

PRACTISING LAW INSTITUTE
TAX STRATEGIES FOR CORPORATE ACQUISITIONS,
DISPOSITIONS, SPIN-OFFS, JOINT VENTURES,
FINANCINGS, REORGANIZATIONS AND
RESTRUCTURINGS 2014

Corporate Divisions Under Section 355

June 2014

By

Mark J. Silverman
Step toe & Johnson LLP
Washington, D.C.

TABLE OF CONTENTS

Internal Revenue Service Circular 230 Disclosure: As provided for in IRS regulations, advice (if any) relating to federal taxes that is contained in this document (including attachments) is not intended or written to be used, and cannot be used, for the purpose of (1) avoiding penalties under the Internal Revenue Code or (2) promoting, marketing or recommending to another party any plan or arrangement addressed herein.

	Page
I. INTRODUCTION	1
A. In General.....	1
B. Historic Focus	1
C. Current Importance	1
D. Future of Section 355 -- Subchapter C Study	3
E. Significant Developments.....	4
II. SECTION 355 -- OVERVIEW.....	6
A. Tax-Free Division.....	6
1. Types of tax-free divisions.....	6
2. Division of one or more businesses -- “D” reorganization.....	7
B. Tax Consequences of a Section 355 Transaction	7
1. No shareholder-level gain.....	7
2. No corporate-level gain.....	7
3. Gain on the distribution of boot.....	7
4. Gain or Loss on Divisive “D” Reorganization	10
5. Basis of stock and securities	12
6. Tax attributes	12
III. REQUIREMENTS UNDER SECTION 355	13
A. In General.....	13
1. Statutory requirements	13

	Page
2. Non-statutory requirements	14
3. Interrelationship between requirements	14
B. Control Requirement.....	14
1. In general	14
2. Definition of control	15
3. Control in a “D” reorganization.....	18
4. Control and application of the step-transaction doctrine	19
C. Device Restriction.....	45
1. In general	45
2. Evidence of a device	46
3. Evidence of nondevice.....	52
4. Transactions not ordinarily considered a device.....	53
5. Additional factors not contained in the regulations	54
D. Five-Year Active Trade or Business Requirement	54
1. In general	54
2. Statutory requirements for an active trade or business -- Generally.....	55
3. Trade or business	58
4. Active conduct	60
5. Percentage of total assets that must be related to the active business	63
6. Five-year period	68
7. Acquisition of a trade or business, or of control of a corporation conducting a trade or business, in a transaction without any gain or loss	75
8. Division of a functionally integrated business.....	82
9. Direct vs. indirect conduct of a business	84

	Page
E. Distribution of All or Substantial Ownership in the Controlled Corporation	97
F. Hot Stock Rule	98
1. In general	98
2. Coordination with the SAG Rules	99
3. Definition of Taxable Transaction	101
G. Business Purpose Requirement	106
1. In general	106
2. Corporate vs. shareholder purpose	109
3. Business purpose for the distribution	111
4. Relation to device test	111
5. Ruling guidelines	114
6. Specific business purposes	118
H. The Continuity of Interest Requirement	157
1. In general	157
2. Degree of continuity	159
3. Post-distribution continuity	159
4. Pre-distribution continuity (i.e. historic continuity)	164
5. Continuity in both Distributing and Controlled	166
6. Continuity issues arising from the division of a subsidiary as part of a “D” reorganization	167
I. Continuity of Business Enterprise Requirement	168
J. Section 355(d) Issues	169
1. In general	169
2. Disqualified distributions	171

	Page
3. Disqualified stock	172
4. Stock acquired by purchase	174
5. Fifty-percent test	182
6. Purpose exception	185
K. Section 355(e) and (f)	188
1. Section 355 In General.....	188
2. Plan regulations under section 355(e).....	198
3. Proposed Section 355(e)(4)(D) Regulations Defining Predecessor and Successor.....	226
4. Intragroup Spin-offs – Section 355(f).....	234
5. Examples.....	235
IV. PLANNING TRANSACTIONS/ALTERNATIVES TO SPIN-OFFS.....	247
A. “Synthetic” Spin-Offs	247
B. Subsidiary Tracking Stock.....	249
C. Dividend Followed by Public Offering.....	250
D. Option to Purchase Corporate Assets	251
E. Transaction to Thwart Hostile Takeovers.....	251
V. REQUESTING A PRIVATE LETTER RULING UNDER SECTION 355	252
A. In General.....	252
B. Checklist	252
C. Request for Expedited Ruling.....	249
D. Change in Facts.....	253
VI. APPENDIX A	255

I. INTRODUCTION

- A. In General. Generally, corporate distributions of appreciated property are subject to tax on the amount by which the property's value exceeds the corporation's basis in the property. Under section 355 of the Internal Revenue Code of 1986, as amended (the "Code"), however, the distribution of stock of a subsidiary that is "controlled" by another corporation may not be subject to tax either at the corporate level or to the recipient shareholders, provided a number of requirements are met.
- B. Historic Focus
1. Traditionally, the focus under section 355 of the Code has been whether the transaction has been undertaken by the shareholders as a "device" in order to bail out earnings and profits at favorable capital gains rates.
 2. Even in the absence of a rate disparity, the device issue remains relevant. A dividend distribution is taxed currently while a section 355 transaction is tax free. Moreover, a dividend is generally fully taxed (without recovery of any basis) while a transaction structured under section 355 followed by a sale permits the selling shareholder to recover basis. Furthermore, section 355 enables a distributing corporation to avoid the impact of the repeal of the General Utilities doctrine by the Tax Reform Act of 1986 (the "1986 Act").
- C. Current Importance
1. The repeal of the General Utilities doctrine resulted in most distributions of appreciated property being subject to a corporate-level tax. Section 355 transactions are one of the few exceptions to this general rule. Accordingly, section 355 remains as one of the few valuable planning tools after the 1986 Act for avoiding the imposition of corporate-level tax on a distribution of stock of a subsidiary corporation.
 2. However, this planning tool has been severely limited by several subsequently enacted provisions.
 - a. Congress has given the Internal Revenue Service (the "Service") broad regulatory authority under section 337(d) of the Code to prevent the avoidance of the tax consequences of the General Utilities repeal; i.e., the imposition of a corporate-level tax upon the distribution of appreciated property. This regulatory authority may be used to thwart section 355 transactions structured to avoid the imposition of corporate-level tax.
 - b. In addition, section 355(d) imposes a corporate-level tax on section 355 distributions if, immediately after the distribution, a shareholder holds a 50% or greater interest in the distributing or

controlled corporation that is attributable to stock acquired by purchase within the preceding five-year period.

- c. Moreover, the Taxpayer Relief Act of 1997, Pub. L. No. 105-34 § 1012, 111 Stat. 788, 914-18 (1997) (“TRA 1997”), which added section 355(e) and (f), essentially eliminated tax-free “Morris Trust” transactions.
 - (1) Section 355(e) provides for a corporate-level tax on section 355 distributions that are part of a plan (or series of related transactions) pursuant to which one or more persons acquire directly or indirectly stock representing a 50% or greater interest in the distributing or any controlled corporation.
 - (2) Section 355(f) provides that section 355 will not apply to the distribution of stock from one member of an affiliated group to another member if such distribution is part of a plan described in section 355(e).
- d. TRA 1997 also granted the Service authority to provide adjustments (under section 358) to the adjusted basis of stock in the case of intragroup distributions to which section 355 applies, in order to appropriately reflect the proper treatment of such distributions.

