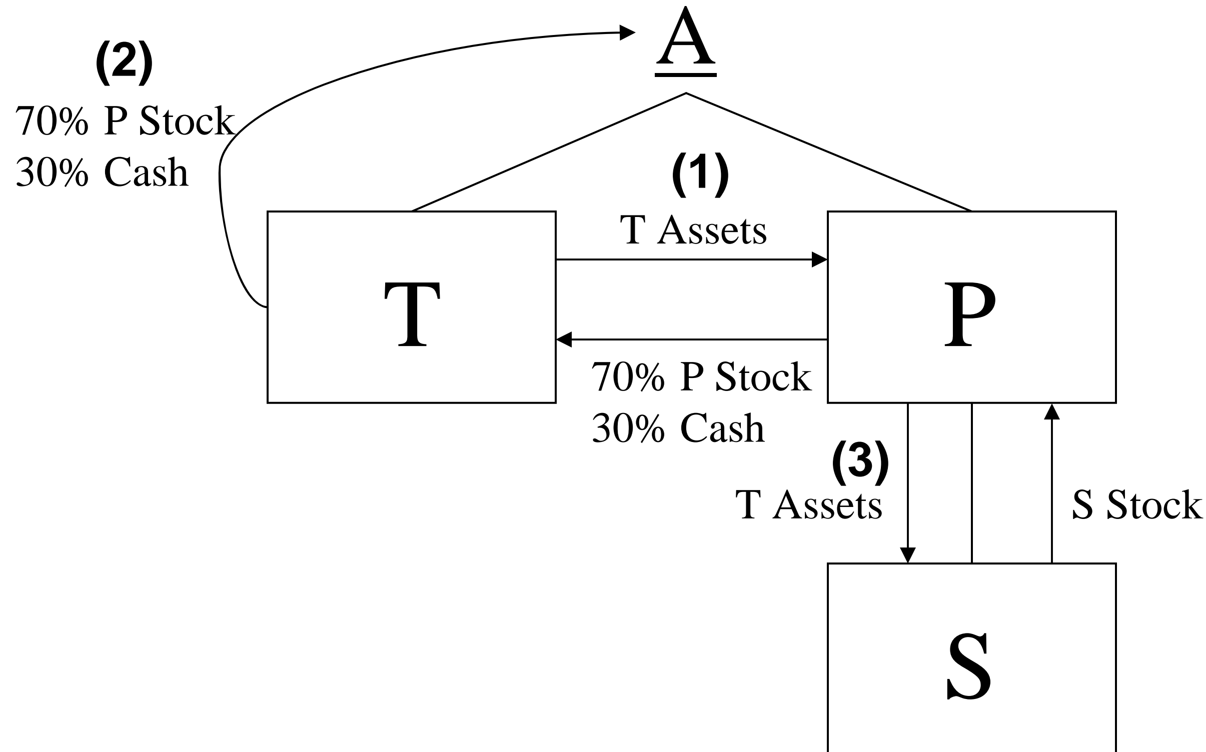
King Enterprises Variation--D Reorganization



Facts: (1) T makes a tender offer to all of its shareholders to acquire T stock to increase the percentage ownership of T's largest shareholders
(2) T's largest shareholders contribute T stock to Q solely in exchange for Q stock
(3) Q forms wholly-owned subsidiary Q1 that merges into T, with T surviving the merger. All of T's remaining shareholders except Q will receive cash for T stock as part of the merger.
(4) Q will make a Subchapter S election and a QSub election for T, resulting in a deemed liquidation of T.

Result: Four steps of transaction will be collapsed and treated as the transfer by T of "substantially all" of its assets to Q in exchange for Q stock and the assumption by Q of T's liabilities, followed by the liquidation of T. The transaction will qualify as a "D" Reorganization.

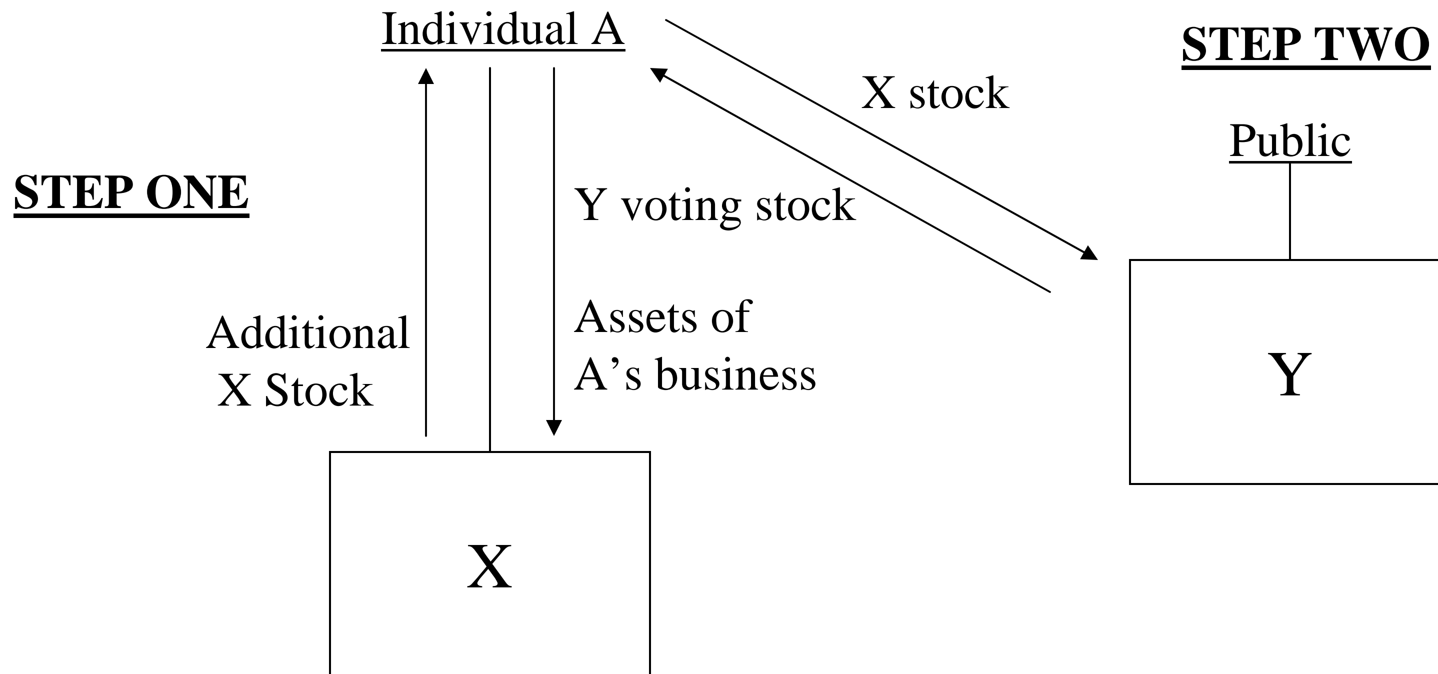
Example 3: Rev. Rul. 2002-85



Facts: A, an individual, owns 100 percent of T, a state X corporation. A also owns 100 percent of P, a state Y corporation. First, pursuant to plan of reorganization, T transfers all of its assets to P in exchange for consideration consisting of 70 percent P voting stock and 30 percent cash. Second, T liquidates, distributing the P voting stock and cash to A. Third, P transfers all of the T assets to S, a preexisting, wholly owned subsidiary of P, in exchange for S stock.

Result: The transaction qualifies as a "D" reorganization even though P does not retain the assets of T.

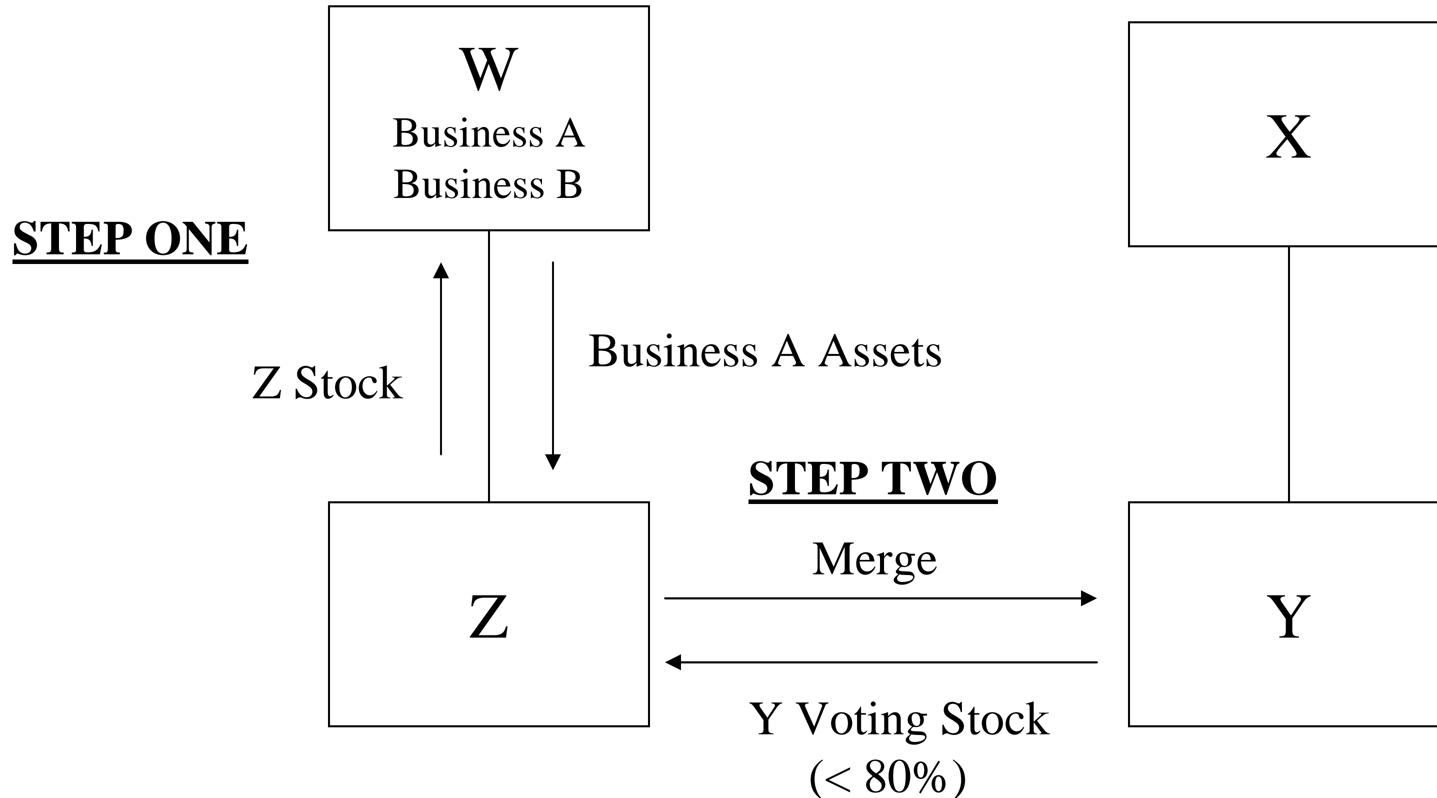
Example 4(a): Rev. Rul. 70-140



Facts: Individual A owns all of the stock of corporation X and operates a business similar to the business of X through a sole proprietorship. A transfers its sole proprietorship business to X in exchange for additional X stock. A then transfers all of his stock in X to Y in exchange for Y voting stock. Both steps were part of a prearranged plan.

Result: The transfer of A's sole proprietorship to X in exchange for X stock does not qualify as a section 351 exchange. The Service ruled that because the sole proprietorship was only transferred to X to allow A to transfer those assets to Y tax-free, the transaction should be recharacterized as a transfer by A of the sole proprietorship directly to Y in a transfer to which section 351 does not apply, followed by a transfer of these assets by Y to X, and a separate transfer of X stock by A to Y for Y voting stock.

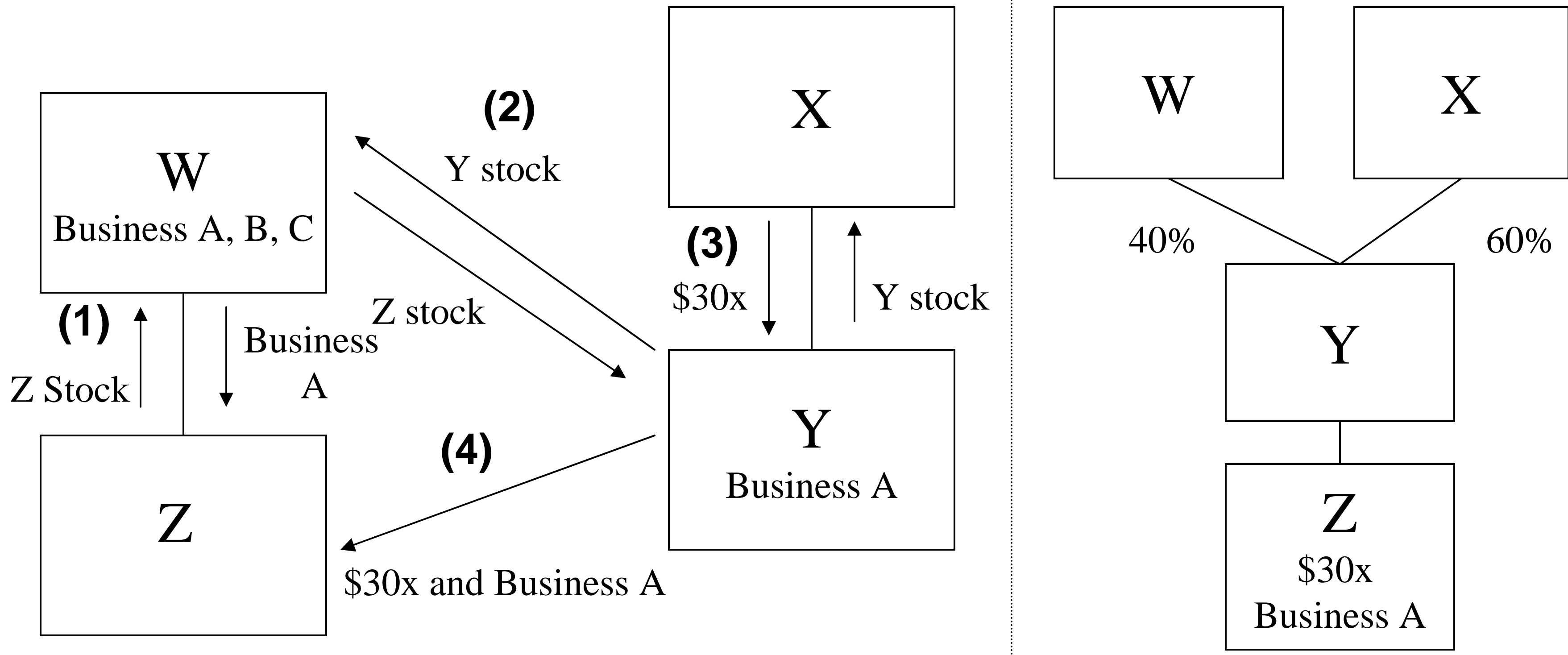
Example 4(b): Rev. Rul. 70-140 (Variation)



Facts: Corporation W transfers it Business A assets to Z in exchange for Z stock. Z then merges into Y in exchange for Y voting stock, which is distributed to W. Both steps are part of a prearranged plan.

Result: The transfer of business A assets by W to Z for Z stock does not satisfy the requirements of section 351 because the transaction is recharacterized under Rev. Rul. 70-140 as a transfer of the business assets by W directly to Y in exchange for Y voting stock.

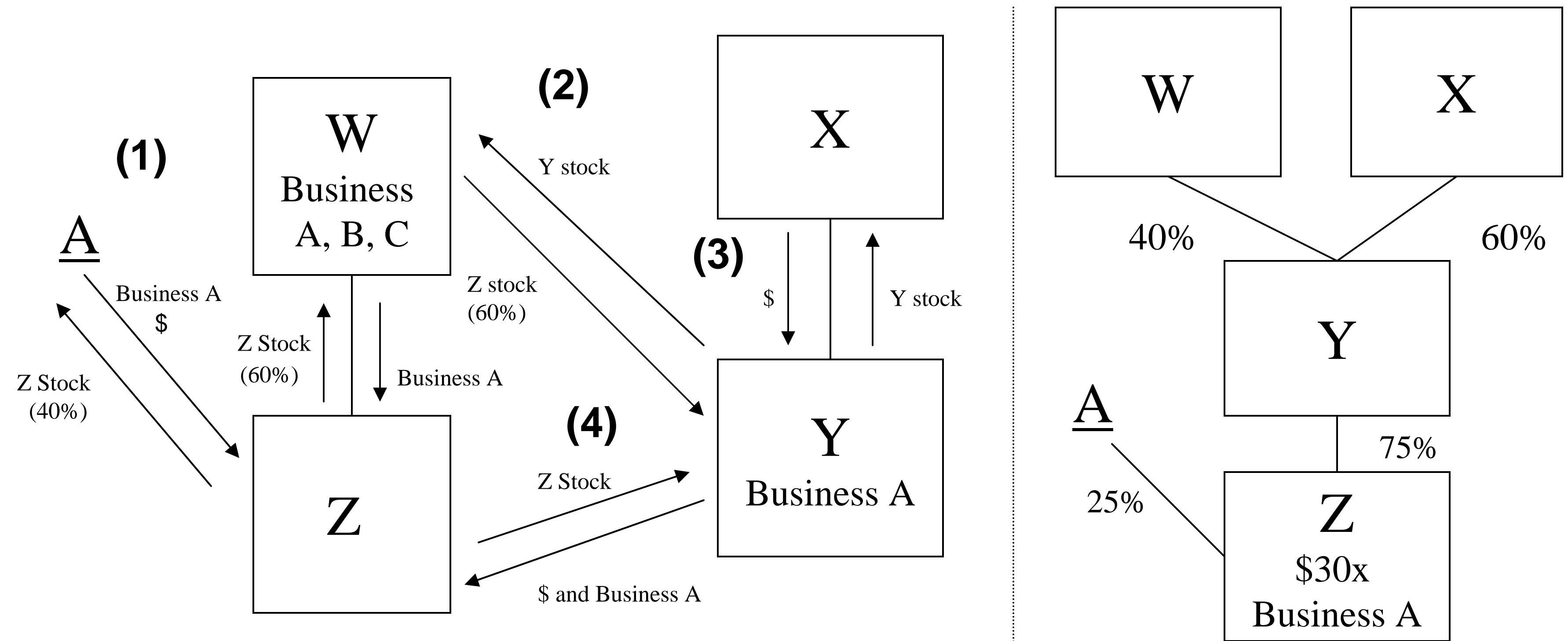
Example 4(c): Rev. Rul. 2003-51



Facts: Corporation W engages in Businesses A, B, and C. X, an unrelated corporation, also engages in Business A through its wholly-owned subsidiary, corporation Y. The corporations desire to combine their businesses in a holding company structure. Under a prearranged plan, the following transfers take place: (1) W forms Z and contributes its Business A to Z for Z stock; (2) W contributes its Z stock to Y in exchange for Y stock; (3) simultaneously, X transfers $30x to Y in exchange for additional Y stock to meet the capital needs of Business A; and (4) Y transfers the $30x and its Business A to Z, which is now a wholly-owned subsidiary of Y. After the transfers, W owns 40% of Y stock and X owns 60% of Y stock.

Result: W's transfer of Business A to Z for Z stock (Transfer 1) qualifies as a tax-free exchange under section 351, notwithstanding the subsequent transfers. Unlike Rev. Rul. 67-274, Rev. Rul. 2001-26, and Rev. Rul. 2001-46, the Service did not recharacterize the steps of the transaction, but instead adhered to the form of the transfers. Transfer 1, Transfers 2 and 3, and Transfer 4 are treated as three successive tax-free exchanges under section 351. <u>See</u> Rev. Rul. 77-448. The Service distinguished Rev. Rul. 70-140 on the basis that the transfer of Business A to Z was not necessary for the parties to have structured the transaction in a tax-free manner. Rev. Rul. 2003-51 appears limited to section 351 transactions.

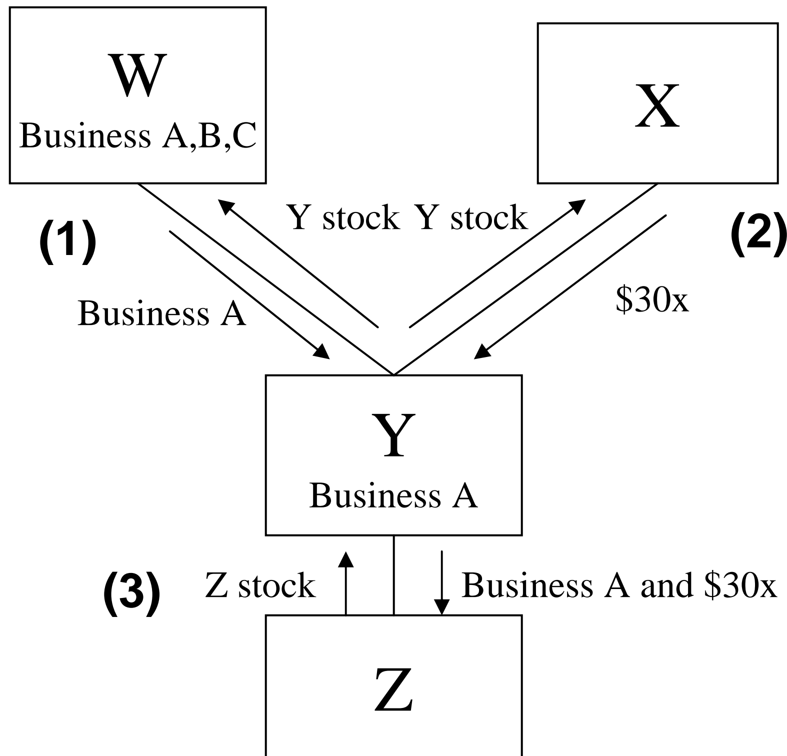
Example 4(d): Rev. Rul. 2003-51 (Variation)

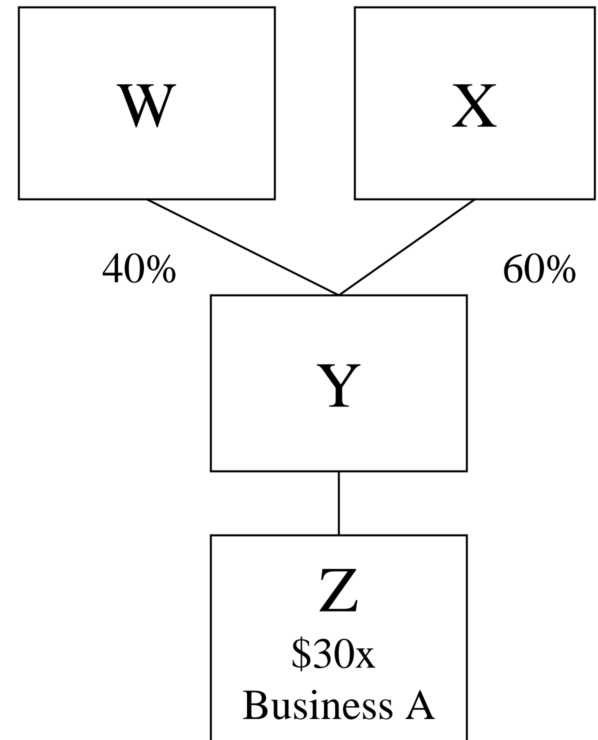


Facts: Corporation W engages in Businesses A, B, and C. X, an unrelated corporation, also engages in Business A through its wholly-owned subsidiary, corporation Y. Individual A has Business A assets. Under a prearranged plan, the following steps take place: (1) W and A form Z. W contributes its Business A to Z for 60% of the Z stock and A contributes its Business A assets and cash to Z for 40% of the Z stock; (2) W contributes its Z stock (60%) to Y in exchange for Y stock; (3) simultaneously, X transfers cash to Y in exchange for additional Y stock to meet the capital needs of Business A; and (4) Y transfers the cash and its Business A to Z for additional Z stock. After the transfers, W owns 40% of Y stock and X owns 60% of Y stock. Y owns 75% of Z stock and A owns 25% of Z stock.

Result: Under the reasoning of Rev. Rul. 2003-51, W's transfer of Business A and A's transfer of Business A assets and cash to Z for Z stock (Transfer 1) should qualify as a tax-free exchange under section 351, notwithstanding the subsequent transfers. Query whether under Rev. Rul. 2003-51, Transfers 2 and 3 (combined) and Transfer 4 would be treated as separate exchanges? If so, Transfers 2 and 3 would be a tax-free exchange under section 351, but Transfer 4 would not be a tax-free exchange under section 351 because Y does not satisfy the control test. Is this inconsistent with Rev. Rul. 70-140?

Example 4(e): Application of Rev. Rul. 70-140 to Facts of Rev. Rul. 2003-51

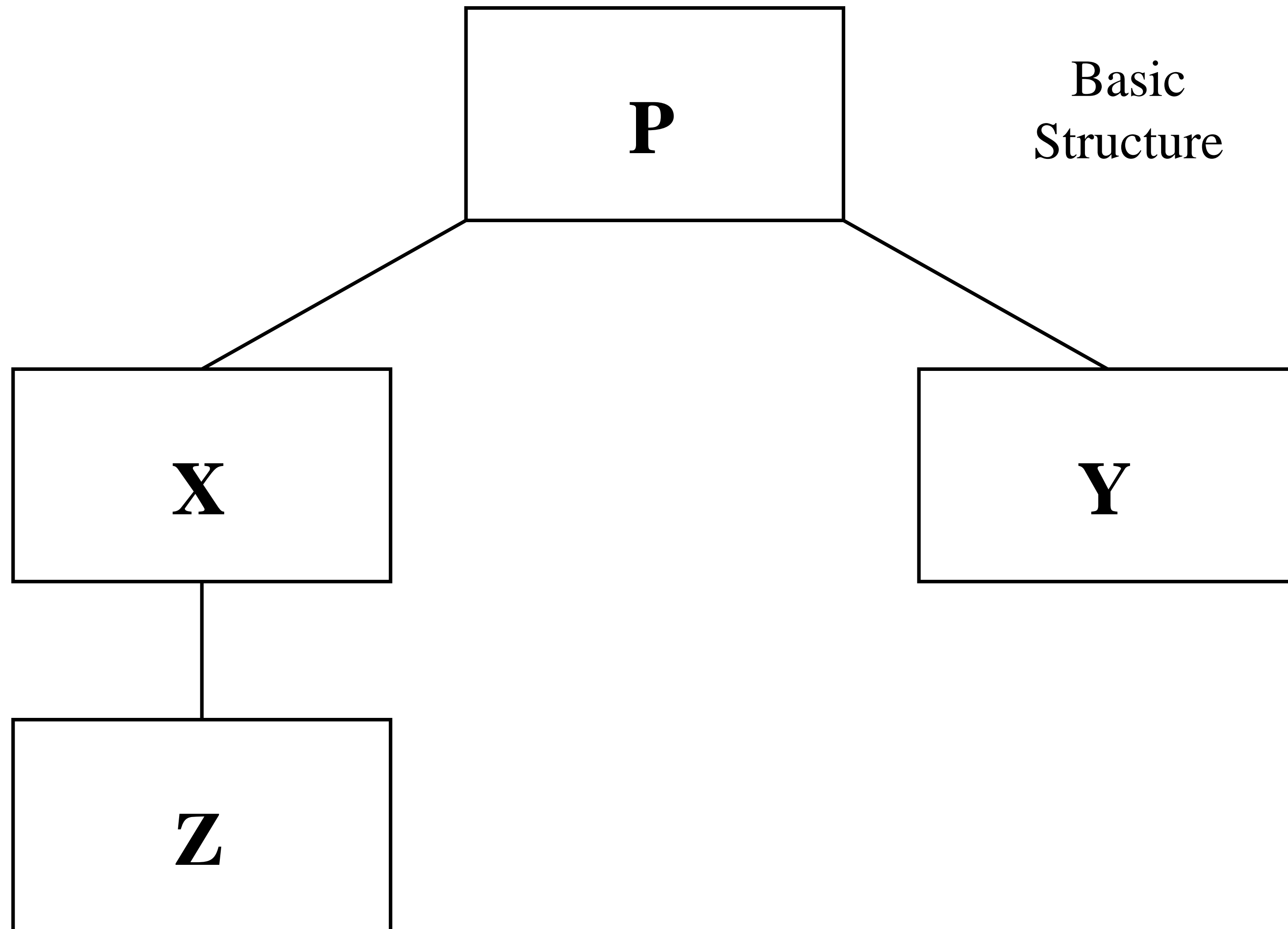




Facts: Same facts as Rev. Rul. 2003-51.

Result: Under Rev. Rul. 70-140, the transaction would be recharacterized as follows: (1) W contributes Business A to Y for Y stock; (2) simultaneously, X contributes $30x to Y for additional Y stock; and (3) Y contributes Business A and $30x to Z for Z stock, with Z becoming a wholly-owned subsidiary of Y. Steps 1 and 2 qualify as a tax-free exchange under section 351 and Step 3 qualifies as a tax-free exchange under section 351.

Example 5(a): Intragroup Asset and Stock Transactions



Example 5(a): Intragroup Asset and Stock Transactions Continued

This example examines the tax consequences of asset and stock transfers within a consolidated group.

Alternative 1: Asset Sale

1. Z sells its assets to Y.

2. Y takes a cost basis in the assets.

Alternative 2: Stock Sale

1. X sells Z stock to Y.

2. Y takes a cost basis in Z stock. Z retains historic basis in its assets.

Alternative 3: Asset Sale and Liquidation

1. Z sells its assets to Y and Z liquidates into X.

2. The transaction appears to constitute a D reorganization. Under Treas. Reg. § 1.1502-13(f)(3)(ii), the boot is treated as received in a separate transaction under Section 302 rather than Section 356.

Example 5(a): Intragroup Asset and Stock Transactions Continued

Alternative 4: Stock Sale and Liquidation

1. X sells the Z stock to Y and Z liquidates into Y.

2. The treatment of the transaction is the same as described above in Alternative 3.

Alternative 5: Asset or Stock Transfer

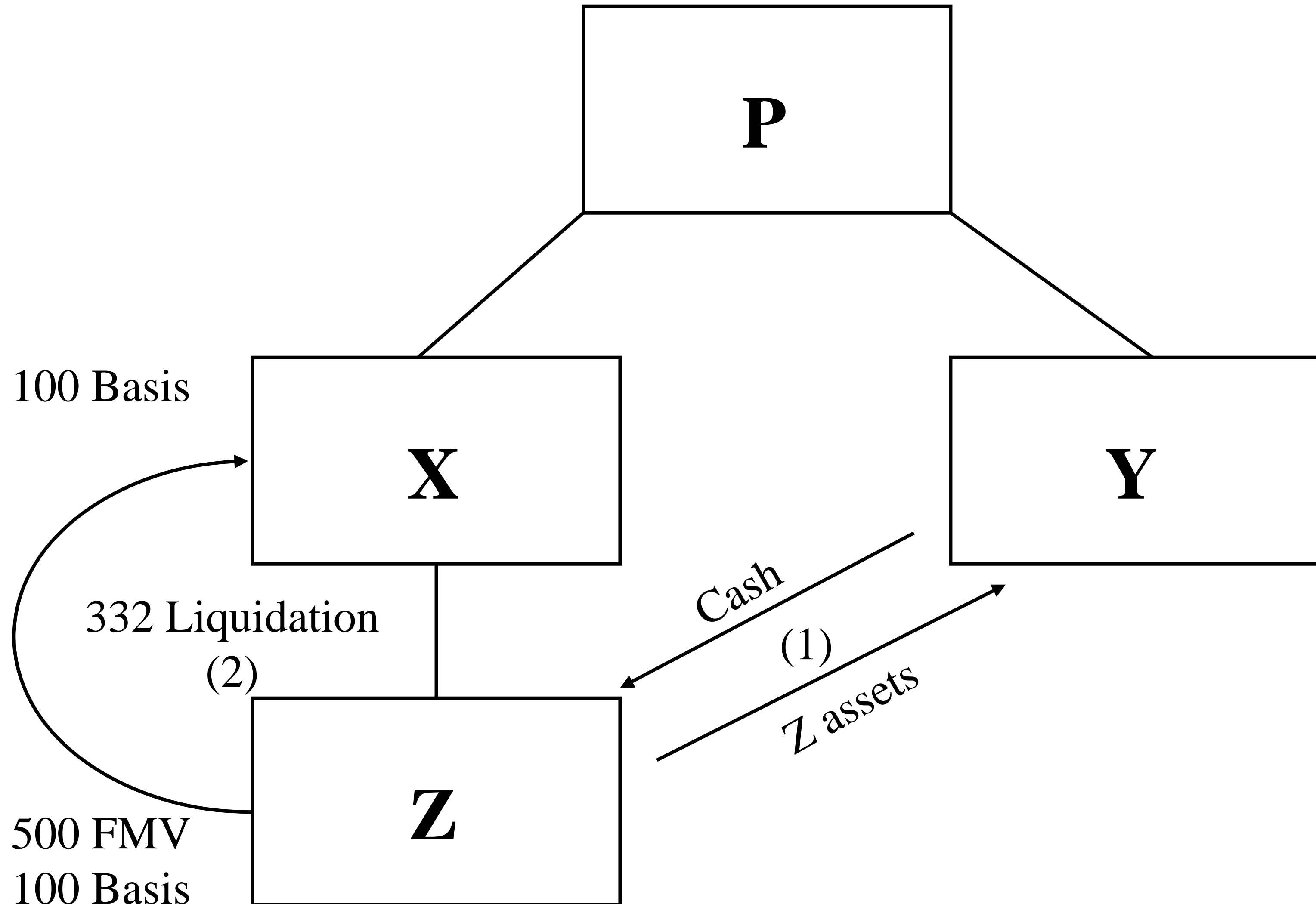
1. Z transfers its assets to Y for no consideration (or X transfers the Z stock to Y for no consideration).

2. Z is deemed to transfer its assets to Y in a Section 351 transaction, followed by a distribution of the Y stock to X and then to P.

3. Alternatively, Z is deemed to distribute its assets to X and then to P followed by a contribution of the assets by P to Y.

4. In the first case, there is deferred gain (loss) on the Y stock. In the second case, there is deferred gain (loss) on the Z assets.

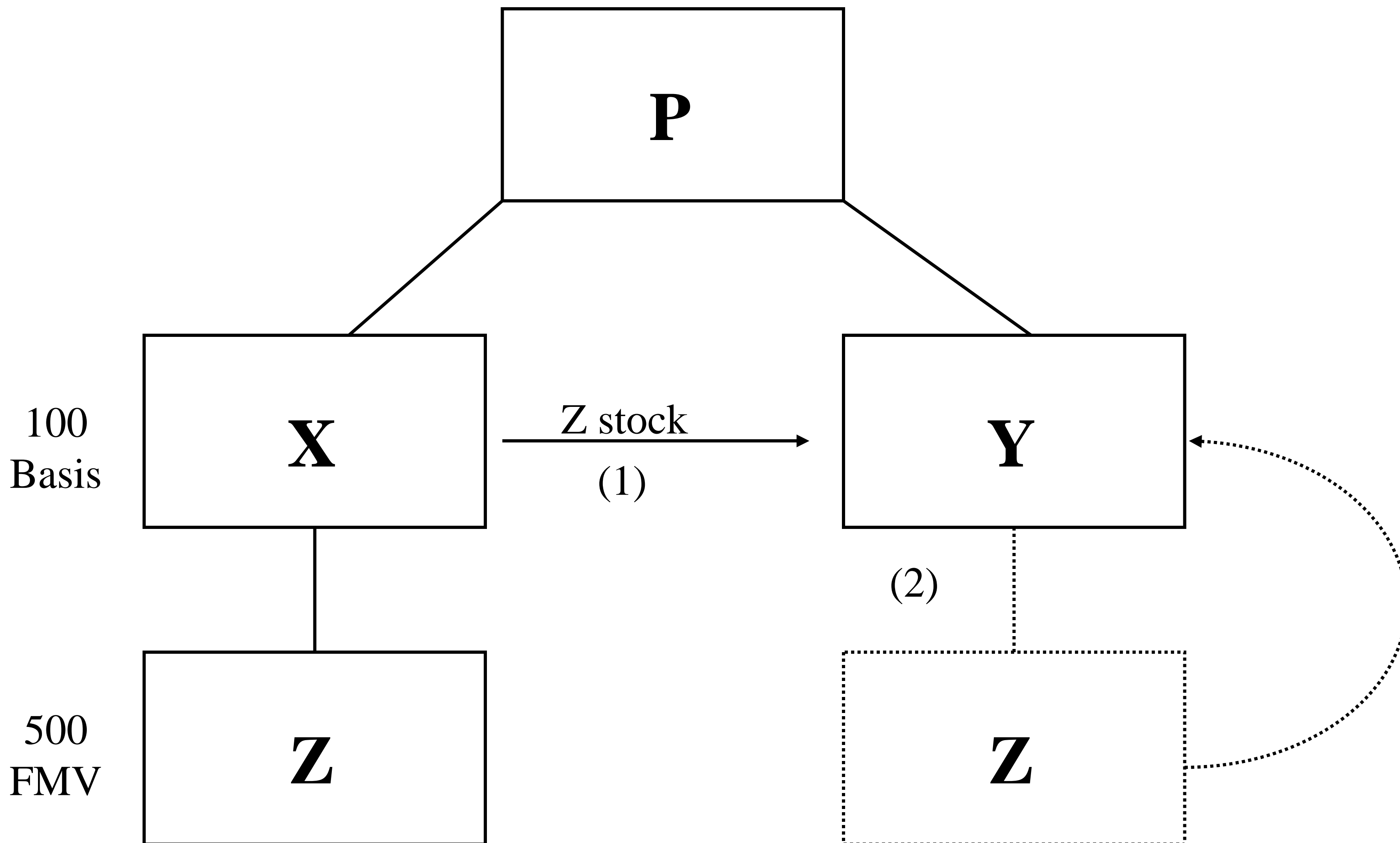
Example 5(b): Boot in D Reorganization



Alternative 1: Asset Sale and Liquidation

Z sells its assets to Y and Z liquidates into X.

Example 5(b): Boot in D Reorganization Continued



Alternative 2: Stock Sale and Liquidation

X sells the Z stock to Y and Z liquidates into Y.

Example 5(b): Boot in D Reorganization Continued

Results

The transactions both appear to constitute D reorganizations. Under Treas. Reg. § 1.1502-13(f)(3)(ii), the boot is treated as received in a separate transaction under Section 302 rather than Section 356.

Issues

1. Is the redemption taxed as a distribution?

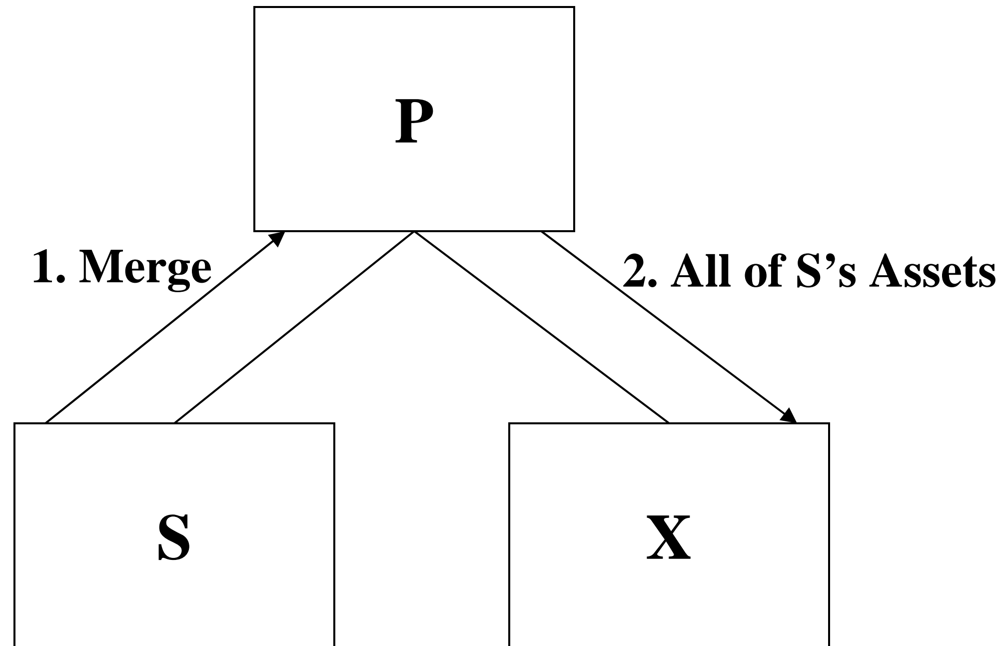
2. If so, do we look to the E&P of Z, Y or both Z and Y in measuring the amount of the dividend?