3. Regulations

- a. The current regulations, which were issued in 1989 and modified the original 1955 regulations, do not directly address the repeal of the General Utilities doctrine and its impact on section 355. However, many of the modifications that were made reflect the impact of General Utilities repeal.
- b. These regulations appeared to shift the emphasis of section 355 from the device restriction to the business purpose requirement, substantially tightening the business purpose requirement. Moreover, the regulations clarified the continuity of interest test, and made certain changes in the device and active trade or business tests.
- c. The regulations do not, however, reflect the amendments to section 355 made by the Revenue Act of 1987 (the “1987 Act”) or the Technical and Miscellaneous Revenue Act of 1988 (the “1988 Technical Corrections Act”).
- d. Final regulations have been issued under section 355(d) and 355(e). The regulations under section 355(e) address the issue of

what constitutes a plan or series of related transactions. Additional regulations under section 355(e) and regulations under section 358 are expected in the future.

D. Future of Section 355 -- Subchapter C Study

There has been ongoing debate as to whether section 355 should be retained in light of the General Utilities repeal. This is a complex issue, the outcome of which depends upon the perceived policy goals of General Utilities repeal.

1. If General Utilities repeal stands for the proposition that assets should not be taken out of corporate solution without the imposition of a corporate-level tax, then section 355 arguably is inconsistent with this policy. Under this view, stock of a subsidiary would be treated as an asset for General Utilities purposes.
2. However, several arguments can be made that section 355 should be retained; i.e., that stock of a subsidiary should not be treated as an asset.
 - a. The first is that, in repealing the General Utilities doctrine, Congress only intended corporate income to be subject to two levels of tax.
 - (1) The presence of sections 338(h)(10) and 336(e) both indicate that three levels of tax were not intended.
 - (2) On the other hand, by disallowing losses arising from certain basis adjustments, Reg. § 1.1502-36 makes it clear that the taxpayer may not always avoid a third level of tax on the sale of the subsidiary's assets.
 - b. If an exception for section 355 is not retained, three levels of tax can be imposed; i.e., one to the distributing corporation upon the distribution of stock, one to the shareholders upon receipt of subsidiary stock, and one to the subsidiary when it sells its assets. A repeal of section 355 would thus be inconsistent with sections 338(h)(10) and 336(e).
 - c. In addition, the various restrictions contained in section 355 limit the potential for abuse. Abusive transactions falling within section 355 can be dealt with under section 337(d).
 - d. Further, in repealing the General Utilities doctrine, Congress gave no indication that it intended to disturb the policy underlying the tax-free treatment of reorganizations (i.e., to allow tax-free movement of assets in modified corporate forms). Thus, it would be anomalous to allow section 355 treatment where a "D" reorganization is involved, but not otherwise.

3. The issue turns, in part, on timing; i.e., whether a corporate-level tax should be imposed at the time of the distribution rather than on the subsequent sale of assets.
 - a. One can argue that section 355 allows an impermissible delay in taxation. Indeed, some view section 355 as a variation of the carryover basis scheme that was rejected by Congress in 1986.
 - b. Importantly, if the distribution is to be taxed, an inside basis step-up would be necessary to prevent three levels of tax. In effect, section 355 would be replaced by section 336(e).
4. However, immediate taxation would stifle valid, non-tax motivated corporate restructurings. To borrow from the section 382 arena, immediate taxation would not be tax neutral -- tax results would affect business decisions.

E. Significant Developments

In the past several years, there have been a number of significant developments under section 355. These developments have occurred in two areas:

1. First, the Service has initiated a significant examination and revision of the advance rulings process.
 - a. Since 1996, this effort has concentrated on improving the transparency and candor of the rulings process. In particular, the Service adopted a more flexible fact-based approach to the business purposes that it would entertain as valid reasons for a section 355 transaction. This additional flexibility came at the cost of more onerous substantiation requirements.
 - b. More recently, however, the Service has revisited its section 355 rulings process.
 - (1) In Rev. Proc. 2003-48, 2003-2 C.B. 86, the Service announced that it would no longer rule on inherently factual issues under section 355. Specifically, the Service would no longer rule as to whether a proposed or completed distribution of Controlled's stock is being carried out for one or more corporate business purposes, whether the transaction is used principally as a device, or whether a distribution and an acquisition are part of a plan under section 355(e). Instead, the Service planned to shift its resources to providing published guidance on legal questions involving these requirements. Although Rev. Proc. 2003-48 indicated that this was a pilot program, representatives of the Service have indicated informally

that unless it hears otherwise from taxpayers, it plans to continue this practice indefinitely.

- (2) Under Rev. Proc. 2014-1, 2014-1 I.R.B. 1, § 7.02(4), taxpayers may request expedited consideration of ruling requests under section 355. Rev. Proc. 2014-1 states that the Service will endeavor to complete and issue letter rulings on these transactions within ten weeks from receipt of the request. The Service implemented this expedited procedure in 2006 to encourage taxpayer participation the letter ruling program.
- (3) Rev. Proc. 2009-25, 2009-24 I.R.B. 1, describes a pilot program allowing taxpayers to request rulings on certain significant issues or on part of a transaction occurring in the context of a section 355 distribution. The relevant issue must be (1) within the jurisdiction of the Office of Associate Chief Counsel (Corporate); (2) “significant” (see § 3.01(39), Rev. Proc. 2013-3, 2013-1 I.R.B. 113); and (3) involve a transaction that occurs as part of a section 355 distribution.
 - a) Thus, for example, Distributing may obtain a ruling that an acquisition of a business contributed to Controlled was an expansion that did not violate section 355(b)(2)(C) without asking for a ruling on the entire spin-off.
 - b) In addition, if Distributing or Controlled engages in a section 351 transaction in the context of the section 355 distribution, Distributing could seek a ruling only on the section 351 transaction.
 - c) The Service stated that it was implementing the single-issue letter ruling process to utilize resources more efficiently and to increase the availability of private letter rulings.
 - d) This pilot program was discontinued by Rev. Proc. 2013-32, 2013-28 I.R.B. 55.
- (4) Rev. Proc. 2013-32, 2013-28 I.R.B. 55 provides that the IRS will no longer rule on whether transactions generally qualify for tax-free treatment under section 355, but will instead rule only on significant issues presented therein.

2. Second, the government has been grappling with the application of the step-transaction doctrine to multi-step transactions that include section 355

distributions. In part, this reflects a general sense on the part of the Service that section 355 transactions are incompatible with General Utilities repeal and a desire to limit the use of such transactions. It also reflects a more general re-examination of the step-transaction doctrine in the context of corporate reorganizations. The government has issued a number of significant published and private rulings involving multi-step transactions that include section 355 distributions, and legislation has also affected this area.

- a. In Rev. Proc. 2013-3, 2013-1 I.R.B. 113, the IRS has stated that it will no longer issue ruling requests involving three specific areas that implicate the step-transaction doctrine. It will not rule on whether transfers of contributions to a corporation and a later distribution from the corporation will be respected as separate transactions. It will not rule when there is recapitalization for control through a two-tier (high vote/ low-vote) voting structure, followed by a spinoff. It will also not rule on leveraged spinoffs where a distribution is in exchange for, and in retirement of, any debt of the distributing corporation, if the debt is issued in anticipation of the distribution.