3. Is the dividend eliminated?

4. Does the distribution of the dividend impact stock basis?

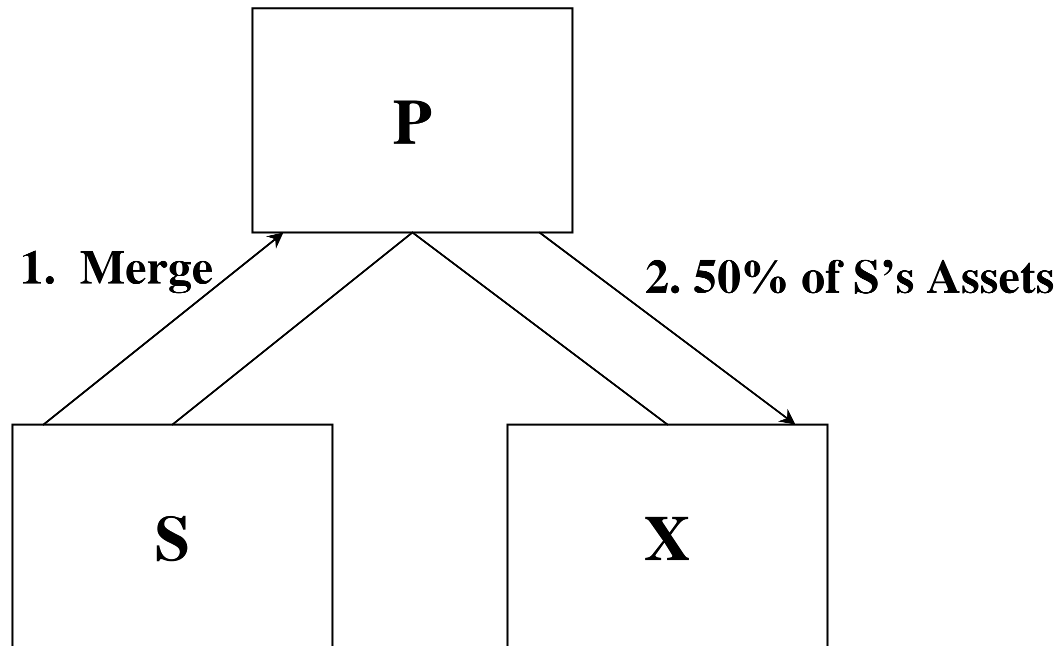
5. If E&P is not available, how is the transaction taxed?

Example 5(c): Rev. Rul. 69-617



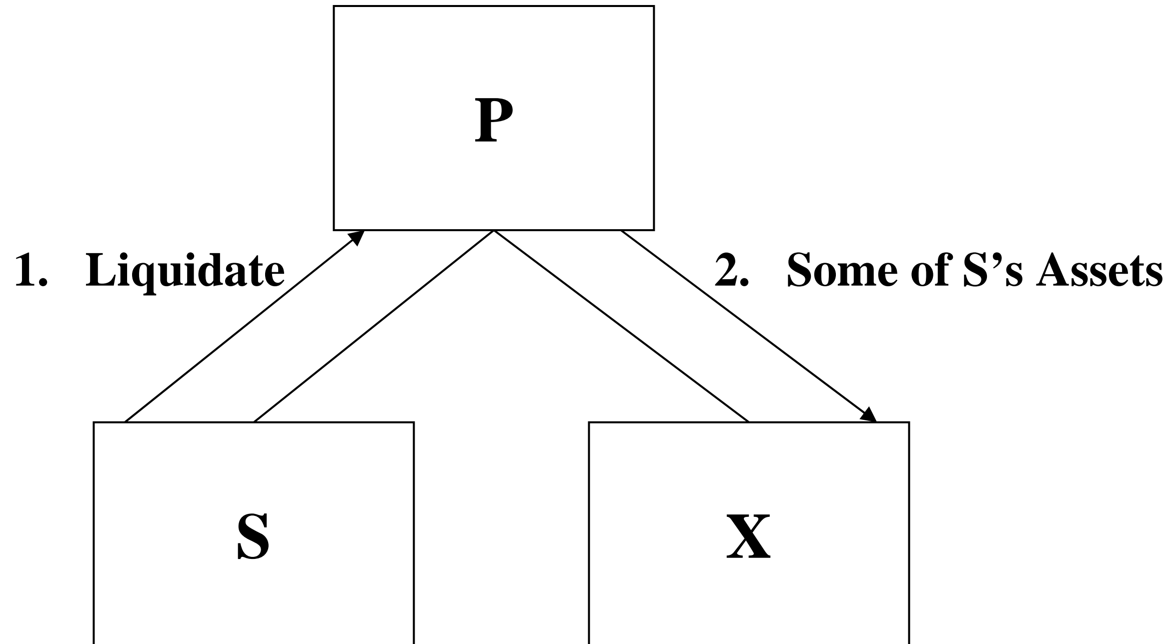
Facts: P owns all of the stock of S and X. S merges into P pursuant to state law. P then transfers all of the assets received from S to X.

Example 5(d): Rev. Rul. 69-617 (Variation)



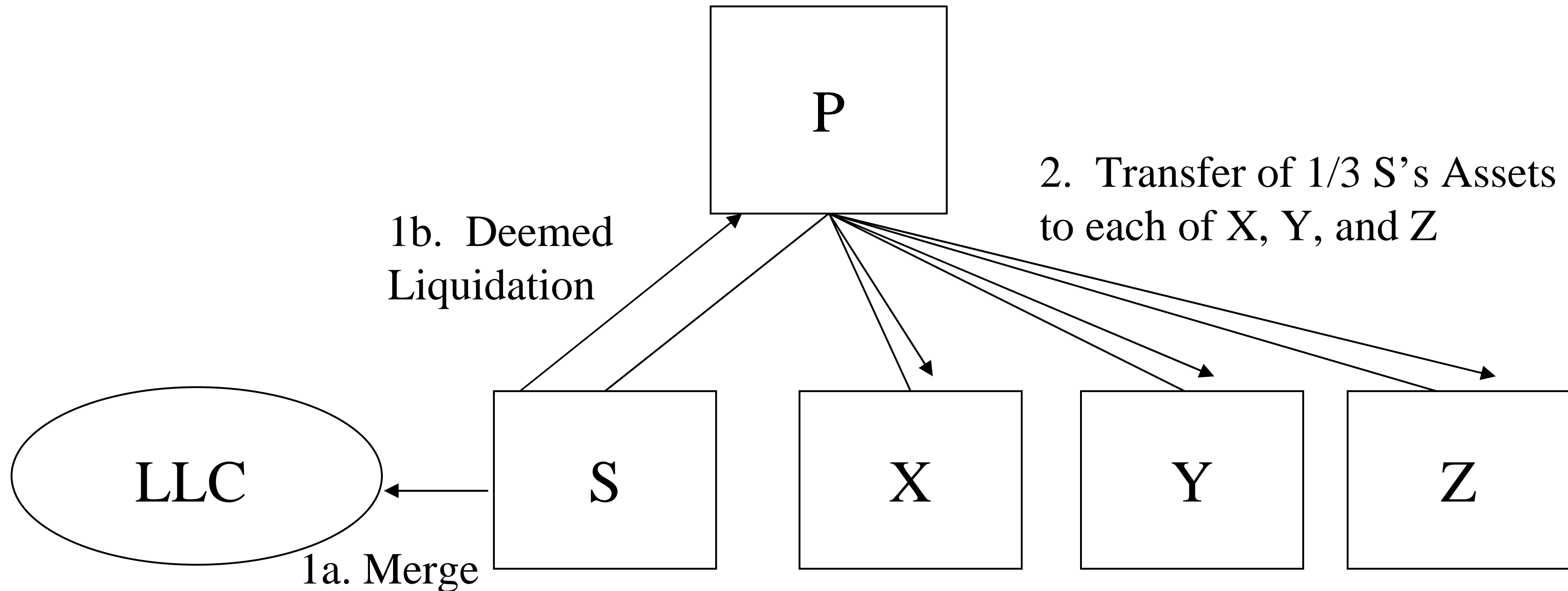
Facts: P owns all of the stock of S and X. S merges into P pursuant to state law. P then transfers 50% of the assets received from S to X. Although this transaction appears to raise "liquidation/reincorporation" issues, private letter rulings allow the partial drop of S's assets to X following the Section 368(a)(1)(A) reorganization. See, e.g., PLR 9222059 (Jun. 13, 1991); PLR 9422057 (Mar. 11, 1994); PLR 8710067 (Dec. 10, 1986). These rulings rely on Rev. Rul. 69-617 and treat the transaction as a merger followed by a Section 368(a)(2)(C) drop of assets. At least one ruling would allow a double-drop of S's assets following the reorganization. See PLR 9222059 (Jun. 13, 1991).

<u>Example 5(e): Rev. Rul. 69-617 & The New Bausch & Lomb Regulations</u>



<u>Facts</u>: P owns all of the stock of S and X. S liquidates, distributing all of its assets to P. P then transfers some of the assets received from S to X. Can this transaction be treated under the analysis of Rev. Rul. 69-617 as a C reorganization followed by a drop of assets under Section 368(a)(2)(C), given the new <u>Bausch & Lomb</u> regulations? <u>See</u> Treas. Reg. Section 1.368-2(d)(4). What if X were a newly formed corporation?

Example 5(f): Rev. Rul. 69-617 (Variation) & The New Bausch & Lomb Regulations



Facts: P owns all of the stock of S, X, Y, and Z. S merges into an LLC created by P, causing a deemed liquidation of S for tax purposes. LLC then transfers 1/3 of S's historic assets to X, Y, and Z respectively. (P will be treated as transferring such assets to X, Y, and Z for tax purposes).

Example 6: Rev. Proc. 2003-48--New Rules for Private Letter Rulings and Determination Letters under Section 355

Effect: Rev. Proc. 2003-48, I.R.B. 2003-48, modifies and amplifies Rev. Proc. 96-30, 1996-1 C.B. 696, and modifies Rev. Proc. 2003-3, 2003-1 I.R.B. 113.

Purpose: To clarify that the Service will not issue private letter rulings or determination letters that rule upon inherently factual issues in the section 355 context. Specifically, the Service will not determine whether (i) the distribution of controlled stock is carried out for one or more corporate business purposes, (ii) the transaction is used principally as a device, or (iii) the distribution and acquisition are part of a plan under section 355(e).

Effective Date: Rev. Proc. 2003-48 is effective for all ruling requests postmarked or received after August 8, 2003. Ruling requests postmarked or received after June 24, 2003 and on or before August 8, 2003 that do not comply with Rev. Proc. 2003-1 and Rev. Proc. 96-30 may be either returned to the taxpayer or treated as being subject to Rev. Proc. 2003-48.

Example 6: Rev. Proc. 2003-48--New Rules for Private Letter Rulings and Determination Letters under Section 355

Changes to Rev. Proc. 96-30—New Representations: Rev. Proc. 2003-48 specifically modifies and amplifies Rev. Proc. 96- 30 by altering the representations a taxpayer is required to make with respect to a private letter ruling or determination letter request as follows. These representations, in effect, foreclose the possibility of a taxpayer receiving a private letter ruling or determination letter based upon section 355 factual issues.

- **Section 4.01** modifies section 4.04(1) through 4.04(7) and Appendices A and C of Rev. Proc. 96-30 by deleting those sections and adding the following representation: "The distribution of the stock, or stock and securities, of the controlled corporation is carried out for the following corporate business purposes: [list these corporate business purposes]. The distribution of the stock, or stock and securities, of the controlled corporation is motivated, in whole or substantial part, by one or more of these corporate business purposes."
- **Section 4.02** modifies section 4.05(1) through 4.05(5) of Rev. Proc. 96-30 by deleting those sections and adding the following representation: "The transaction is not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both. See § 355(a)(1)(B)."

Example 6: Rev. Proc. 2003-48--New Rules for Private Letter Rulings and Determination Letters under Section 355

Changes to Rev. Proc. 96-30—New Representations (cont.):

- **Section 4.03** amplifies Rev. Proc. 96-30 by adding new section 4.08(12), which requires one of the following representations; the representation may be modified if necessary:

(i) "There is no acquisition of stock of the distributing corporation or any controlled corporation (including any predecessor or successor of any such corporation) that is part of a plan or series of related transactions (within the meaning of §1.355-7T) that includes the distribution of the controlled corporation stock;"

(ii) "Each of the following acquisitions of stock of the distributing corporation or any controlled corporation (including any predecessor or successor of any such corporation) is or may be part of a plan or series of related transactions (within the meaning of §1.355-7T) that includes the distribution of controlled corporation stock: [describe acquisitions here]. Taking all of these acquisitions into account, stock representing a 50-percent or greater interest (within the meaning of §355(d)(4)) in the distributing or controlled corporation (including any predecessor or successor of any such corporation) will not be acquired by any person or persons;" or

(iii) "The distribution is not part of a plan or series of related transactions (within the meaning of §1.355-7T) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest (within the meaning of §355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation)."

Example 6: Rev. Proc. 2003-48--New Rules for Private Letter Rulings and Determination Letters under Section 355

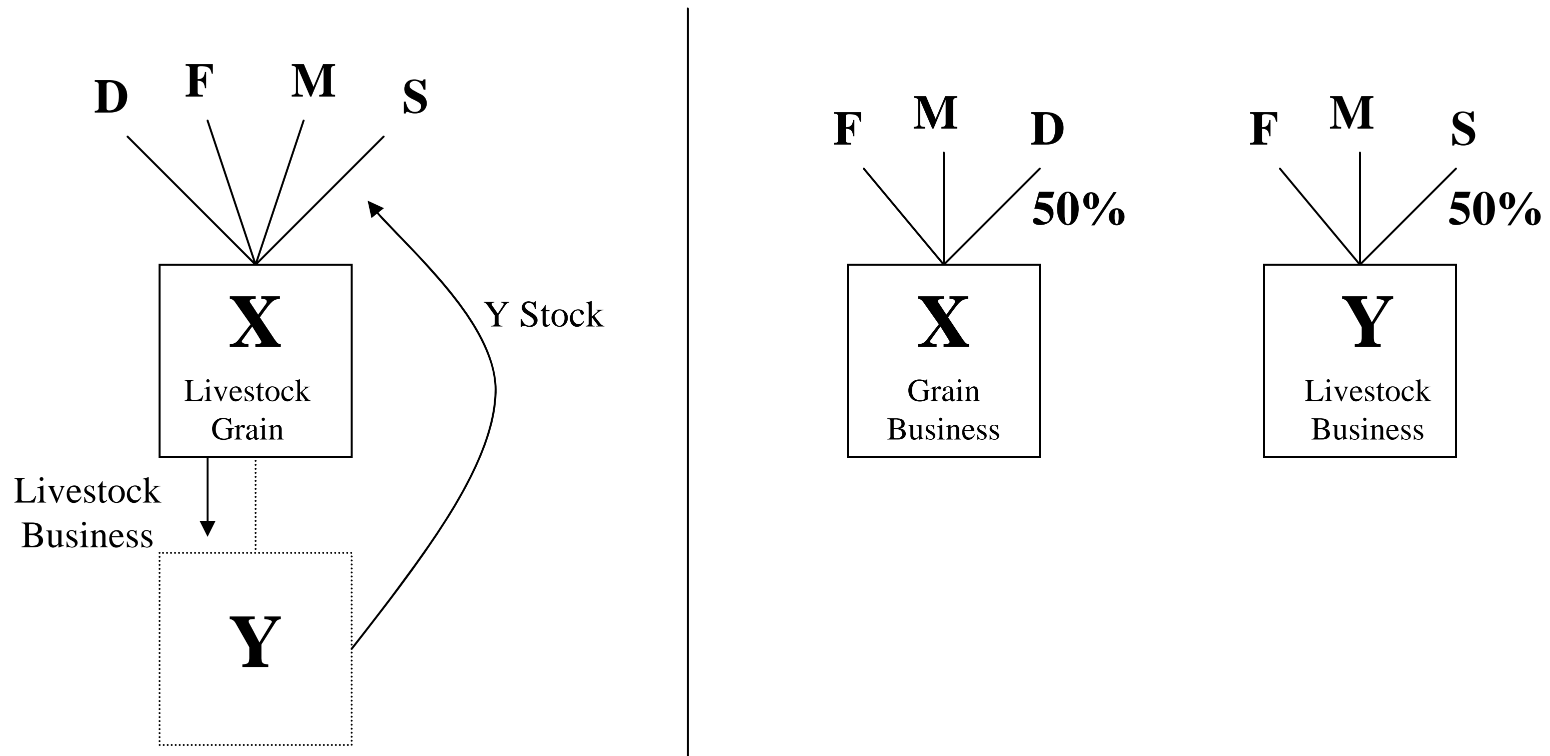
Changes to Rev. Proc. 96-30—Additional Requirements and Limitations:

- **Section 4.04** amplifies Rev. Proc. 96-30 by adding new section 4.08(13), which requires taxpayers to file with their ruling request copies of any proxy statements, information statements, or prospectuses filed or prepared in connection with the distribution or any related transaction.

- **Section 4.05** amplifies Rev. Proc. 96-30 by adding new section 4.08(14), which provides: "The Service will not entertain any ruling request regarding a proposed or completed transaction if the Service has previously declined to rule on that transaction (or a similar transaction) because the Service was not satisfied that the distribution met the corporate business purpose requirement, was not a device for the distribution of earnings and profits, or was not part of a plan (or series of related transactions) under § 355(e)."

- **Section 4.06** amplifies Rev. Proc. 96-30 by adding new section 4.08(15), which provides: "The Service will decline a request for a supplemental letter ruling, unless the request presents a significant issue (as defined in section 3.01(29) of Rev. Proc. 2003-3). A change in circumstances arising after the transaction ordinarily does not present a significant issue."

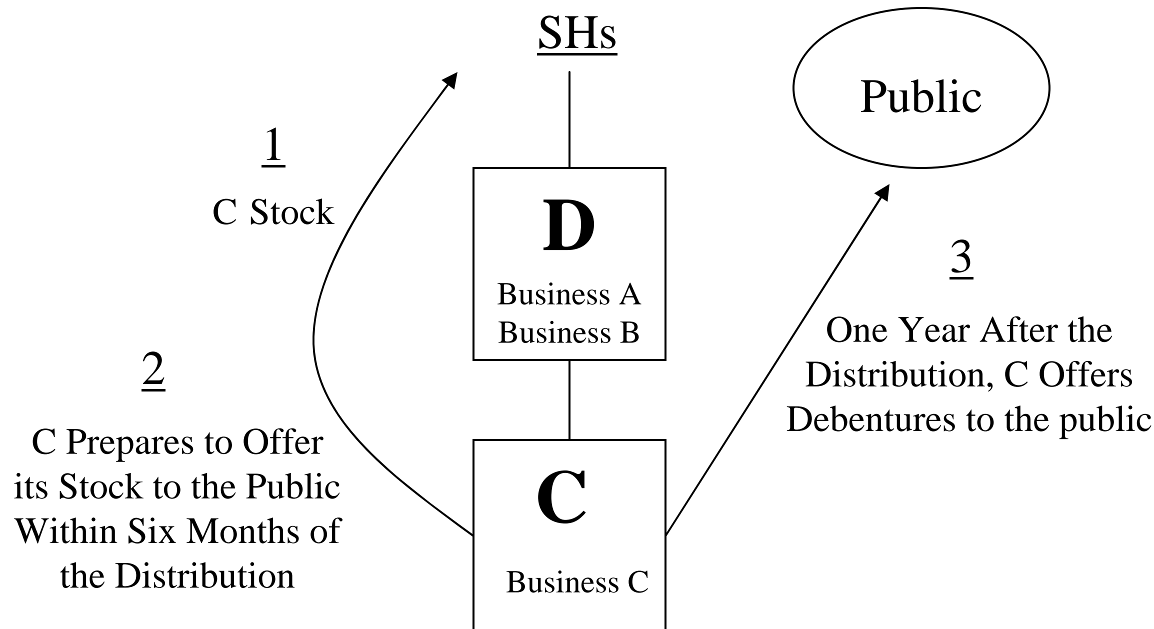
Example 7(a): Rev. Rul. 2003-52
Independent Business Purpose Under Treas. Reg. § 1.355-2(b)



Facts: Father ("F"), Mother ("M"), Son ("S"), and Daughter ("D") each own 25 percent of Corporation X, a domestic corporation that has been engaged in the livestock and grain growing businesses for more than five years. S and D, who manage and operate X, disagree over the future direction of X; S wants to expand the livestock business and D wants to expand the grain business. Also, the spouses of S and D dislike one another. To allow each child to develop the business they are most interested in, to further the estate planning goals of F and M, and to preserve family harmony, X transfers the livestock business to newly formed, wholly owned domestic corporation Y and distributes 50 percent of the Y stock to S in exchange for all of S's stock in X. F and M each receive 25 percent of the Y stock in exchange for one half of their X stock. F and M amend their wills to ensure that S inherits only Y stock and that D inherits only X stock. Apart from the business purpose requirement of Treas. Reg. § 1.355-2(b), the distribution of Y stock meets all of the requirements of section 368(a)(1)(D).

Ruling: Although the distribution is intended, in part, to further the estate plans of F and M and to promote family harmony, the business purpose requirement of Treas. Reg. § 1.355-2(b) is satisfied because the distribution eliminates the disagreement between S and D regarding how to develop the future operations of X and allows S and D to devote their undivided attention to the business in which they are most interested.

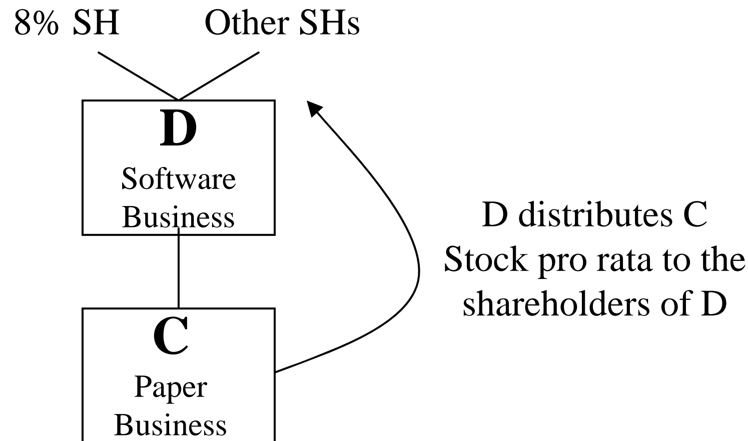
Example 7(b): Rev. Rul. 2003-55
Independent Business Purpose Under Treas. Reg. § 1.355-2(b)



Facts: D is a publicly traded corporation that conducts Businesses A and B directly and Business C through its wholly owned subsidiary C. Business C needs to raise significant capital and D has been advised that the best way to raise the capital is through an initial public offering ("IPO") of C stock after C has been separated from D; the investment banker believes that spinning off C prior to the IPO will be more efficient than an offering by C or D without first separating the corporations because it would raise the needed capital with significantly less dilution of the existing shareholders' interests in the combined enterprises. In reliance on the investment banker's opinion, D distributes the stock of C to its shareholders and prepares to offer the C stock to the public with a target date of six months from the distribution. Following the distribution, market conditions unexpectedly deteriorate to an extent that C and its advisors determine to postpone the IPO. One year after the distribution, conditions have not improved to permit the IPO and C raises the needed capital though the issuance of debentures. Apart from the business purpose requirement of Treas. Reg. § 1.355-2(b), the distribution of C stock meets all of the requirements of section 368(a)(1)(D).

Ruling: Although C does not complete the IPO that motivated its separation from D, the business purpose requirement of Treas. Reg. § 1.355-2(b) is satisfied because an unexpected change in market or business conditions following a distribution will not prevent satisfaction of that requirement.

Example 7(c): Rev. Rul. 2003-74
Independent Business Purpose Under Treas. Reg. § 1.355-2(b)

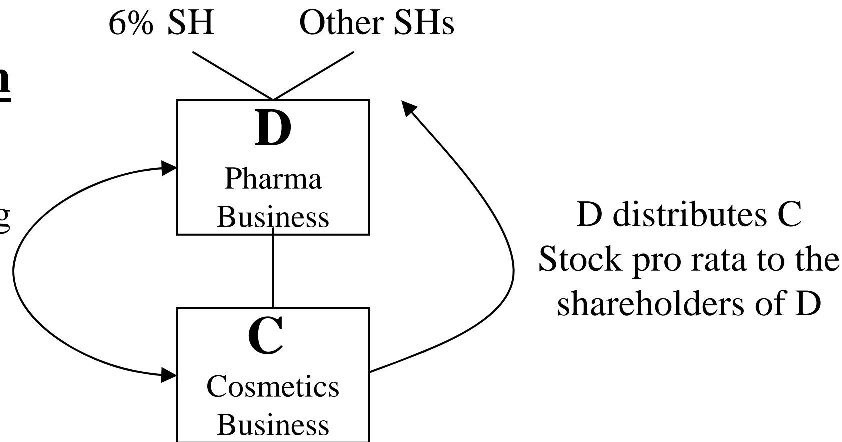


Facts: Distributing ("D") is a publicly traded corporation that conducts a technology software business. Controlled ("C") is a wholly owned subsidiary of D that conducts a paper product business. One shareholder, who does not actively participate in the management or operation of D or C, owns eight percent of the D stock. D acquired the paper products business of C five years ago to support D's software business; the paper products business is smaller and grows at a slower rate than D's software business. D's senior management would like to devote more time and effort to growing the software business and would like to focus exclusively on that business, but cannot do so because of the needs of C's paper products business. The senior management of C believes that its paper business could be more fully developed if less time and effort was spent on D's software business. Thus, in order to allow D's management to concentrate on the software business and to alleviate its responsibility with respect to C's paper business, and in order to allow C's management to concentrate on the paper business, D distributes the C stock pro rata to the D shareholders. There is no other tax-free transaction that would allow the D and C management to concentrate exclusively on the corporations' respective businesses. Both D and C expect that the transaction will benefit their respective businesses in a real and substantial way. No officer will serve both D and C. However two of D's eight directors will hold temporary position on C's six-member board; one director will serve C for two years and assist with the administrative aspects of the transaction, and the other director, an expert in corporate finance, will serve C for six years and reassure the financial markets by providing a sense of continuity. Neither of these directors will serve as an officer of C. Apart from the business purpose requirement of Treas. Reg. § 1.355-2(b), the distribution of C stock meets all of the requirements of section 355.

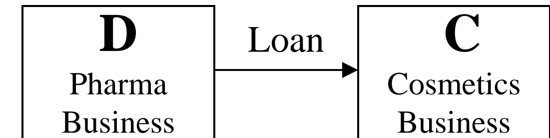
Ruling: Although the continuing relationship between Distributing and Controlled evidenced by the two common directors appears inconsistent with the assertion that the software business and the paper products business require independent management teams, this relationship does not conflict with the business purpose for the separation. Accordingly, the distribution of C stock by D to D's shareholders satisfies the corporate business purpose requirement of Treas. Reg. § 1.355-2(b).

Example 7(d): Rev. Rul. 2003-75
Independent Business Purpose Under Treas. Reg. § 1.355-2(b)

The Transaction



Post-Transaction



Facts: Distributing ("D") is a publicly traded corporation that conducts a pharmaceuticals business. Controlled ("C") is a wholly owned subsidiary of D that conducts a cosmetics business. One shareholder, who does not actively participate in the management or operation of D or C, owns six percent of the D stock. D's pharmaceuticals business is a higher-margin business and grows at a faster rate than C's cosmetics business; however, both business require substantial capital for reinvestment and research and development. D does all of the borrowing for both D and C and makes all decisions regarding the allocation of capital spending between the businesses. The competition for capital traditionally has prevented both businesses from pursuing development strategies that the management of both businesses believes are appropriate. Moreover, D has had to limit its total expenditures to maintain its credit ratings. Thus, to eliminate the competition for capital, D distributes the C stock pro rata to the D shareholders. There is no other tax-free transaction that would allow the D and C management to concentrate exclusively on the corporations' respective businesses. D and C expect that the transaction will benefit their respective businesses, and that the cosmetics business will benefit in a real and substantial way by gaining increased control over spending and direct access to capital markets. To facilitate their separation, D and C enter into transitional agreements that relate to information technology, benefits administration, and accounting and tax matters. Other than the tax agreements, each agreement will terminate in two years (absent extraordinary circumstances), but may be extended on arm's-length terms for a limited period. Following the separation of D and C, there will be no cross-guarantee or cross-collateralization of debt between D and C, and D will enter into an arm's length agreement with C to loan C working capital for a term of two years. Apart from the business purpose requirement of Treas. Reg. § 1.355-2(b), the distribution of C stock meets all of the requirements of section 355.

Ruling: The limited continuing relationship between D and C evidenced by the various administrative agreements and the loan for working capital is not incompatible with the extent of separation contemplated by section 355; except for the tax agreement, the administrative agreements and the loan are transitional and designed to facilitate the separation of the two businesses. Accordingly, the distribution of C stock by D to D's shareholders satisfies the corporate business purpose requirement of Treas. Reg. § 1.355-2(b).

Example 8(a): 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 of 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.

Example 8(a): 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.

Example 8(a): Expansion Doctrine - General

- **Preamble to final 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 (8th 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.

Example 8(a): Expansion Doctrine – Examples

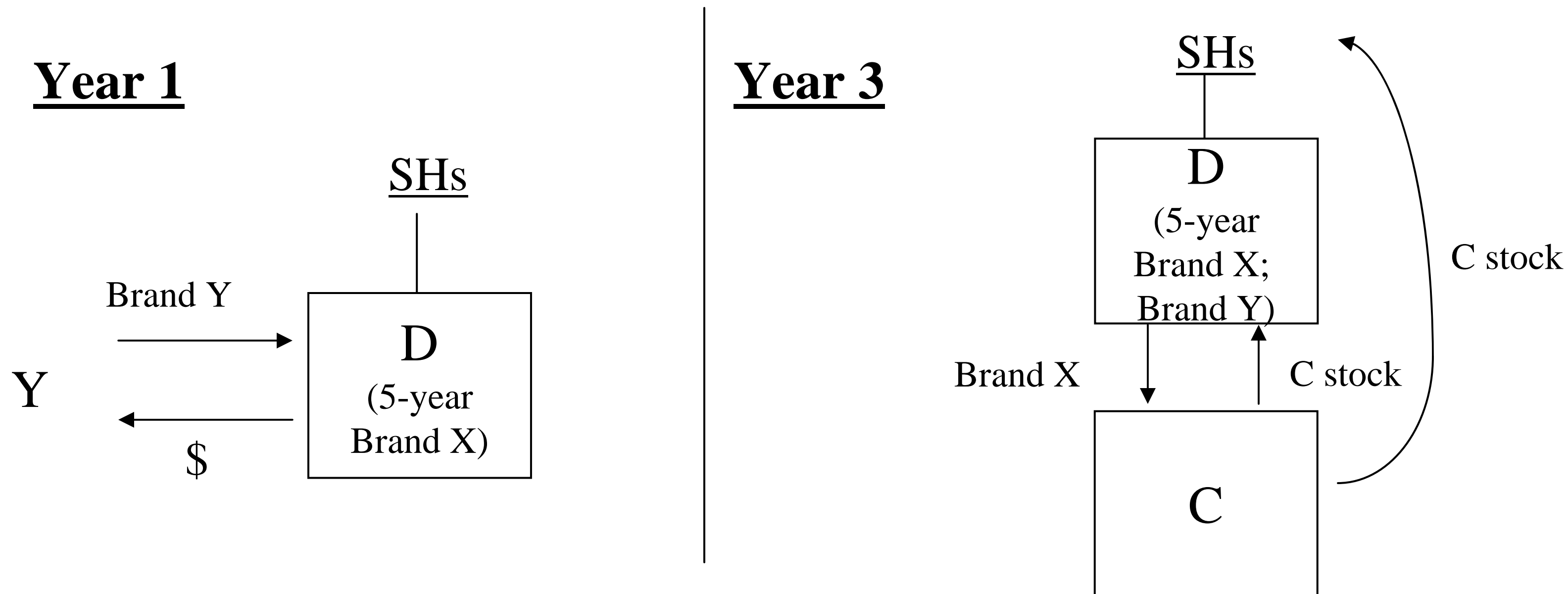
- A corporation that owns and operates a department store downtown may acquire a parcel of land in the suburbs and construct a new department store. Treas. Reg. § 1.355-3(c), Example 7.

- 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 (8th 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).

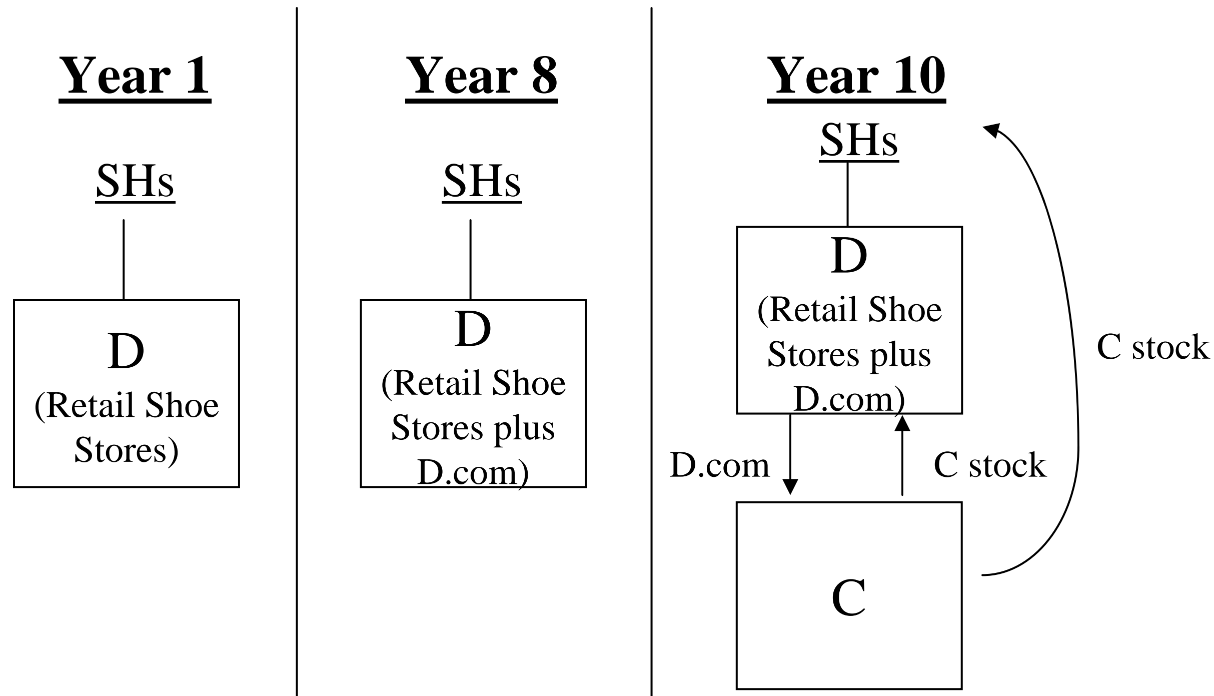
Example 8(b): Rev. Rul. 2003-18



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 C.B. 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.

Example 8(c): Rev. Rul. 2003-38



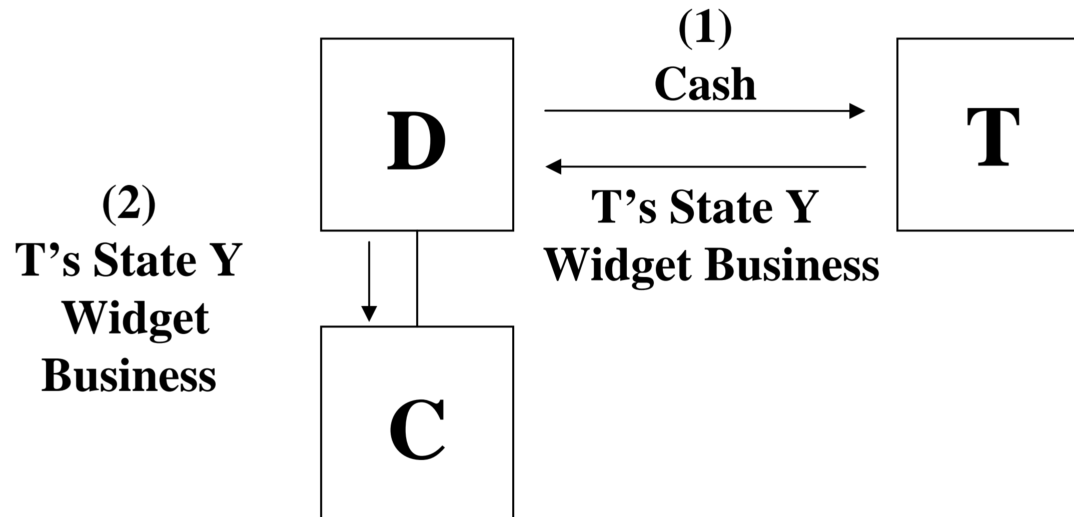
Facts: D has operated a retail shoe store business under the name "D" since Year 1. D's business enjoys favorable name recognition, customer loyalty, and other elements of goodwill. In Year 8, D created an Internet web site, which it named D.com to take advantage of its goodwill, and began selling shoes 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?