II. SECTION 355 -- OVERVIEW

A. Tax-Free Division

Section 355 permits the separation of two or more existing businesses formerly operated, directly or indirectly, by a single corporation (“distributing corporation” or “Distributing”) without the recognition of gain or loss by the shareholders or security holders of Distributing.

1. Types of tax-free divisions

A section 355 transaction can be structured in one of three ways; i.e., as a spin-off, a split-off, or a split-up.

a. Spin-off

A spin-off is the pro rata distribution of the stock of a corporation that is controlled by Distributing (“controlled corporation” or “Controlled”). In a spin-off, the shareholders of Distributing do not surrender any stock.

b. Split-off

A split-off is the distribution of the stock of Controlled (generally to some but not all of the shareholders). In a split-off, the recipient shareholders of Distributing surrender stock of that corporation.

c. Split-up

A split-up is the distribution of the stock of two or more controlled corporations in complete liquidation of Distributing.

2. Division of one or more businesses -- “D” reorganization

In a divisive “D” reorganization, part of the assets of Distributing that constitute a business are transferred to Controlled (often, but not necessarily, newly formed). The stock of Controlled is then distributed to the shareholders of Distributing in a section 355 transaction. Section 368(a)(1)(D).

B. Tax Consequences of a Section 355 Transaction

1. No shareholder-level gain

A distribution qualifying under section 355 will not result in the imposition of tax at the shareholder level. Section 355(a)(1).

2. No corporate-level gain

A distribution qualifying under section 355 will also not result in the imposition of any corporate-level tax, unless section 355(d), (e), or (f) applies. Section 355(c)(1).

3. Gain on the distribution of boot

Boot distributed as part of a section 355 transaction will, however, be subject to both corporate- and shareholder-level tax. Section 355(c)(2).

a. If Distributing distributes any property other than stock or securities in Controlled as part of the distribution, the distribution is taxable to the distributee receiving such property under section 356, and any appreciation in this other property is taxable to Distributing under section 355(c). See Reg. § 1.355-2(a).

b. In Rev. Rul. 93-62, 1993-2 C.B. 118, the Service addressed the issue of when the distribution of boot in a section 355 transaction “has the effect of a distribution of a dividend” under section 356(a)(2).

(1) The Service concluded that boot should be treated as if received in a hypothetical redemption of stock prior to the section 355 transaction.

- a) This differs from the treatment of boot in an acquisitive reorganization under Commissioner v. Clark, 489 U.S. 726 (1989), where the hypothetical redemption is deemed to occur after the reorganization.
 - b) The Service noted that the rationale of Clark is to compare the shareholder's percentage ownership in the assets of the corporation following the reorganization with the percentage ownership that would have resulted if no boot had been received in the transaction. In an acquisitive reorganization, this requires comparing the stock owned in the acquiring corporation with the stock that would have been owned had no boot been received; in a divisive reorganization, this requires comparing the total stock owned in both Distributing and Controlled after the transaction with the stock that would have been owned had no boot been received.
 - c) Nonetheless, the Service noted that its conclusion was not inconsistent with Clark, because whether the distribution has the effect of a dividend is based on an analysis of the entire transaction.
- (2) Whether the hypothetical redemption is equivalent to a dividend is determined under the principles of section 302.
- a) This determination is made by comparing the recipient shareholder's interest in Distributing before the exchange with the interest the shareholder would have retained if he had surrendered only the Distributing shares equal to the value of the boot.
 - b) Thus, for example, if A owns 400 of the 1,000 Distributing shares outstanding, and A receives stock of Controlled worth \$200 and \$200 cash in the distribution, A would be treated as holding 400 shares before the deemed section 302 redemption and 200 shares after.
- c. The Service has concluded that stock purchase rights that are attached to the stock of Controlled distributed does not constitute the distribution of stock or boot by Distributing. See, e.g., P.L.R. 200137042 (June 20, 2001); P.L.R. 200131024 (May 8, 2001); P.L.R. 199919025 (Feb. 12, 1999); P.L.R. 9749018 (Sept. 11,

1997); P.L.R. 9610034 (Dec. 15, 1995); P.L.R. 9422057 (Mar. 11, 1994); P.L.R. 9245019 (Aug. 7, 1992).

- (1) Stock purchase rights entitle the holder to purchase additional stock of the corporation upon the occurrence of certain triggering events (usually involving changes in corporate control).
 - (2) Such stock purchase rights generally must satisfy the requirements of Rev. Rul. 90-11, 1990-1 C.B. 10; i.e., they must remain contingent, non-exercisable, and subject to redemption if issued.
- d. Under TRA 1997, “nonqualified preferred stock” will be treated as boot for purposes of sections 351, 354, 355, 356, and 368. See, e.g., section 355(a)(3)(D).
- (1) Nonqualified preferred stock is defined in section 351(g) as preferred stock for which (1) the holder has the right to require the issuer to redeem or purchase the stock, (2) the issuer is required to redeem or purchase the stock, (3) the issuer has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part with reference to interest rates, commodity prices, or other similar indices.
 - (2) The first three rules above do not apply if (1) the right cannot be exercised within 20 years of the date the right is issued or is subject to a contingency that makes the likelihood of redemption or purchase remote, (2) the right may be exercised only upon the death, disability, or mental incompetency of the holder, or (3) the right to redeem or purchase is in connection with the performance of services for the issuer and may be exercised only upon the holder’s separation from service.
- e. Excess principal amount of securities may constitute boot. Section 355(a)(1) (providing for nonrecognition to the shareholder or security holder) does not apply if the principal amount of Controlled securities received exceed the principal amount of Controlled securities surrendered, or if Controlled securities are received and none are surrendered. Section 355(a)(3)(A).
- f. Payment of accrued interest on Distributing’s securities with stock or securities of Controlled is considered to be a transaction independent from the section 355 transaction. Such payment is not

considered to be part of the section 355 distribution, nor is it considered to be boot. Section 355(a)(3)(C).

- (1) A step-transaction analysis should be applied to determine whether the distribution of stock of Controlled accomplished by a series of steps should be treated as part of the same transaction. See Commissioner v. Gordon, 391 U.S. 83 (1968).

4. Gain or Loss on Divisive “D” Reorganization

- a. If the distribution is preceded by a transfer of assets by Distributing to Controlled in exchange for Controlled stock in a divisive “D” reorganization:
 - (1) Distributing recognizes no gain or loss on the transfer. Section 361(a).
 - (2) Controlled takes a basis in the assets equal to the basis that Distributing had in them. Section 362(b).
- b. If Distributing receives boot from Controlled in the exchange, then gain will be recognized to the extent of the boot received. Section 361(b)(1)(B).
 - (1) However, Distributing will not recognize gain if it distributes the boot to its shareholders. Section 361(b)(1)(A).
 - a) As an alternative to straight cash distributions, Distributing may use the boot to fund stock repurchases. See, e.g., P.L.R. 200841020 (July 8, 2008); P.L.R. 200803012 (Oct. 17, 2007); P.L.R. 200725016 (Mar. 20, 2007).
 - (2) Similarly, Distributing will not recognize gain if it transfers the boot to its creditors. Section 361(b)(3).
 - a) This exception applies only to the extent that the boot transferred to the creditors does not exceed the adjusted bases of the assets transferred by Distributing to Controlled (reduced by any liabilities assumed). Section 361(b)(3).
 - b) In order to ensure that the boot is used to pay creditors, Distributing may:

- i) Deposit cash boot in a segregated account or entity, which is used to repay existing indebtedness. See, e.g., P.L.R. 200944026 (June 29, 2009); P.L.R. 200701010 (Sept. 1, 2006); P.L.R. 200629007 (Apr. 21, 2006); P.L.R. 200716024 (Dec. 22, 2005).
 - ii) Exchange boot in the form of Controlled securities for existing Distributing debt, either directly with creditors or with an investment banker that acquired such debt in the secondary market. See, e.g., P.L.R. 201216023 (Jan. 19, 2012); P.L.R. 200839024 (Jun. 20, 2008); P.L.R. 200802009 (Oct. 5, 2007); P.L.R. 200732002 (May 11, 2007).
 - iii) Use the boot to satisfy intercompany indebtedness. Note that there is often a representation that the intercompany creditor will use the boot to repay outside debt. See, e.g., P.L.R. 200832001 (Apr. 30, 2008); P.L.R. 200802009 (Oct. 5, 2007); P.L.R. 200634005 (May 25, 2006).
- (3) Distributing may represent in the alternative that it will distribute the boot either to shareholders or to creditors for ruling purposes. See, e.g., P.L.R. 20111003 (Dec. 15, 2010) (involving the same transaction as in P.L.R. 200843011 (July 9, 2008), in which a similar representation was made); P.L.R. 200826032 (Mar. 21, 2008).
- c. Currently, Distributing may receive Controlled securities and use those securities to retire debt (typically through an investment banker). See, e.g., P.L.R. 200702033 (Sept. 25, 2006); P.L.R. 200701010 (Sept. 1, 2006); P.L.R. 200629001 (Apr. 7, 2006); P.L.R. 200624001 (July 20, 2005); P.L.R. 200310005 (Nov. 21, 2003). However, there have been legislative proposals to treat distributions of Controlled securities in the same manner as a distribution of boot—i.e., to permit a tax-free transfer of such securities to Distributing’s creditors but only to the extent of the basis of the assets transferred to Controlled. E.g., S. 1813 (112th Cong.), § 40307.

5. Basis of stock and securities

- a. The basis of the stock and securities received in a section 355 transaction is determined with reference to the recipient's basis in the stock and securities of Distributing. See section 358(a)(1); 358(b)(2). But see section 358(g) (authorizing the Service to provide adjustments to the stock basis of members in connection with intragroup distributions).
- b. The recipient's aggregate basis in the stock and securities of Distributing, before the distribution, is allocated based on relative fair market values between the stock and securities retained in Distributing and the stock and securities received in Controlled. Section 358(b)(2).

6. Tax attributes

a. Divisive "D" reorganization

- (1) In a divisive "D" reorganization, the tax attributes of Distributing, except for that corporation's earnings and profits, will remain with Distributing. See section 381(a).
- (2) Distributing's earnings and profits will be allocated between Distributing and Controlled in proportion to the value of the retained and transferred assets. Reg. § 1.312-10(a).

b. Spin-off or split-off

- (1) If a section 355 transaction is a spin-off or a split-off, the regulations provide that the earnings and profits of Distributing are decreased by the lesser of (1) the amount of the adjustment that would have been made to the earnings and profits of Distributing if it had transferred the stock of Controlled to a new subsidiary in a divisive "D" reorganization, or (2) the net worth of Controlled. Reg. § 1.312-10(b).
- (2) The remaining tax attributes of Distributing and the tax attributes of Controlled are generally unaffected. However, in a non-pro rata split-off, section 382 may limit the carryover of Distributing or Controlled's losses.

c. Split-up

If the section 355 transaction is a split-up, the tax attributes of

Distributing disappear. The tax attributes of Controlled are not affected.

III. REQUIREMENTS UNDER SECTION 355

A. In General

1. Statutory requirements

In order for section 355 to be applicable to the distribution of Controlled's stock, each of the following statutory requirements must be satisfied.

a. Control

Distributing must be in control of Controlled immediately before the distribution.

b. Device restriction

The transaction must not be principally a device for the distribution of earnings and profits.

c. Active trade or business requirement

(1) With respect to spin-offs and split-offs, immediately after the distribution, Distributing and Controlled must each be engaged in the active conduct of a trade or business.

(2) With respect to split-ups, immediately before the distribution, Distributing cannot hold any assets other than stock or securities in controlled corporations, and immediately after the distribution, each of controlled corporations must be engaged in the active conduct of a trade or business.

d. Distribution of all or substantial ownership in the controlled corporation

Distributing must distribute either all of the stock and securities held by it immediately before the distribution, or it must distribute an amount of stock in Controlled constituting control and establish to the satisfaction of the Service that the retention of stock or securities in Controlled did not have the principal purpose of avoiding federal income tax.

e. Restrictions

Sections 355(b)(2)(D), 355(d), 355(e), and 355(f) impose further

requirements as to the holding of stock in Distributing and Controlled, which must be met if the distribution is to be free of tax at the corporate level.

2. Non-statutory requirements

In addition to the statutory requirements described above, each of the following non-statutory requirements must be satisfied in order for section 355 to apply to the distribution of Controlled's stock.

a. Business purpose

The transaction must have a corporate business purpose.

b. Continuity of interest

The pre-distribution owners of Distributing and Controlled must maintain a continuing interest in those corporations after the distribution.

c. Continuity of business enterprise

The regulations under section 355 appear to impose a continuity of business enterprise requirement on section 355 transactions.

3. Interrelationship between requirements

Each of the above noted requirements must be separately satisfied. However, there is significant overlap among these requirements which, as will be seen, often makes it difficult to ascertain whether the distribution qualifies for tax-free treatment.

B. Control Requirement

1. In general

a. In order for section 355 to apply to the distribution of a corporation's stock, Distributing must be in control of Controlled immediately before the distribution. Section 355(a)(1)(A). In addition, Distributing must distribute all of its stock and securities in Controlled or an amount that constitutes control. Section 355(a)(1)(D).

b. If a spin-off involves a threshold "D" reorganization, it is also necessary that either Distributing or its shareholders control Controlled "immediately after the transfer." Section 368(a)(1)(D).

2. Definition of control

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

(1) The key factor in determining voting control is the ability to elect directors. See Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 3.07[2] (7th ed. 2000); Hermes Consol., Inc. v. United States, 14 Cl. Ct. 398 (1988); Rev. Rul. 69-126, 1969-1 C.B. 218; see also Official Summary of P.L.R. 9802048 (July 11, 1997), 2000 TNT 250-56 (rejecting dicta in Hermes regarding the power to approve or disapprove fundamental changes in corporate structure and confirming that the power to elect directors is the key factor).

a) In certain circumstances, however, a court may look beyond the power to elect directors. See, e.g., Framatone Connectors USA, Inc. v. Commissioner, 118 T.C. 32 (2002) (stating in dicta that supermajority and unanimous approval requirements for certain corporate actions prevented the corporation from being a controlled foreign corporation); Alumax v. Commissioner 109 T.C. 133 (1997), aff'd, 165 F.3d 822 (11th Cir. 1999) (involving disproportionate voting rights as a result of certain class vote and veto provisions); Hermes, 14 Cl. Ct. at 405 (stating in dicta that the power to approve or disapprove fundamental changes in the corporate structure may be relevant in determining voting power of minority shareholders).

b) It may also be possible to give away a certain amount of voting control through a proxy agreement and still maintain control for purposes of section 355. For example, in P.L.R. 201005022 (Oct. 28, 2009), the stock of Controlled was subject to a proxy agreement in order to insulate it from any foreign control or influence that might arise from Foreign Parent's indirect ownership and maintain Controlled's security clearance. Distributing retained approval rights for major corporate actions and was entitled to receive cash dividends. The

Service ruled that Distributing possessed the requisite control.