Example 8(d): Rev. Rul. 2003-18 v. Rev. Rul. 2003-38

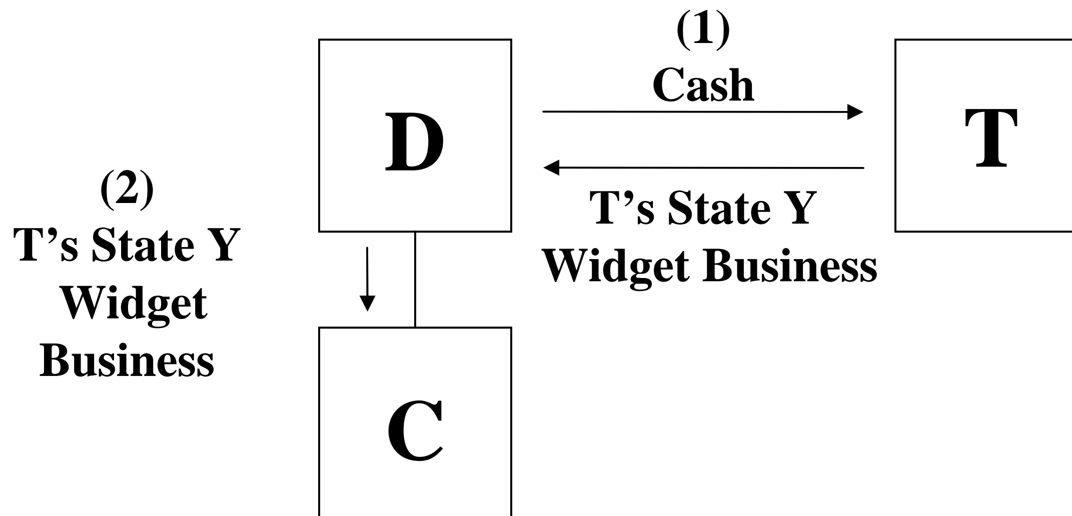
Factors Considered	Rev. Rul. 2003-18	Rev. Rul. 2003-18
1. Similar Products Sold	Present	Present
2. Same Business Activities	Present	Present
3. Use of Experience and Know-How of Existing Business	Present	Partially Present (web site's operation differs from retail store)
4. Goodwill Associated with Name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

Business Expansion: Example 1: Direct Acquisition of T Assets by D



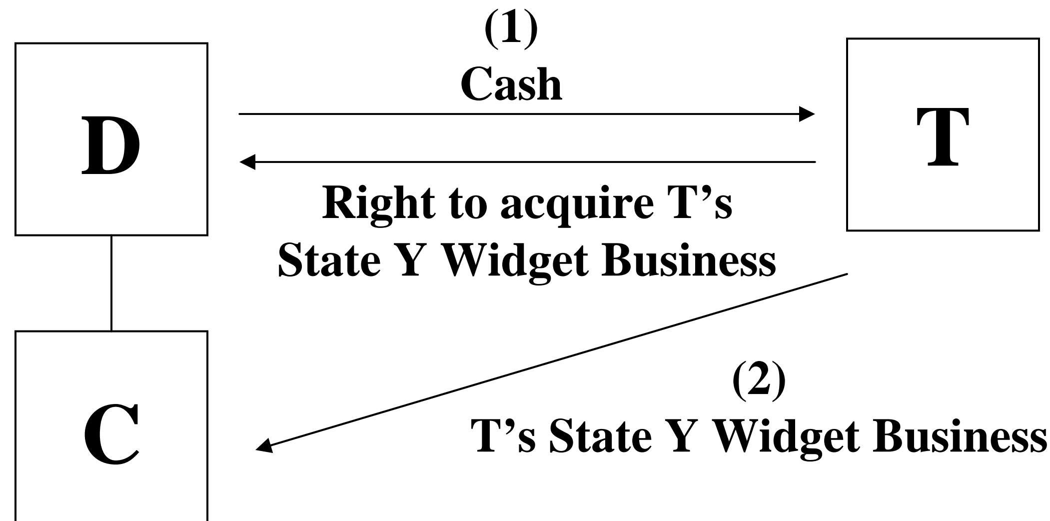
- D owns a 5-year Widget business operating in State X.
- D acquires T's 5-year Widget business operating in State Y for cash.
- D operates in States X and Y for two years.
- D contributes T's business to C, and immediately thereafter spins-off C.
- See Treas. Reg. §1.355-3(b)(3)(ii)(acquisition of trade 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); 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).

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



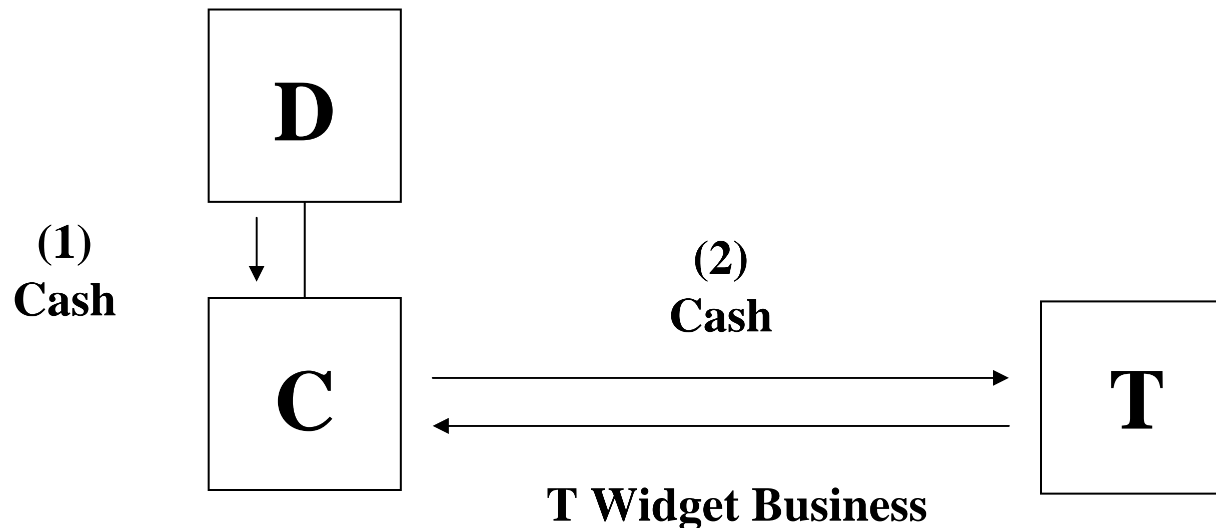
- Same facts as Example 1, except the following:
- D contributes T's State Y Widget business to C immediately after its acquisition.
- D spins-off C two years after acquiring T's State Y Widget business.
- Is D's transitory ownership of T's business disregarded?

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



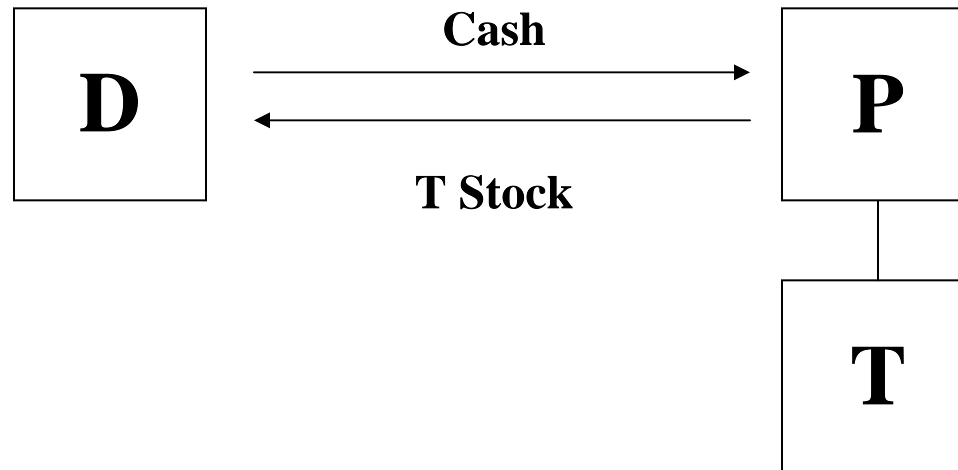
- Same facts as Example 2, except the following:
- D directs the T assets to be transferred directly from T to C.
- The directed transfer presumably is treated as a transfer to D, followed by a contribution of the assets from D to C. See Rev. Rul. 70-224, 1970-1 C.B. 79.
- See PLR 199937014 (June 15, 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).

Business Expansion: Example 4: Acquisition of T Assets Directly by C



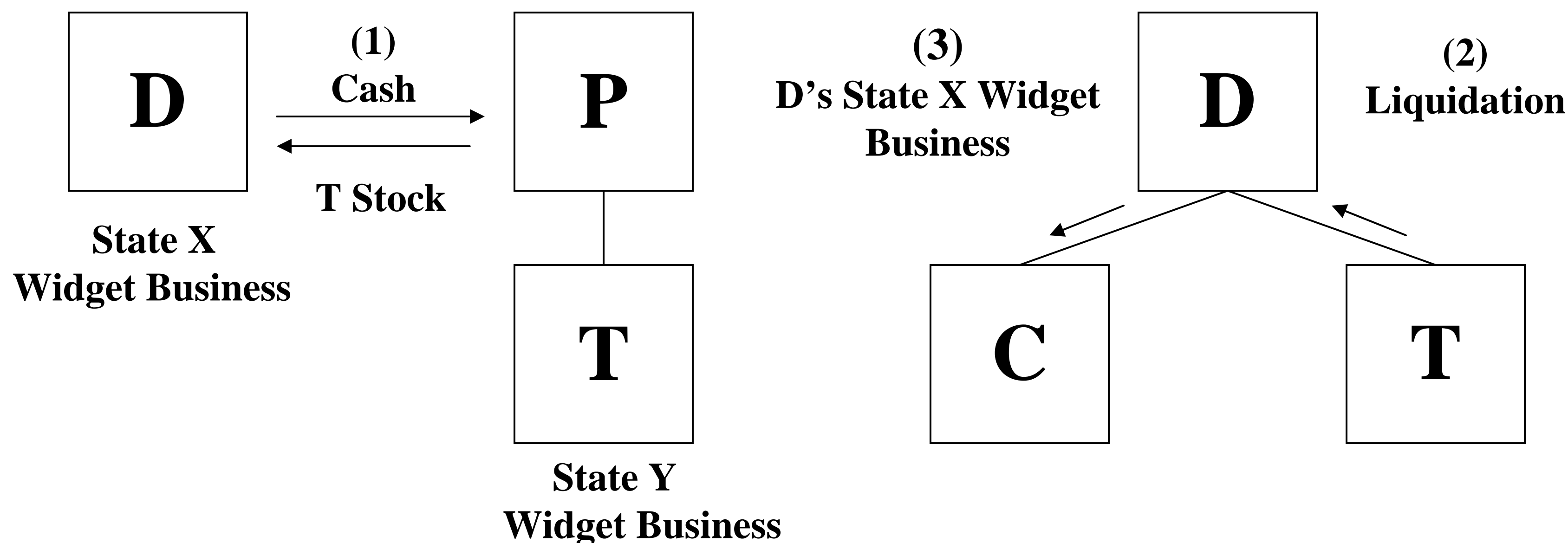
- Same facts as Example 2, except D contributes cash to C; C contracts directly with T for the cash acquisition of T's 5-year Widget business operating in State Y.
- Should the lack of any transitory actual or constructive ownership by D of the T assets, as in the previous examples, preclude satisfaction 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).

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



- 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.
- 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 PLR 200109027 (Nov. 30, 2000) (suggesting that expansion of business requirements not met with respect to a stock acquisition).

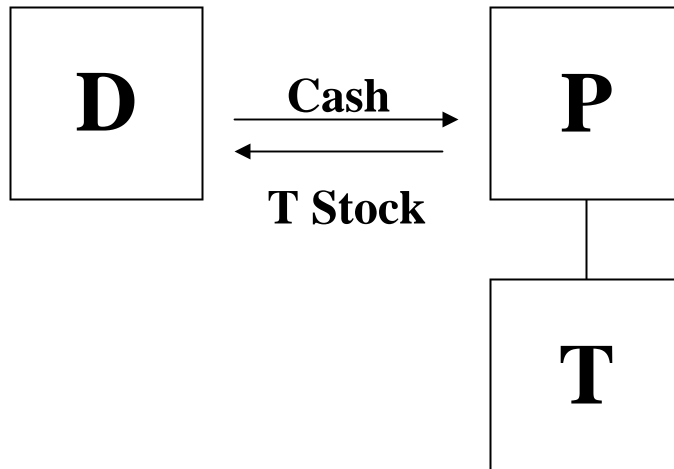
<u>Business Expansion: Example 6: Indirect Expansion of D's Business through Acquisition of T Stock</u>



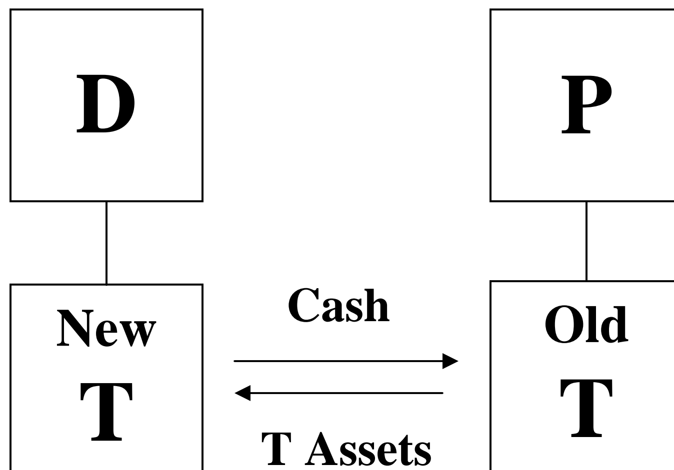
- Same historic facts as Example 1 regarding D's and T's respective Widget businesses.
- D acquires all of the stock of T from P in a qualified stock purchase; no Section 338 election is made.
- Two years after its acquisition, T is liquidated.
- Immediately thereafter, D contributes its historic State X Widget Business to C and spins off C.
- Should the expansion of business principle apply to D's acquisition of the State Y Widget business via the liquidation of T?
- <u>See</u> PLR 200109027 (Nov. 30, 2000); <u>cf.</u> <u>Commissioner v. Gordon</u>, 382 F2d 499 (2d Cir. 1967), <u>rev'd on other grounds</u>, 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).

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

(1)

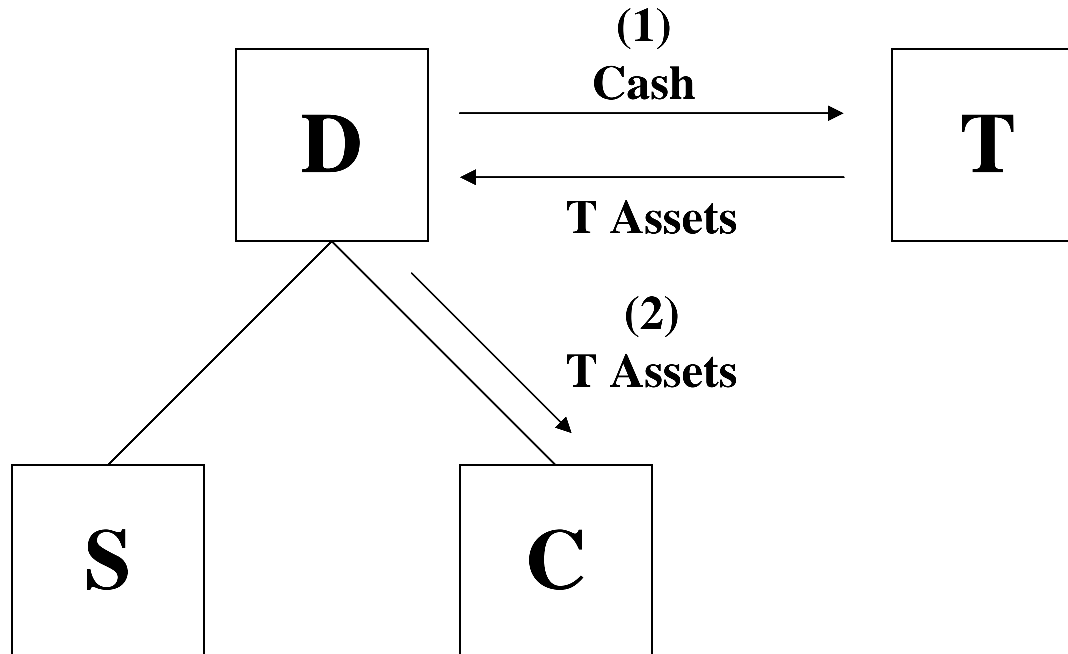


(2) **Recharacterization via a Section 338(h)(10) Election**



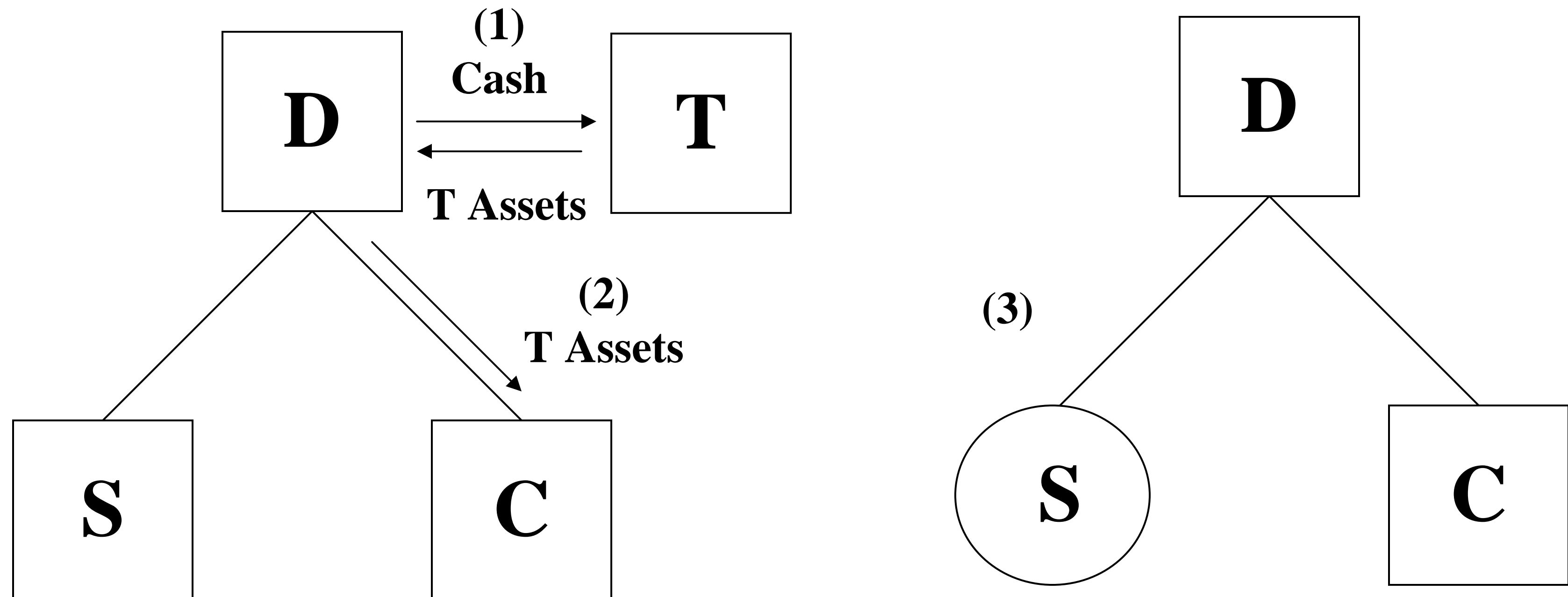
- Same historic facts as Example 1 regarding D's and T's respective Widget businesses.
- D acquires all of the stock of T from P in a qualified stock purchase
- D and P make a Section 338(h)(10) election.
- Acquisition is treated as purchase by New T of all of the Old T assets.
- Should this transaction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

Business Expansion: Example 8: Acquisition of T Assets by Holding Company D



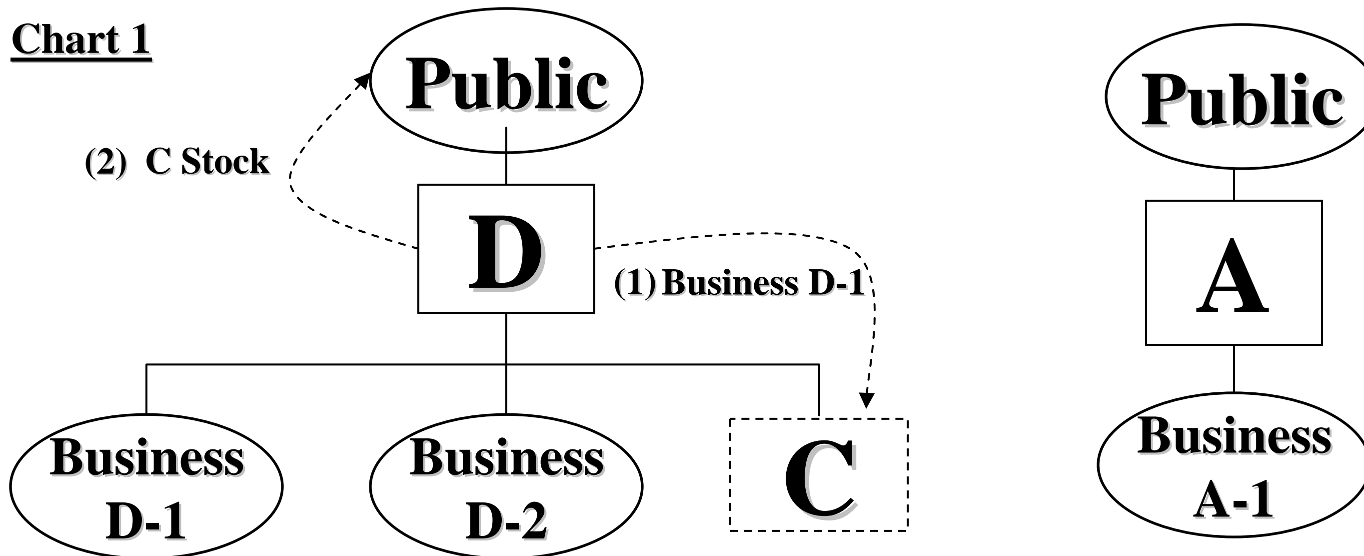
- S owns a 5-year Widget business operating in State X.
- D is a holding company and satisfies the active trade or business requirement through its ownership of the stock of S.
- D acquires all of the assets of T's 5-year Widget business operating in State Y.
- D immediately contributes the T assets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

Business Expansion: Example 9: Acquisition of T Assets by Holding Company D



- Same facts as Example 8, except for the following:
- 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.
- 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).