- (2) Note that a nondivisive “D” reorganization must satisfy a different control requirement. Section 368(a)(2)(H) adopts the 50% vote or value test set forth in section 304(c).
 - (3) Other areas of the Code adopt different control definitions; e.g., sections 332, 338, 382, and 1504 use an 80% vote and 80% value requirement. Thus, for example, a public offering of stock by Controlled could result in a situation where Controlled is deconsolidated but nonetheless satisfies the control requirement of section 355. See P.L.R. 200243049 (Aug. 1, 2002); P.L.R. 200103037 (Oct. 20, 2000).
- b. It is not necessary that Distributing’s control of Controlled be “historic control.” Steps may be undertaken prior to the section 355 transaction in order to satisfy the control requirement.
- (1) A recapitalization of Controlled prior to its distribution by Distributing, which results in the control requirement being satisfied, will be respected as long as the recapitalization results in a permanent realignment of control. Rev. Rul. 69-407, 1969-2 C.B. 50; see also P.L.R. 200815020 (Dec. 27, 2007); P.L.R. 200411033 (Dec. 11, 2003); P.L.R. 200135039 (May 24, 2001); P.L.R. 200048030 (Aug. 30, 2000); P.L.R. 200007005 (Nov. 1, 1999); P.L.R. 199951014 (Sept. 22, 1999); P.L.R. 199935031 (June 2, 1999); P.L.R. 9836019 (June 8, 1998); P.L.R. 9547049 (June 2, 1995); P.L.R. 9544003 (Nov. 21, 1994); P.L.R. 9409043 (Dec. 9, 1993); P.L.R. 8744035 (Aug. 4, 1987).
 - a) The Service will generally require that the taxpayer represent that the recapitalization will not be undone. See Official Summary of P.L.R. 9644028 (July 31, 1998), 1999 TNT 182-39.
 - b) Nonetheless, the Service may permit a reversal of a recapitalization if the taxpayer can show that such a reversal is necessitated by unexpected events occurring after the distribution. See P.L.R. 200527004; P.L.R. 200403041 (Oct. 8, 2003); P.L.R. 200125083 (Mar. 27, 2001); P.L.R. 200118018 (Jan. 31, 2001); P.L.R. 200139011 (June 28, 2001); P.L.R. 200113019 (Dec. 27, 2000).

- c) The Service may also permit a reversal of a recapitalization if subsequent events, such as an increase in the value of Controlled, make the recapitalization no longer necessary. See P.L.R. 201007050 (Nov. 13, 2009).
 - d) The Service has also permitted Controlled to provide shareholders the right to vote, at any time after the two-year anniversary of the spin-off, to reverse the effect of the recapitalization. See P.L.R. 200408009 (Nov. 7, 2003).
 - e) In P.L.R. 200837027 (Mar. 14, 2008), the Service ruled that a distribution was tax-free under section 355 despite the fact that it was expected that, following the distribution of Controlled stock, Controlled's board of directors would consider a proposal to convert its high-vote stock into low-vote stock, subject to shareholder approval. The proposal would reverse the recapitalization of Controlled prior to its distribution by Distributing that had resulted in the control requirement being satisfied. See also P.L.R. 200841021 (Apr. 29, 2008).
 - i) Notably, the ruling did not require the dual-class voting structure to remain for any specified period of time, nor was the ruling conditional on a representation that there was no intent to change the structure. The separate shareholder approval was apparently sufficient to respect the recapitalization apart from the proposed stock conversion.
 - f) In Rev. Proc. 2013-3, the IRS has determined that it will not rule on whether a corporation is "controlled" in transactions that involve recapitalization or exchanges involving stock of differing voting power.
- (2) The merger of two sister corporations that jointly own stock in a subsidiary resulting in the surviving corporation having control of the subsidiary will be respected. Rev. Rul. 70-18, 1970-1 C.B. 74.

- (3) The transfer of assets for additional stock causing the transferor to be in control of the transferee will be respected. Rev. Rul. 71-593, 1971-2 C.B. 181. The Service, however, has declined to rule on whether the active business requirement has been satisfied if liquid or nonbusiness assets are transferred to obtain control. Rev. Proc. 2013-3, § 4.01(28), 2013-1 I.R.B. 113.
- (4) However, control may not be acquired in a taxable transaction, or it could violate section 355(b)(2)(D). For example, the redemption by Controlled of shareholders other than Distributing, giving Distributing control of C, violates section 355(b)(2)(D). See McLaulin v. Commissioner, 276 F.3d 1269 (11th Cir. 2001); Rev. Rul. 57-144, 1957-1 C.B. 123.

3. Control in a Divisive “D” reorganization

- a. As mentioned above, if a spin-off involves a threshold “D” reorganization, either Distributing or its shareholders must control Controlled “immediately after the transfer.” Section 368(a)(1)(D).
 - (1) Control is defined as ownership of stock possessing 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of each of the other classes of stock of that corporation. Section 368(c).
 - (2) Note: TRA 1997 initially lowered the control requirement for divisive “D” reorganizations from 80% to 50% of the vote and value of Controlled.
 - a) However, the Internal Revenue Service Restructuring and Reform Act of 1998 (the “1998 IRS Restructuring Act”) replaced the 50% control test enacted in TRA 1997 with a provision that states that if the requirements of section 355 are met, the fact that the shareholders of Distributing dispose of part or all of their Controlled stock will not be taken into account for purposes of determining whether the transaction qualifies under section 368(a)(1)(D). See Section 368(a)(2)(H)(ii).
 - b) The Tax and Trade Relief Extension Act of 1998 (the “1998 Extension Act”) contained a further technical correction of section 368(a)(2)(H)(ii), providing that the fact that Controlled issues

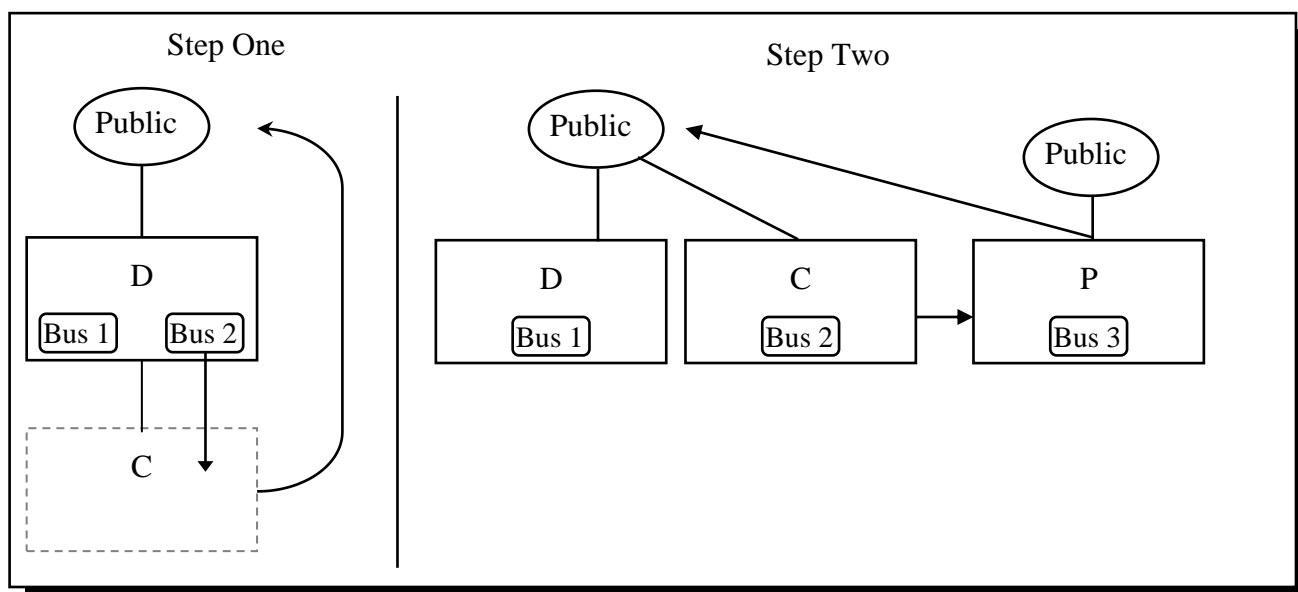
additional stock will not be taken into account for purposes of determining whether the transaction qualifies under section 368(a)(1)(D). See Section 368(a)(2)(H)(ii), as amended.

- c) Thus, the 80% control test in section 368(c) again applies to divisive section 368(a)(1)(D) transactions; although, as further discussed below, application of the step-transaction doctrine has been limited.

4. Control and application of the step-transaction doctrine

- a. Where events that could be viewed as part of the same overall transaction as the spin-off reduce the historic shareholders' ownership percentage in the spun-off corporation below 80%, the Service has historically applied step-transaction principles to reorder the steps so that the transaction fails the control test. However, because there is no requirement that shareholders control Distributing before or after a spin-off, the Service has only applied step-transaction principles in situations where Controlled, rather than Distributing, is acquired.

b. Example 1 -- Rev. Rul. 70-225



- (1) Facts: Public shareholders own all of the stock of Distributing. Distributing conducts two qualifying five-year businesses, Business 1 and Business 2. P, a public corporation, wants to acquire Business 2, but not Business 1. P is willing to issue 10% of its outstanding stock in exchange for Business 2. Distributing's shareholders are willing to dispose of Business 2 for P stock.

The parties agree on the following transaction: (i) Distributing will contribute Business 2 to a newly formed subsidiary, Controlled; (ii) Distributing will distribute the stock of Controlled to its shareholders pro rata; and (iii) Controlled will merge into P, and the Distributing shareholders will transfer their Distributing stock to P in exchange for P voting stock. Thus, the transaction is almost identical to the Morris Trust structure, except that the wanted assets are contributed to Controlled, and Controlled rather than Distributing merges into P.

- (2) Issues:

- a) Arguably, the separation of the wanted and unwanted assets to facilitate a merger should be a valid business purpose. Cf. Commissioner v. Mary Archer W. Morris Trust, 42 T.C. 779 (1964), aff'd 367 F.2d 794 (4th Cir. 1966), acq. Rev. Rul. 68-

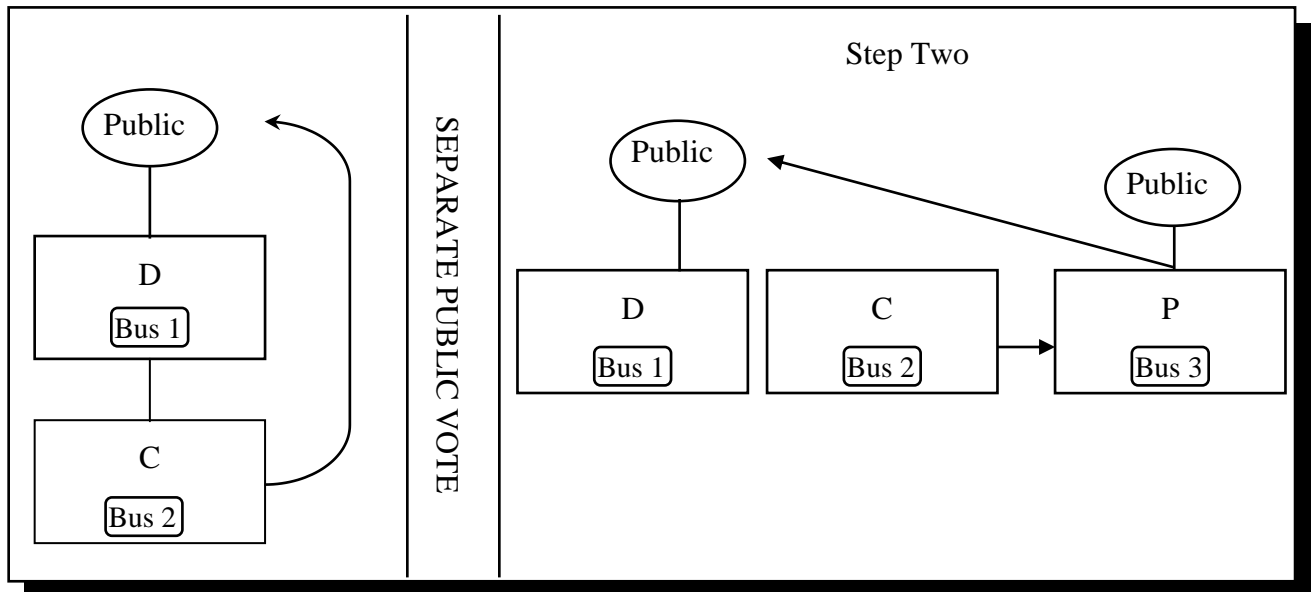
603, 1968-2 C.B. 148. But see Part III.J., infra, for an explanation of section 355(e), which imposes a corporate-level tax on Morris Trust transactions. There may be legitimate business reasons why the shareholders wish to merge Controlled and permit Distributing to survive as a legal entity. For example, there may be agreements or licenses in Distributing's name that are impossible or unduly expensive to assign or transfer to Controlled under state law. Moreover, the acquirer may be reluctant to assume all of Distributing's hidden liabilities. Therefore, a traditional Morris Trust structure may require unduly expensive due diligence or unduly stringent warranties and indemnities.

- b) Although, in substance, the transaction is virtually identical to a Morris Trust transaction, in Rev. Rul. 70-225, 1970-1 C.B. 80, the Service ruled that this transaction did not qualify as a tax-free distribution. The Service reasoned that a pre-arranged disposition of Controlled stock as part of the same plan as the distribution prevented the transaction from satisfying the requirement in section 368(a)(1)(D) that Distributing's shareholders be in "control" of Controlled "immediately after" the distribution. See Rev. Rul. 70-225, 1970-1 C.B. 80, obsoleted, Rev. Rul. 98-44, 1998-2 C.B. 315. The Service recharacterized the transaction as (1) a direct taxable transfer of assets by Distributing to P in exchange for P stock, followed by (2) a distribution of the P stock.
- c) Note that section 355(e), discussed in Part III.J., infra, imposes a corporate-level tax only, whereas Rev. Rul. 70-225 would impose a tax at both the corporate and shareholder levels, due to the failure to satisfy the requirements of section 368(a)(1)(D).
- d) In Rev. Rul. 98-27, 1998-1 C.B. 1159, the Service modified Rev. Rul. 70-225, stating that it would no longer apply the step-transaction doctrine to reorder the steps for purposes of the section 355(a)(1)(D) requirement (i.e., in determining whether Distributing distributes control of Controlled). However, Rev. Rul. 98-27 did not rule out the application of the step-transaction doctrine under the facts of Rev. Rul. 70-225 for purposes of

applying the section 368(a)(1)(D) requirement (i.e., control immediately after a “D” reorganization).