Example 9(a): Rev. Rul. 2003-79 – Spin-off and Acquisition of Transitory C



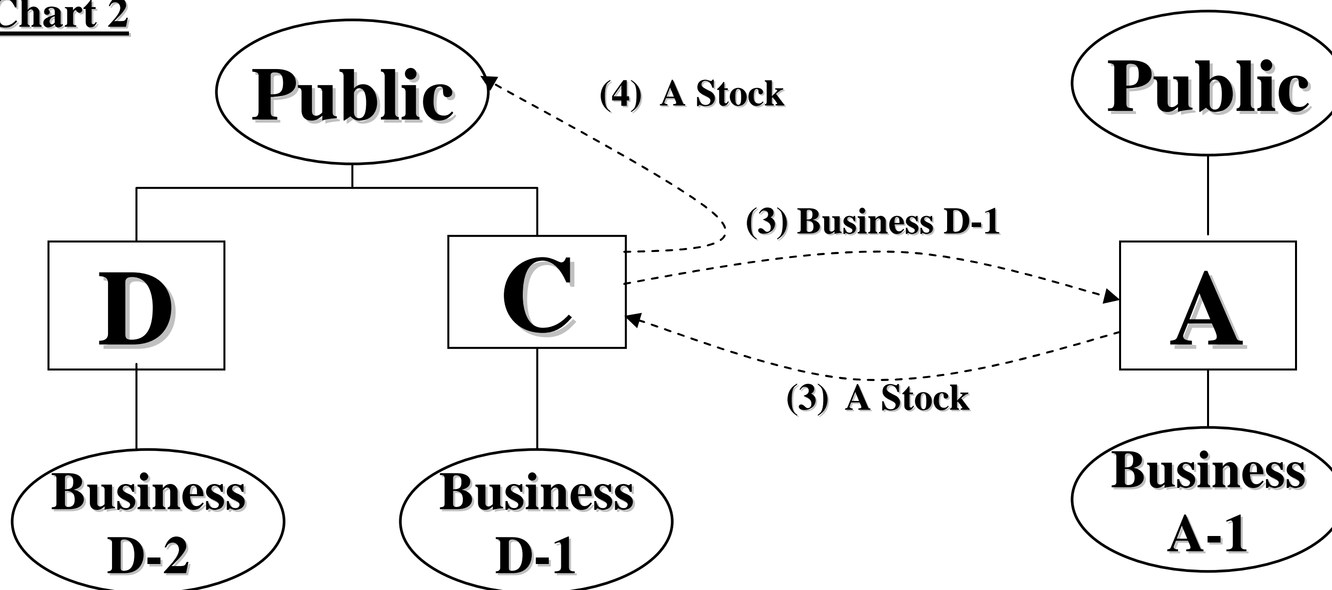
Publicly-traded D owns Business D-1 and Business D-2. Unrelated A owns a Business A-1 and wishes to acquire Business D-1 but not Business D-2.

(1) D forms C Corp and transfers Business D-1 to C in exchange for all the stock of C.

(2) D distributes all the stock of C to the D shareholders, *pro rata*.

(Continued next page)

Example 9(a): Rev. Rul. 2003-79 -- Spin-off and Acquisition of Transitory

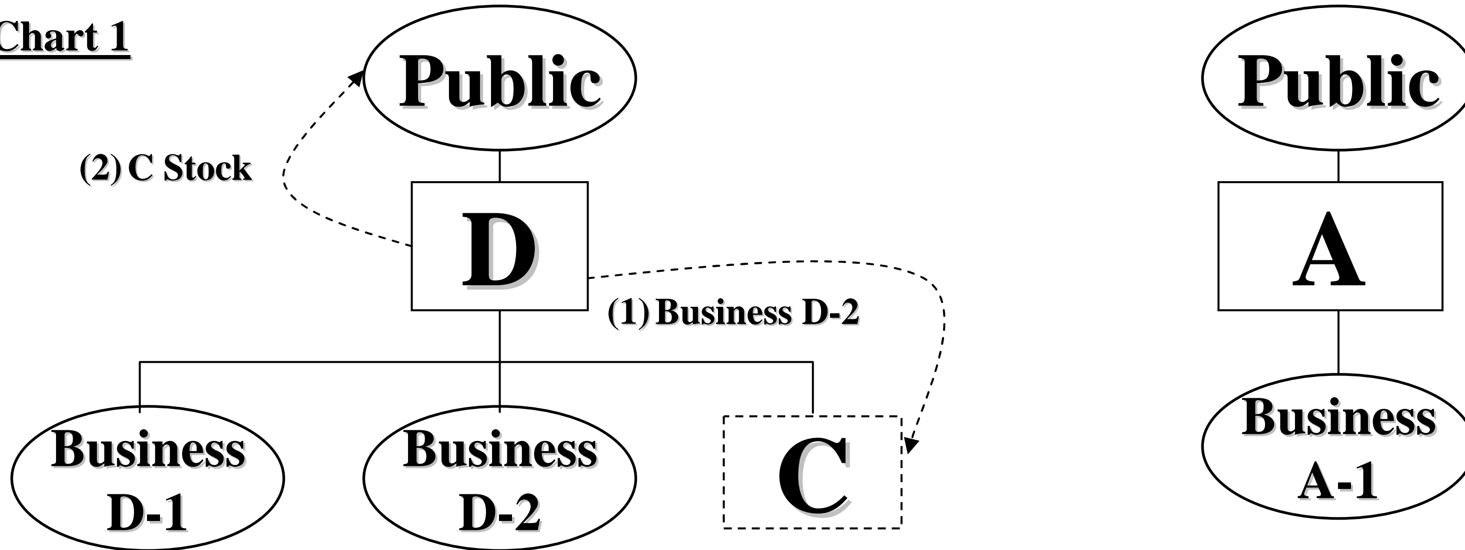


(3) Pursuant to a binding commitment in place at the time of the spin-off, C transfers all its assets to A in exchange solely for voting stock of A (less than 50% of the A stock).

(4) Pursuant to the same binding commitment, C is liquidated and distributes its A stock to the C shareholders (same as the D shareholders), *pro rata*.

(5) Different result if a 51% shareholder of D owns 1 share of A stock?

Example 9(b): Spin-off and Acquisition of D



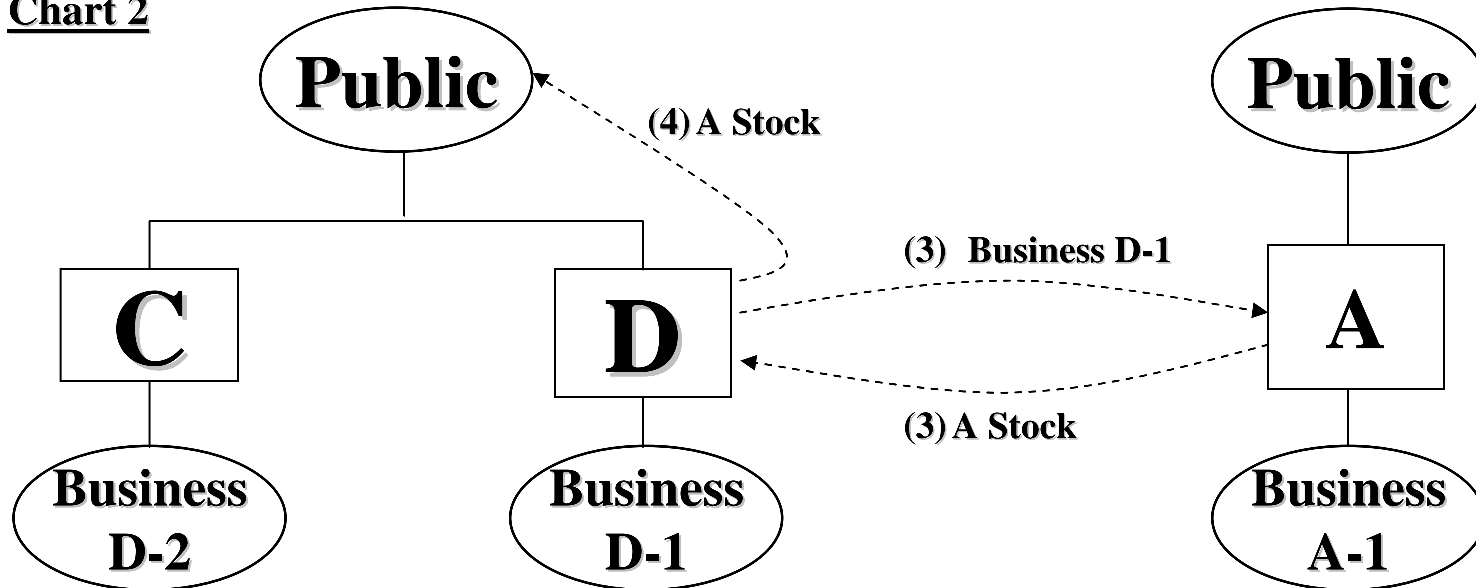
Publicly-traded D owns Business D-1 and Business D-2. Unrelated A owns a Business A-1 and wishes to acquire Business D-1 but not Business D-2.

(1) D forms C and transfers Business D-2 to C in exchange for all the stock of C.

(2) D distributes the stock of C to the D shareholders, *pro rata*.

(Continued next page)

Example 9(b): Spin-off and Acquisition of D



(3) Pursuant to a binding commitment in place at the time of the spin-off, D transfers all its assets to A in exchange solely for voting stock of A (less than 50% of the A stock).

(4) Pursuant to the same binding commitment, D is liquidated and distributes its A stock to the D shareholders (same as the D shareholders), *pro rata*.

Code sections 355(e) and 368(a)(1)(D); Rev. Rul. 2003-79, 2003-29 I.R.B. 80; Rev. Rul. 98-44, 1998-2 C.B. 315; Rev. Rul. 98-27, 1998-1 C.B. 1159; H.R. Conf. Rep. No. 105-220, 105th Cong., 1st Sess. (1997), 529-530; JCT Staff, General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97) (1997), 205; S. Rep. No. 105-174, 105th Cong., 2d Sess. (1998), 173-176; *Helvering v. Elkhorn Coal Co*., 95 F.2d 732 (4th Cir. 1937) *cert. denied*, 305 U.S. 605, *reh. denied*, 305 U.S. 670 (1938).

Example 10(a): Tier Effect – Different Recovery Classes

T

	Value	Basis
Marketable securities --	4,000	2,500
Accounts receivable --	4,000	4,000

Facts

Corporation T has two groups of assets, marketable securities with a value of \$4,000X and a basis of \$2,500X and accounts receivable with a value and basis of \$4,000X. P purchases the T stock for \$6,000X, and P and S join in a Section 338(h)(10) election for T.

Case 1. All assets are held in T.

Case 2(a). The securities are held in a wholly owned subsidiary of T (T1) and the receivables are held in a second wholly owned subsidiary (T2). Section 338(h)(10) elections are made for T, T1, and T2.

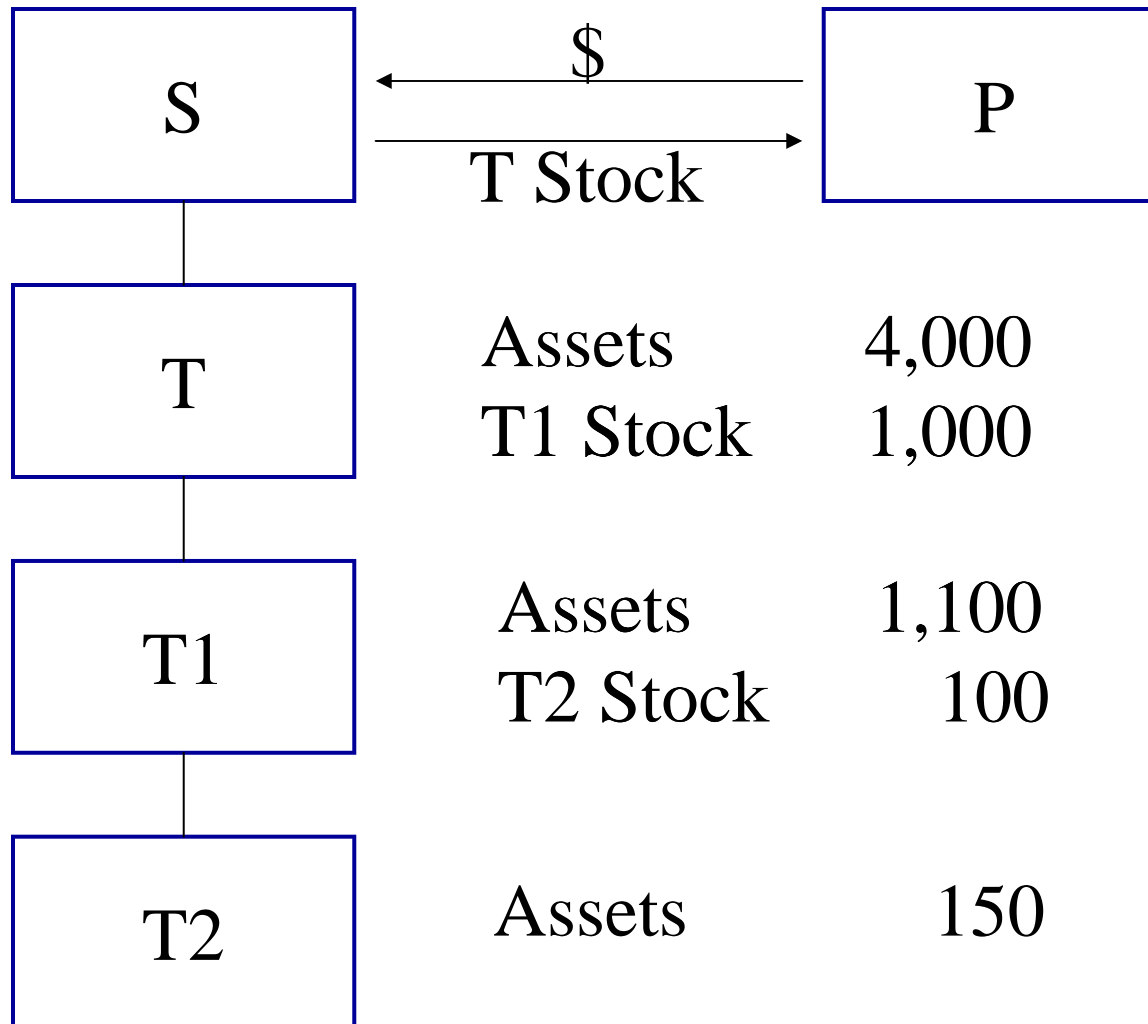
Case 2(b). A Section 338(h)(10) election is made for T1 (securities), but not T2 (receivables).

Example 10(a): Tier Effect – Different Recovery Classes Continued

Case 3(a). The receivables are held directly by T. The securities are held by T1. A Section 338(h)(10) election is made for T1.

Case 3(b). No Section 338(h)(10) election is made for T1.

Example 10(b): Section 338(h)(10) Vs. Section 1060



Example 10(b): Section 338(h)(10) Vs. Section 1060 Continued

Facts

Corporation T owns and operates a business with a value of 4,000X, and also owns all of the stock of Corporation T1. The value of the T1 stock is 1,000X. T1 owns and operates a business with a value of 1,100X, and also owns all of the stock of T2. The value of the T2 stock is 100X. T2 owns and operates a business with a value of 150X.

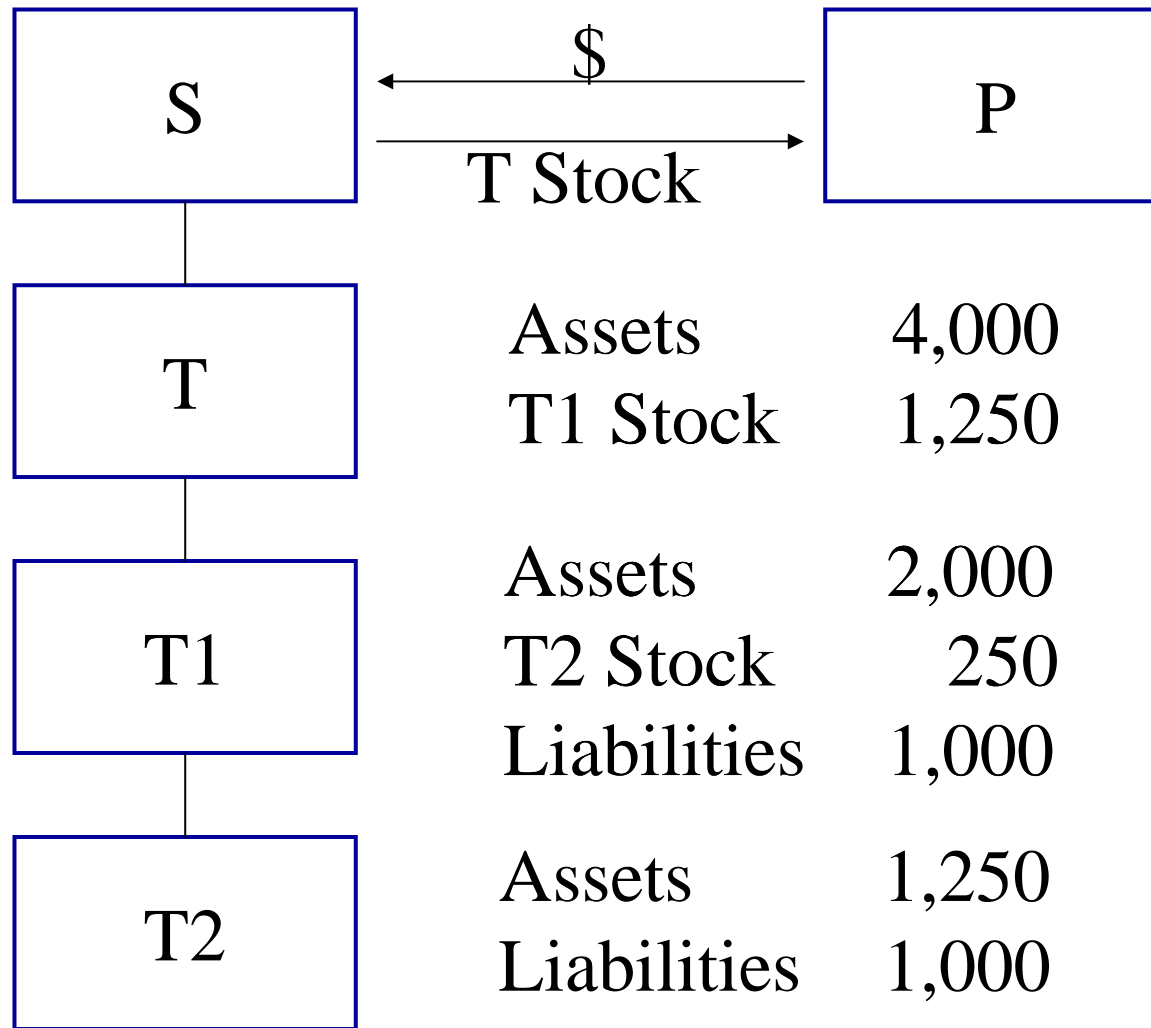
P purchases all of the T stock from S for 4,500X and P and S (the common parent of the T group) join in a Section 338(h)(10) election with respect to T, T1, and T2.

Questions

1. What are the basis and selling price consequences to P and to S?

2. What would the results be if the businesses of T1 and T2 were separately conducted as divisions of T, and P purchased all of the T assets for 4,500X in a transaction to which Section 1060 applied?

Example 10(c): Section 338(h)(10) Vs. Section 1060



Example 10(c): Section 338(h)(10) Vs. Section 1060 Continued

Facts

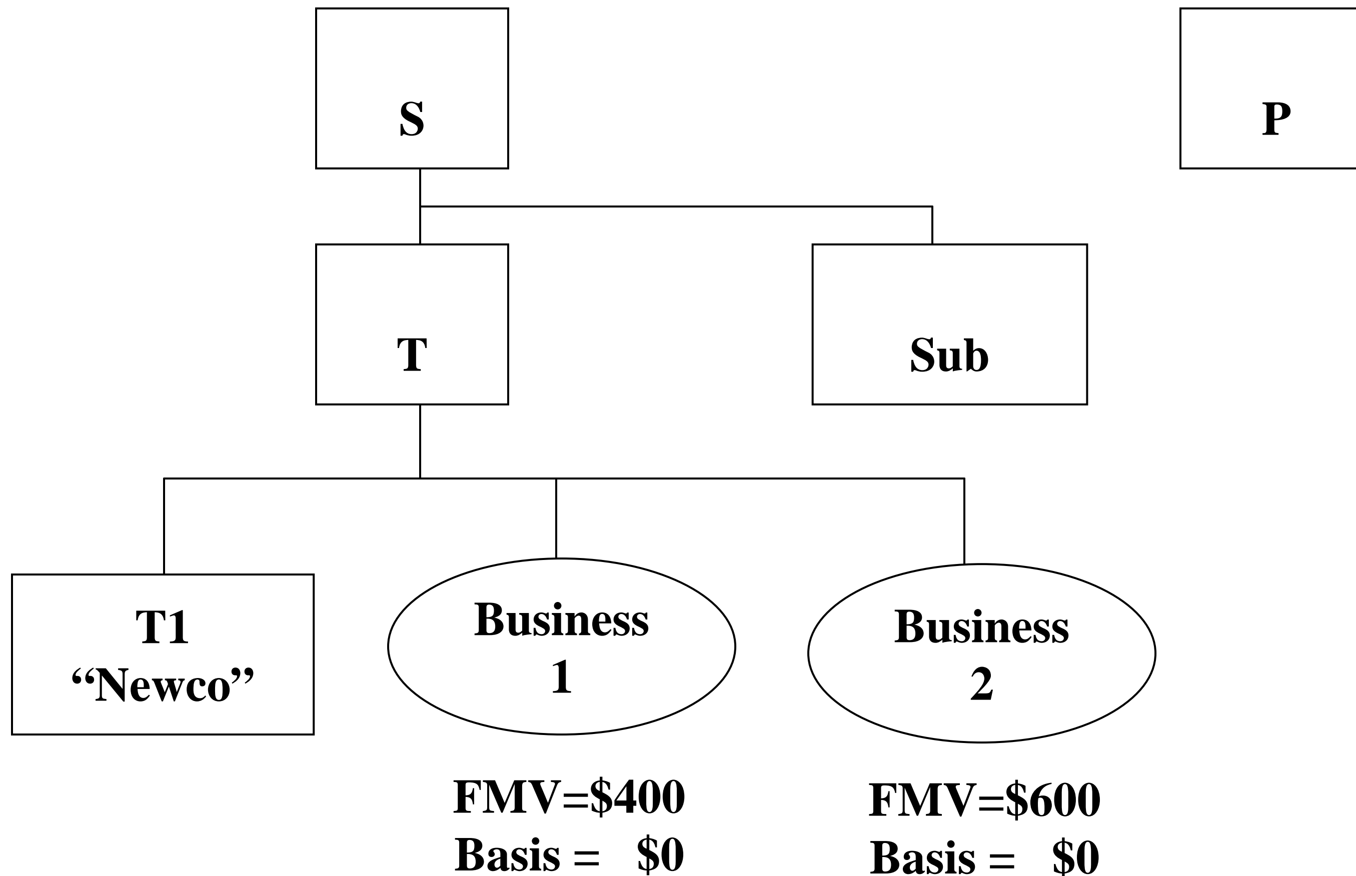
Corporation T owns and operates a business with a value of 4,000X, and also owns all of the stock of T1. The value of the T1 stock is 1,250X. T1 owns and operates a business with a value of 2,000X, and also owns all of the stock of T2 with a value of 250X. T1 also has liabilities of 1,000X. T2 owns and operates a business with a gross value of 1,250X and has liabilities of 1,000X.

P purchases all of the T stock from S for 4,500X and P and S (the common parent of the T group) join in a Section 338(h)(10) election with respect to T, T1 and T2.

Questions

1. What are the basis and selling price consequences to P and S?
2. What would the results be if the businesses of T1 and T2 were separately conducted as divisions of T, and P purchased all of the T assets for 4,500X (plus the assumption of liabilities) in a transaction to which Section 1060 applied?

Example 11: Section 338(h)(10) and Unwanted Assets



Facts

The S group files consolidated returns. S owns all the stock of T. T owns Business 1 and Business 2. S also owns all the stock of Sub.

Example 11: Section 338(h)(10) and Unwanted Assets Continued

P wants to buy Business 1 but not Business 2. The parties want to structure the transaction as a sale of the T stock with a Section 338(h)(10) election.

Questions

- May the parties make a Section 338(h)(10) election?
- If so, is P entitled to a cost basis in the assets it is deemed to acquire from T?
- Will the S group be taxed on the deemed sale of the assets wanted by P and/or on the transfer of the assets not wanted by P?

Transactions

Basic Transaction

- T distributes Business 2 to S, and S retains Business 2.
- S sells the T stock to P for $400 cash.

Example 11: Section 338(h)(10) and Unwanted Assets Continued

Variation 1

- T sells Business 2 to Sub for $600 cash.
- S sells the T stock to P for $1,000 cash.

Variation 2

- T distributes Business 2 to S.
- S transfers Business 2 to Sub.
- S sells the T stock to P for $400 cash.

Variation 3

- T distributes Business 2 to S.
- S transfers Business 2 and $300 cash to Sub.
- S sells the T stock to P for $400 cash.

Variation 4

- T transfers Business 2 to a new subsidiary, T1, for all the T1 stock.
- T distributes the T1 stock to S, and S retains the T1 stock.
- S sells the T stock to P for $400 cash.

Example 11: Section 338(h)(10) and Unwanted Assets Continued

Authorities

Code Sections 338(h)(10), 354(b)(1), 368(a)(1)(D) and 368(a)(2)(H)

Old Reg. §§ 1.338(h)(10)-1(e)(1) and (e)(2)

Reg. §§ 1.338(h)(10)-1(b)(6), (d)(4)(i), (d)(5), (d)(9) and (e) Examples 2 and 3, 1.1502-6 and 1.1502-13(f)(3)

Telephone Answering Service Co. v. Commissioner, 63 T.C. 423 (1974), *aff'd* 546 F.2d 423 (4th Cir. 1976) *cert. denied* 431 U.S. 914 (1977)

PLR 8821047 (February 26, 1988)

PLR 8938036 (June 27, 1989)

PLR 9044063 (August 7, 1990)

PLR 9210041 (December 12, 1991), *supplementing* PLR 9137040 (June 17, 1991)

PLR 9253027 (October 2, 1992)

PLR 9303005 (October 19, 1992)

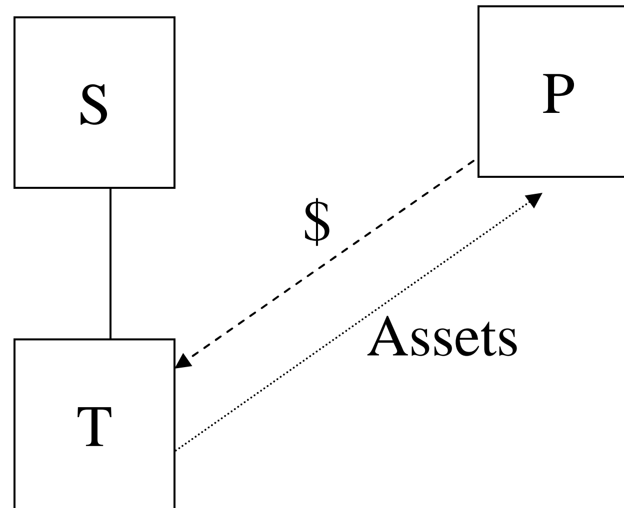
PLR 9434009 (May 18, 1994)

PLR 9735038 (June 2, 1997)

PLR 9738031 (June 24, 1997)

PLR 9847027 (August 25, 1998)

Example 12: Contingent Items



Facts

S owns all the stock of T, which operates a business. T's basis in its assets is $2,000. T has no debts, but a patent infringement lawsuit is pending against T. The plaintiff in the lawsuit claims $1,500 damages, but T's counsel has advised that the claim is weak, and that its settlement value is $100. T sells all its assets to P for –

- $3,000 cash at closing.
- An earn-out payment after three years of up to $800 plus interest, with a discounted present value estimated at $400.

Example 12: Contingent Items Continued

- T's assumption of the patent infringement liability.

Three years after closing, P pays T the earn-out of $400 plus interest.
Ten years after closing, the patent infringement case is tried. X wins a $1,500 judgment against P as successor to T, and P pays the judgment plus $1,000 interest.

Questions

a. What are the amounts realized and the taxable gain or loss to T?

b. How is P's basis in the T assets determined?

c. How would the results change if the actual earn-out payment is $600 plus interest? $0?

d. How would the results change if T's basis in its assets totaled $3,200?

e. How would the results change if S and T had agreed to indemnify P for the patent infringement liability above $100? Suppose a $1,000 escrow fund had been set aside out of the purchase price to fund the indemnity.

Example 12: Contingent Items Continued

f. How would the results change if, instead of T selling its assets to P, S sold the T stock to P with a Section 338(h)(10) election?

Authorities

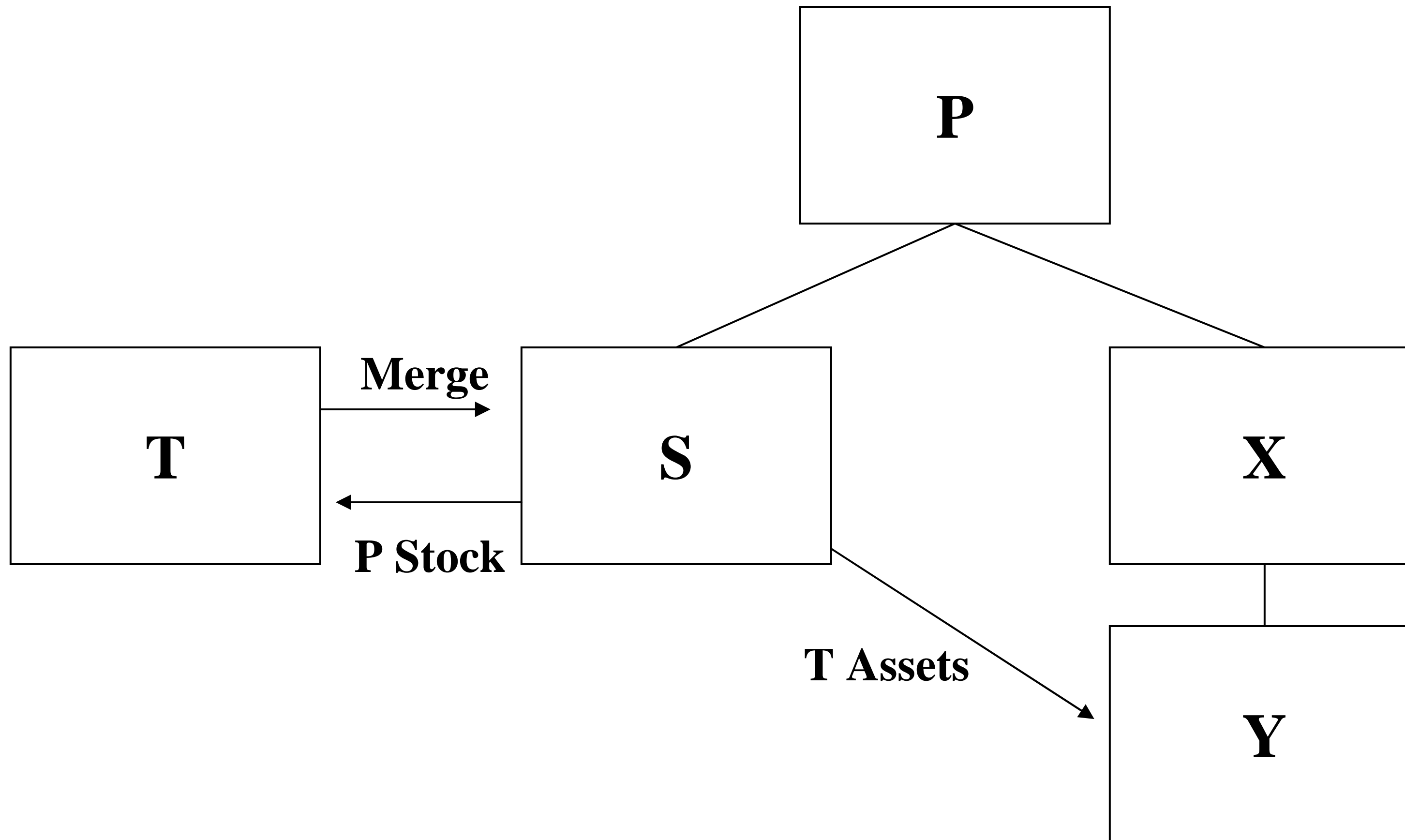
Reg. §§ 1.1001-1(a), (g)(2), 1.1001-1(a), 1.1012-1(g), 1.1274-2(g), 1.274-5(a), 1.1275-4(c), 1.338-4(b)(1)(ii), (d)(2), 1.338-5(b)(2)(ii), (b)(2)(iii) *Example 2*, 1.338-7, 15a.453-1(d)(2)(iii), 1.461-1(a)(2), (a)(5), (g)(1)(ii)(c)

TAM 9125001 (December 24, 1990), *modifying* TAM 8741001 (June 16, 1987)

TAM 9721002 (January 24, 1997)

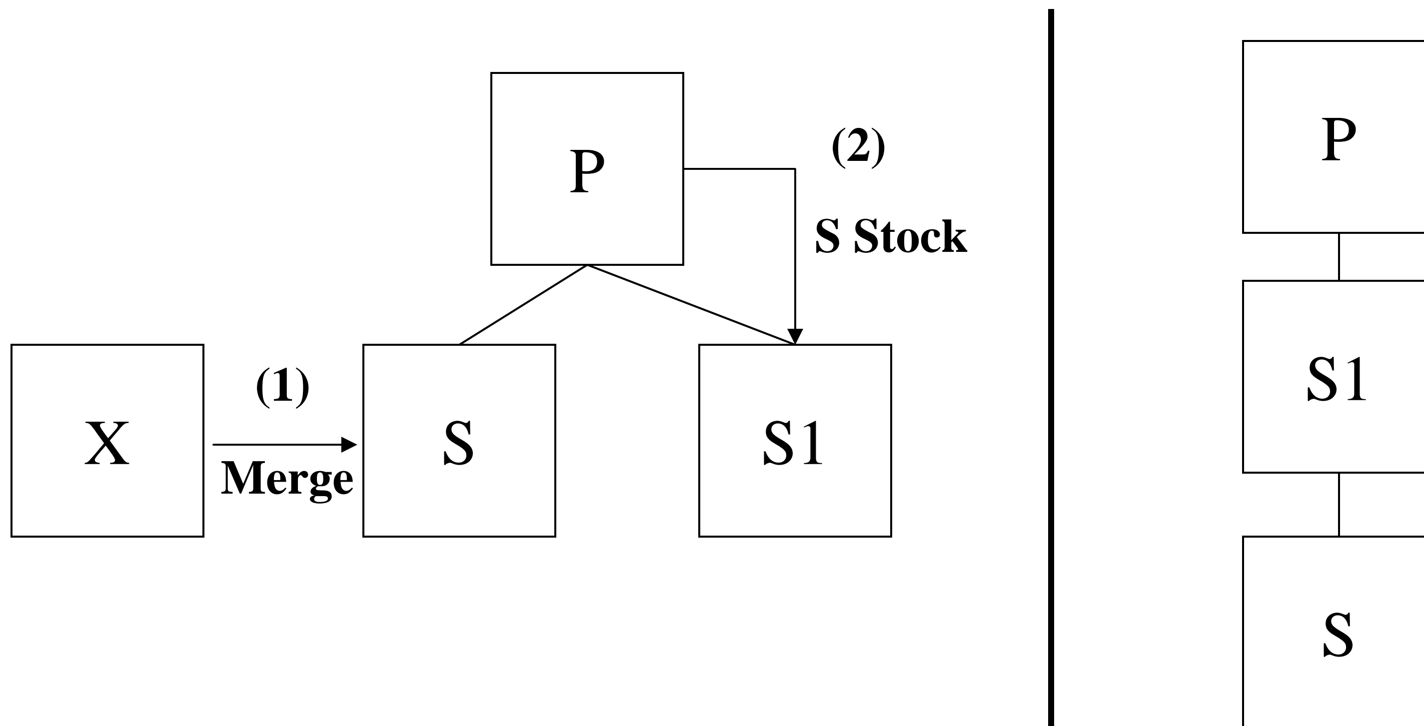
Illinois Tool Works, Inc. v. Commissioner, 117 T.C. 139 (2001)

Example 13(a): Cross-Chain Transfers: COBE vs. Step Transaction



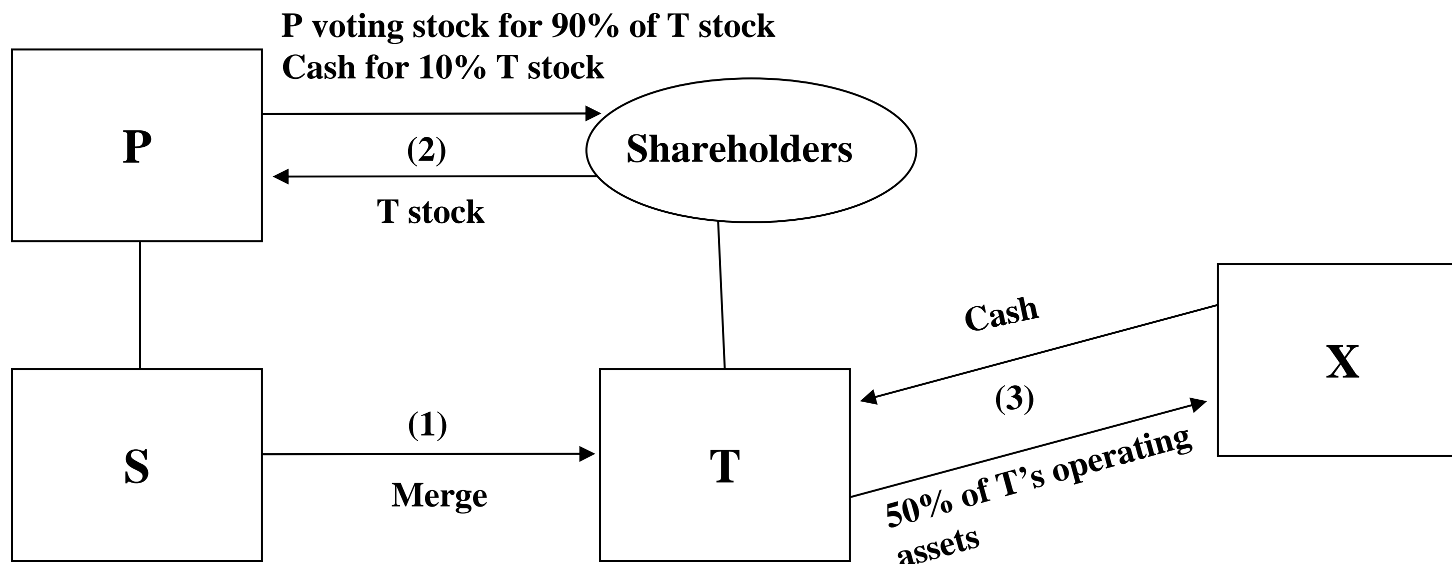
Facts: P owns 100% of the stock of S and X. X owns 100% of the stock of Y. T, an unrelated corporation, merges into S, with the T shareholders receiving P stock for their T stock. Immediately thereafter, S transfers the T assets to Y.