- e) The 1998 IRS Restructuring Act finished what was started by Rev. Rul. 98-27. The 1998 IRS Restructuring Act limited the effect of the step-transaction doctrine to the control test of section 368(a)(1)(D) in a section 355 transaction. Under new section 368(a)(2)(H)(ii), if the requirements of section 355 are met, the fact that the shareholders of Distributing dispose of part or all of their Controlled stock, or the fact that Controlled issues additional stock, will not be taken into account for purposes of determining whether the transaction qualifies under section 368(a)(1)(D). As a result of this statutory change, the Service issued Rev. Rul. 98-44, formally declaring Rev. Rul. 70-225 obsolete.

c. Example 2 -- Rev. Rul. 75-406 / Revisited by Rev. Rul. 96-30



- (1) Facts: The same as in Example 1, except that (1) Controlled is a pre-existing subsidiary of Distributing, and (2) immediately after the distribution and prior to the merger, the public shareholders of Distributing must vote to approve the merger. Thus, consummation of the merger is contingent on the approval of the shareholders.

(2) Issues:

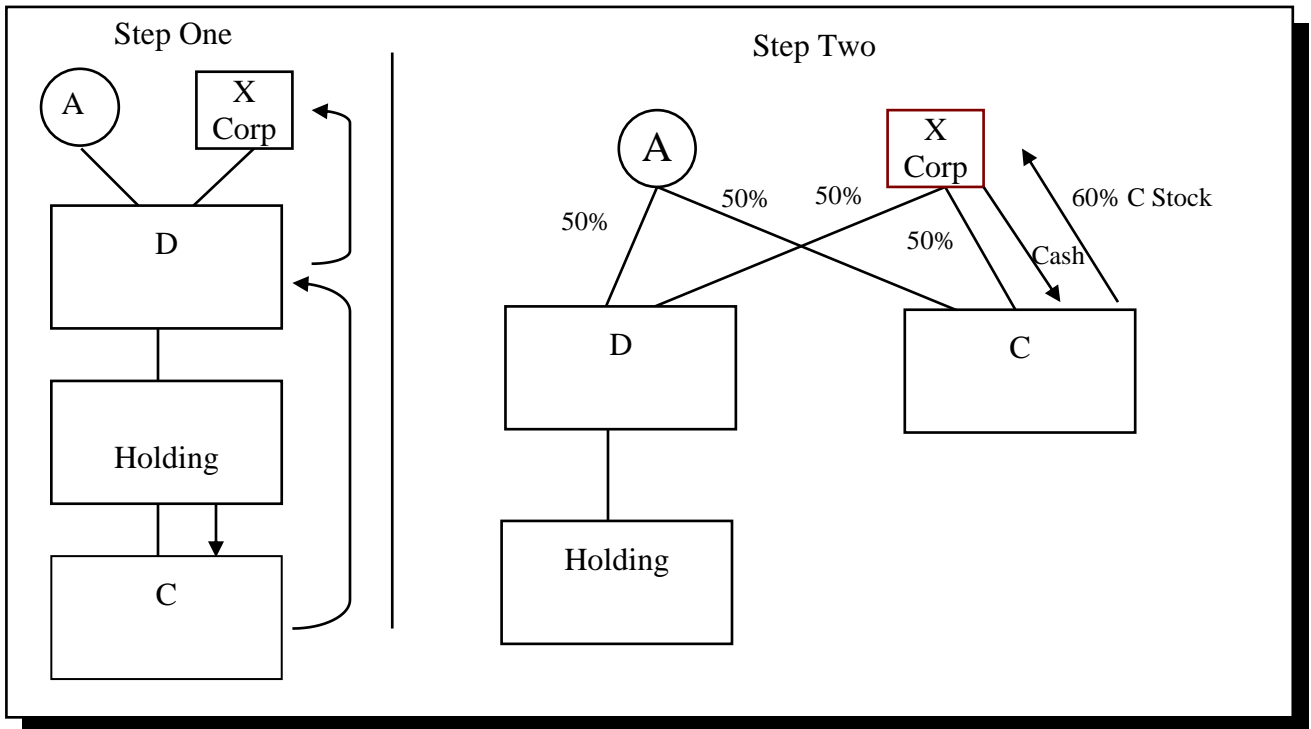
- a) In Rev. Rul. 75-406, 1975-2 C.B. 125, the Service ruled that such a “non-D” transaction would qualify as a tax-free section 355 distribution followed by a merger. The Service reasoned that, in a non-D section 355 distribution, the shareholders of Distributing were not required to retain control of Controlled under section 355, provided there is a distribution of control as required under section 355(a)(1)(D).
 - i) The Service also held that (1) the transaction was not a device, and (2) continuity of interest was satisfied because the Distributing shareholders continued to have an indirect interest in Controlled.
 - ii) Importantly, in Rev. Rul. 75-406, there was a business purpose for the distribution separate and apart from the merger. In contrast, in Morris Trust, the business purpose for the distribution was to facilitate the merger. If the business purpose for the distribution in this case were the merger, it would be difficult to argue that the two steps should be viewed as independent as a result of the public vote.
- b) On almost identical facts, the Service ruled that a spin-off of a subsidiary followed by a merger of that subsidiary into an unrelated corporation would qualify as tax free, provided that (1) there is a separate and independent shareholder vote after the distribution approving the merger, and (2) Distributing has not entered into negotiations with the acquirer before the distribution. See Rev. Rul. 96-30, 1996-1 C.B. 36. (The merger in that ruling reduced the interest of the historic shareholders to 25% of the surviving entity.) But see Part III.J., infra, for an explanation of section 355(e), which imposes a corporate-level tax on Morris Trust transactions, and which creates a rebuttable presumption that any acquisition within two years of a section 355 distribution is part of a plan including such distribution.

- i) In focusing on whether negotiations had been conducted by Distributing, Rev. Rul. 96-30 appears to have relied heavily on Commissioner v. Court Holding Co., 324 U.S. 331 (1944). If Court Holding applied, the transaction would be recharacterized as a disposition by Distributing of the Controlled stock or assets to P, followed by a distribution of the P stock received in the exchange. Therefore, unless the Distributing shareholders received “control” of P in the transaction, Distributing would not be deemed to have distributed “control” of Controlled as required by section 355(a)(1)(D).
 - ii) Practitioners understood that the Service would not extend the “second separate vote” concept of these rulings to closely held corporations. Like Rev. Rul. 75-406, Rev. Rul. 96-30 involved a distributing corporation that was “widely held and actively traded.”
 - iii) Similarly, the Service had previously been unwilling to extend the “second separate vote” concept of these rulings to “D” reorganizations (i.e., to situations involving the same facts as in Rev. Rul. 70-225, but with a separate shareholder vote). As a policy matter, this distinction between “D” and “non-D” section 355 transactions makes little sense.
- c) In Rev. Proc. 96-39, 1996-2 C.B. 300, the Service announced that it would not issue advance rulings when there are “negotiations, plans or arrangements” to consummate a subsequent transaction that, if consummated before the distribution, would have resulted in a loss of control of the distributed corporation.
- i) Unlike Rev. Rul. 96-30, which involved a post-distribution “disposition” of the distributed corporation, the Service’s “no ruling” position appeared to apply even to

the issuance of a comparable amount of stock in a public offering.