Example 13(b): Rev. Rul. 2001-24



Facts: Pursuant to a plan of reorganization, X merges into S, P's newly formed wholly owned subsidiary, in a transaction that is intended to qualify as a reorganization under Sections 368(a)(1)(A) and 368(a)(2)(D). S continues the historic business of X. As part of the reorganization plan, P then transfers the S stock to S1, P's pre-existing wholly owned subsidiary. Without regard to P's transfer of the S stock to S1, X's merger into S qualifies as a reorganization under Sections 368(a)(1)(A) and 368(a)(2)(D).

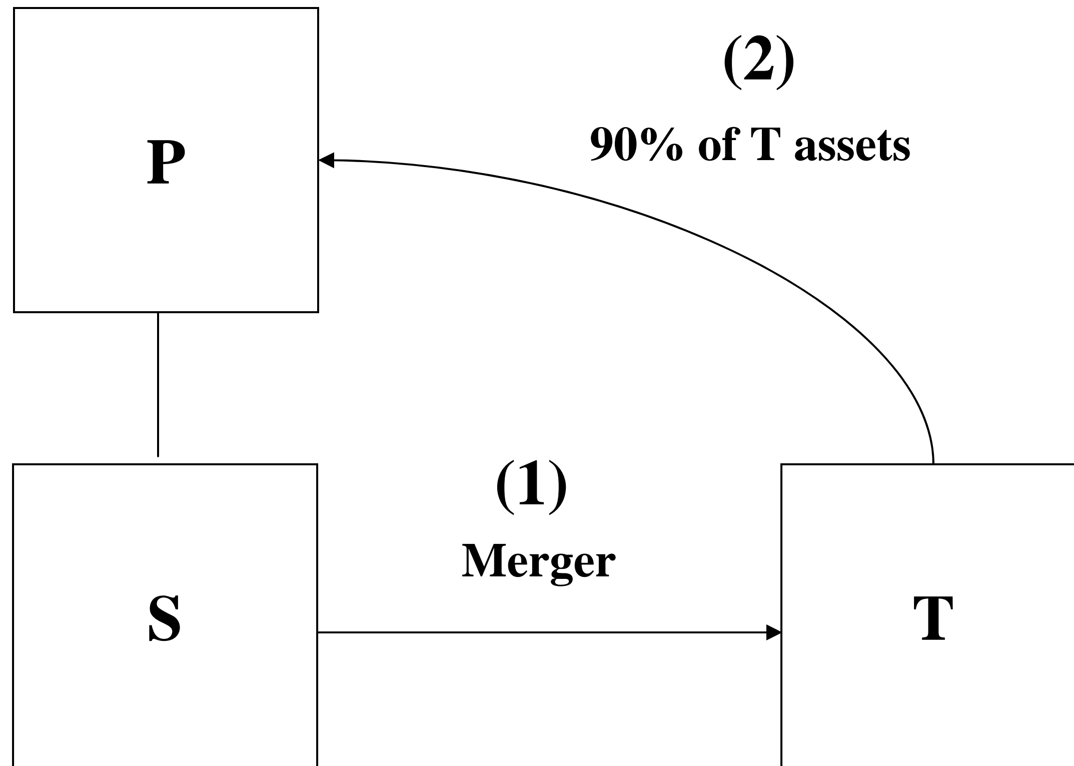
Example 14(a): Rev. Rul. 2001-25



Facts: P and T are manufacturing corporations organized under the laws of state A. S, P's newly formed wholly owned subsidiary, merges into T in a statutory merger under the laws of state A. In the merger, P exchanges its voting stock for 90% of the T stock, and tenders cash for the remaining 10% of T stock. As part of the merger plan, T sells 50% of its operating assets to X, an unrelated corporation, for cash. T retains the sales proceeds. Without regard to the requirement that T hold substantially all of the assets of T and S, the merger satisfies all the other requirements applicable to reorganizations under Sections 368(a)(1)(A) and 368(a)(2)(E).

Variation: What if T uses the cash it received for 50% of its assets to pay down its own debt?

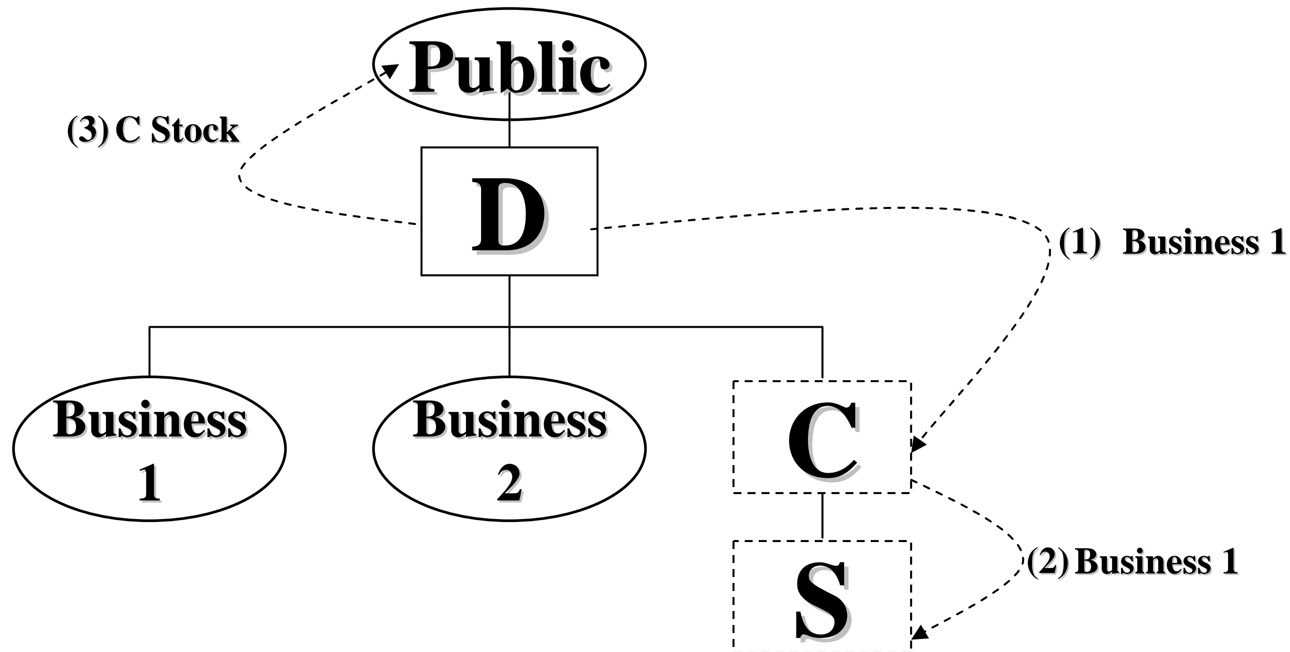
Example 14(b): Variation on Rev. Rul. 2001-25



Facts: The same facts as in Example 6(a) except that immediately after S merges into T, T distributes to P 90% of its assets.

Question: What are the Federal income tax consequences of T's distribution of 90% of its assets to P?

Example 15(a): Double Asset Drop and Spin-off



Publicly-traded D owns Business 1 and Business 2. D wishes to separate the businesses to improve their "fit and focus." For business reasons, Business 1 is to be operated in a subsidiary of a holding company.

(1) D forms C, and C forms S.

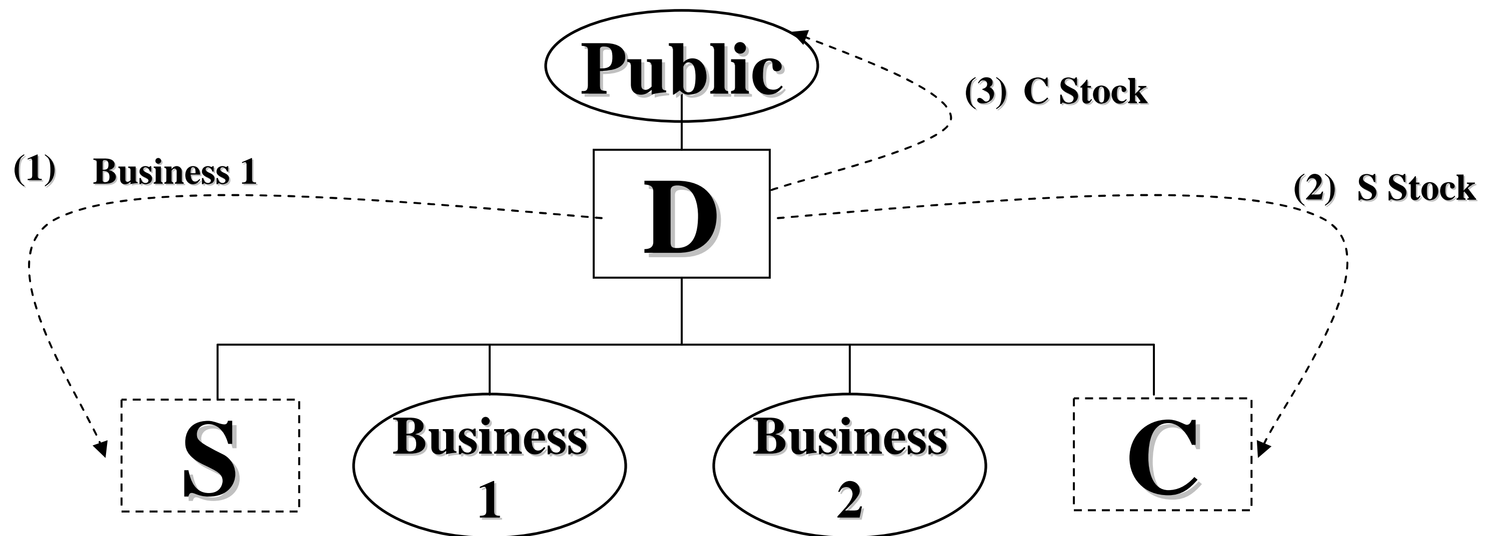
(2) D transfers Business 2 to C in exchange for all the stock of C.

(3) C transfers Business 2 to S in exchange for all the stock of S.

(4) D distributes all the stock of C to the D shareholders, *pro rata*.

Code sections 368(a)(1)(D) and 368(a)(2)(C); Reg. § § 1.368-2(k), 1.1502-34; Rev. Rul. 2002-85, 2002-52 I.R.B. 986; Rev. Rul. 77-449, 1977-1 C.B. 110

Example 15(b): Double Stock Drop and Spin-off



Publicly-traded D owns Business 1 and Business 2. D wishes to separate the businesses to improve their "fit and focus." For business reasons, Business 1 is to be operated in a subsidiary of a holding company. The separation is accomplished as follows:

(1) D forms C and S.

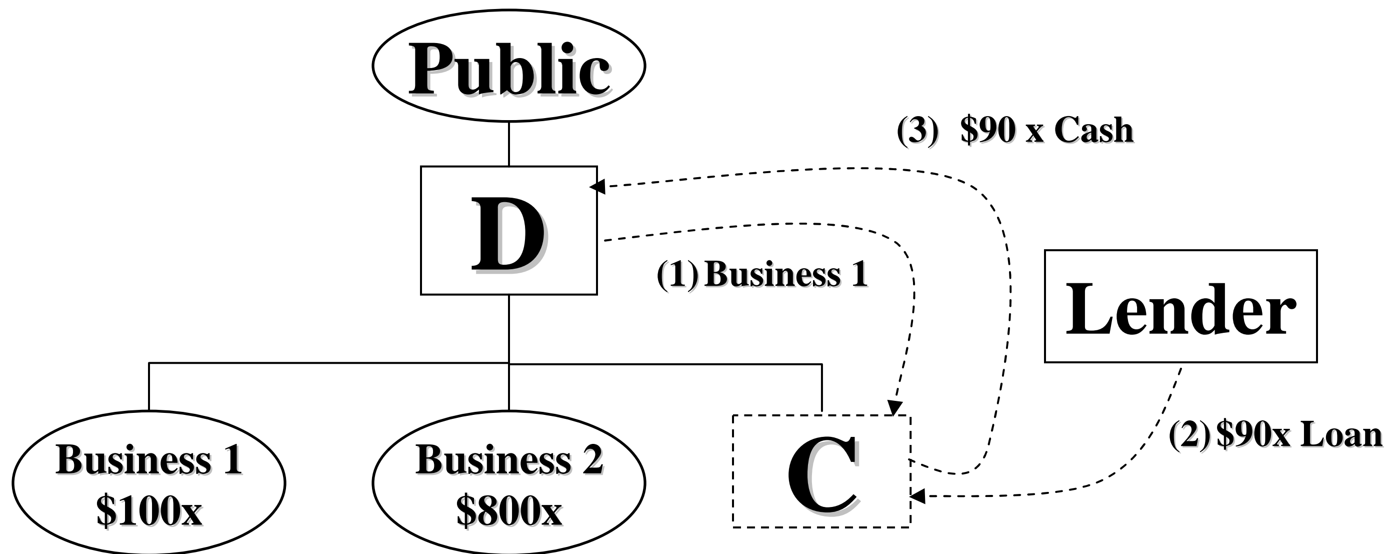
(2) D transfers Business 1 to S in exchange for all the stock of S.

(3) D transfers all the stock of S to C in exchange for all the stock of C.

(4) D distributes all the stock of C to the D shareholders, *pro rata*.

Code sections 368(a)(1)(D) and 368(a)(2)(C); Reg. § 1.368-2(k); Rev. Rul. 2003-51, 2003-21 I.R.B. 938; Rev. Rul. 2002-85, 2002-52 I.R.B. 986

Example 15(c): Spin-Off and Stock Redemption



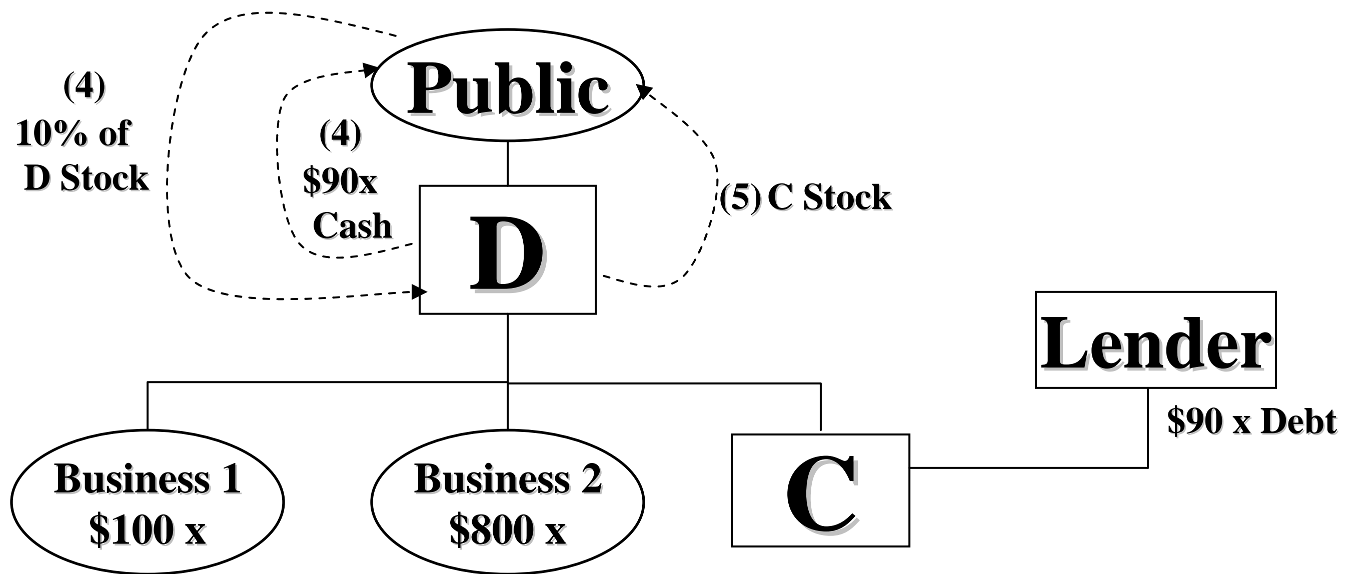
Publicly-traded D owns Business 1 (value, $100x) and Business 2 (value, $800x).

(1) D forms C and transfers Business 1 to C.

(2) C borrows $90x cash from Lender.

(3) C distributes $90x cash to D.

Example 15(c): Spin-Off and Stock Redemption

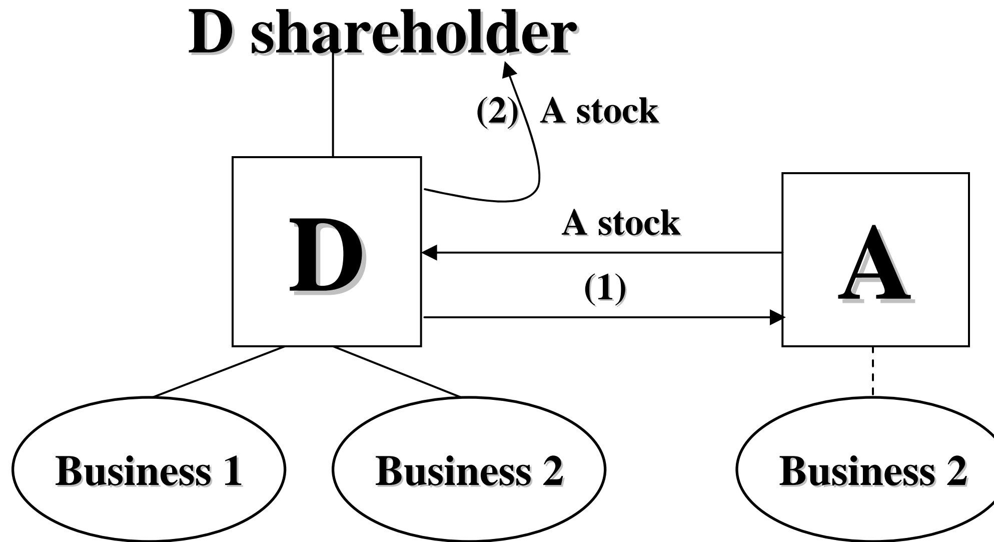


(4) D repurchases 10% of its stock in the market for $90x cash.

(5) D distributes all the C stock to its remaining shareholders, pro rata.

Code section 361(b)(1)(A); Rev. Proc. 96-30, 1996-1 C.B. 696, Section 4.05(1)(B); PLR 200252058 (Sept. 6, 2002).

Example 15(d): Asset Transfer Treated Under §355



- **Stock distributions are not required under §355 where the transaction, in substance, is equivalent to a §355 distribution. Rev. Rul. 57-311, 1957-2 C.B. 243, *cf.* Rev. Rul. 77-191, 1977-1 C.B. 94.**
- **No requirement for Controlled to survive at completion of transaction. Rev. Rul. 2003-79, 2003-29 I.R.B. 1.**
- **Rev. Rul. 2000-5 not undermined as it polices the transaction as qualifying only as a divisive reorganization.**