- ii) The most dramatic departure of Rev. Proc. 96-39 is that it suggests the government may reorder steps in a transaction to deny the transaction tax-free treatment. However, such an expansive approach to the step-transaction doctrine has seldom been accepted by courts. See, e.g., Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988).
- iii) As authority for this approach, it is possible that the announcement relies on Court Holding. One might infer this from the announcement's emphasis on "negotiations" and the approach adopted in Rev. Rul. 96-30. If so, it is not clear that such reliance is either apposite or sensible. Court Holding reached its result by treating the selling shareholder as a mere "conduit."
- iv) However, the no-rule position taken by the Service in Rev. Proc. 96-39 was revoked in Rev. Proc. 97-53, 1997-2 C.B. 528. It is unclear whether this revocation meant that the Service would no longer apply step-transaction principles to these types of transactions or whether it would look to the facts of each case.
- d) In response to section 355(e) and the legislative history thereunder, the Service stated in Rev. Rul. 98-27, that it would no longer apply the step-transaction doctrine for purposes of determining whether Distributing had "control" of Controlled immediately before the spin-off. Thus, Rev. Rul. 98-27 obsoletes Rev. Rul. 75-406 and Rev. Rul. 96-30.

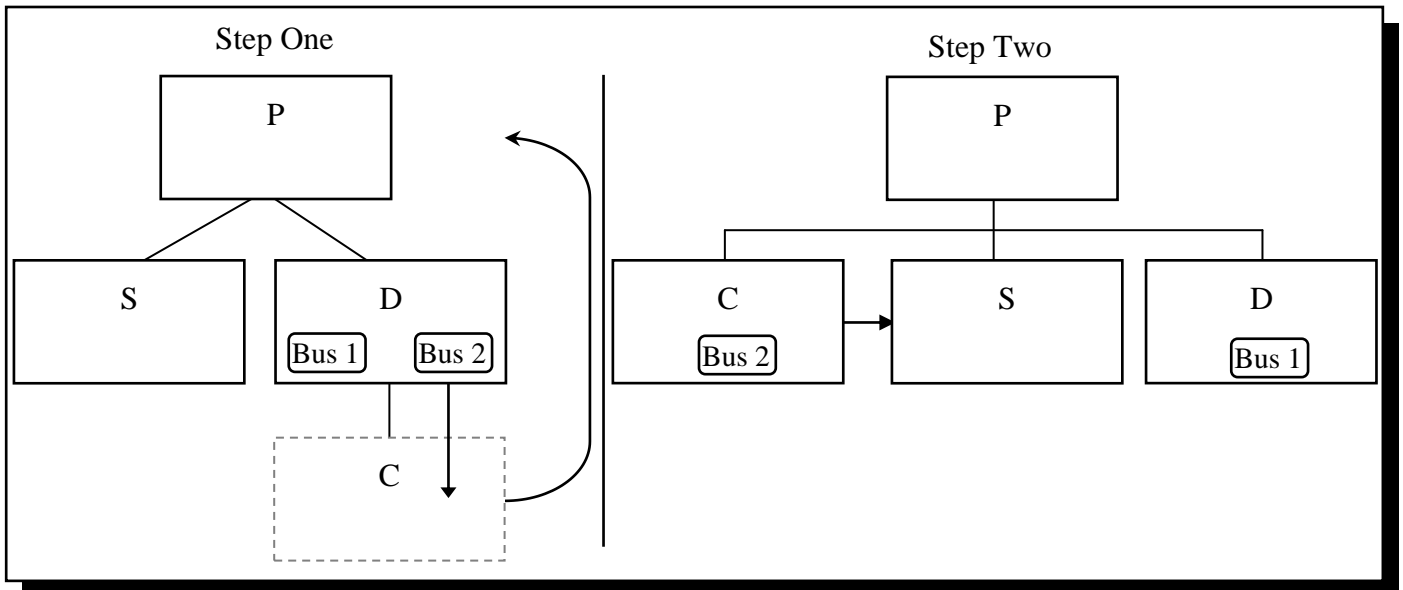
d. Example 3 -- Sale to historic shareholders



- (1) Facts: Individual A and X Corp own the stock of Distributing. Distributing owns the stock of Holding, and Holding owns the stock of Controlled. The following transaction is proposed: (1) Holding transfers assets to Controlled in a “D” reorganization; (2) Holding spins-off Controlled to Distributing; (3) Distributing spins-off Controlled to its shareholders, A and X Corp; and (4) X Corp, now a shareholder of Controlled, purchases new stock from Controlled representing 60% of Controlled’s outstanding stock.
- (2) Issues: This transaction raises issues regarding both the control requirement of section 368(a)(1)(D) and the control requirement of section 355(a)(1)(A).
 - a) Section 368(a)(1)(D) requires that the transferor of assets, or its shareholders, be in control after the transaction. Here indirect shareholders of Controlled will be in control, so the control requirement should be met.

- b) Section 355(a)(1)(A) requires that Distributing distribute control of Controlled in the transaction.
 - i) If the Service were to seek to recharacterize the transaction as if the sale to historic shareholders took place before the spin-offs, then the section 355 control requirement could not be satisfied.
 - ii) Prior to Rev. Proc. 96-39, it appeared from Rev. Rul. 73-246, 1973-1 C.B. 181, that the Service would not recharacterize the transaction. Under Rev. Proc. 96-39, however, the Service presumably would not rule, because if consummated before the distribution, X Corp's purchase of Controlled stock would prevent Distributing from distributing a "controlled" corporation.
 - iii) However, the no-rule position taken by the Service in Rev. Proc. 96-39 was revoked in Rev. Proc. 97-53. As noted above, it is unclear whether this revocation meant that the Service would no longer apply step-transaction principles to these types of transactions or whether it would look to the facts of each case.
 - iv) The transaction should, however, qualify under section 355.

e. Example 4 – Merger into Subsidiary



(1) Facts: P owns all of the stock of Distributing and S. Distributing conducts two qualifying five-year businesses, Business 1 and Business 2. The following transaction is proposed: (i) Distributing will contribute Business 2 to a newly formed subsidiary, Controlled; (ii) Distributing will distribute the stock of Controlled to P; and (iii) Controlled will merge into P's wholly owned subsidiary, S.

(2) Issues:

a) Section 368(a)(1)(D) requires that the transferor of assets, or its shareholders, be in control after the transaction. Here P will be in control, so the control requirement should be met.

b) Section 355(a)(1)(A) requires that Distributing distribute control of Controlled in the transaction.

i) If the Service were to seek to recharacterize the transaction as a transfer of assets by Distributing to S in exchange for S stock, followed by a distribution of the S stock to P, then the section 355 control requirement would not be satisfied.

ii) In Rev. Rul. 98-27, 1998-1 C.B. 1159, the Service stated that it would no longer apply

the step-transaction doctrine to reorder the steps for purposes of the section 355(a)(1)(D) requirement.

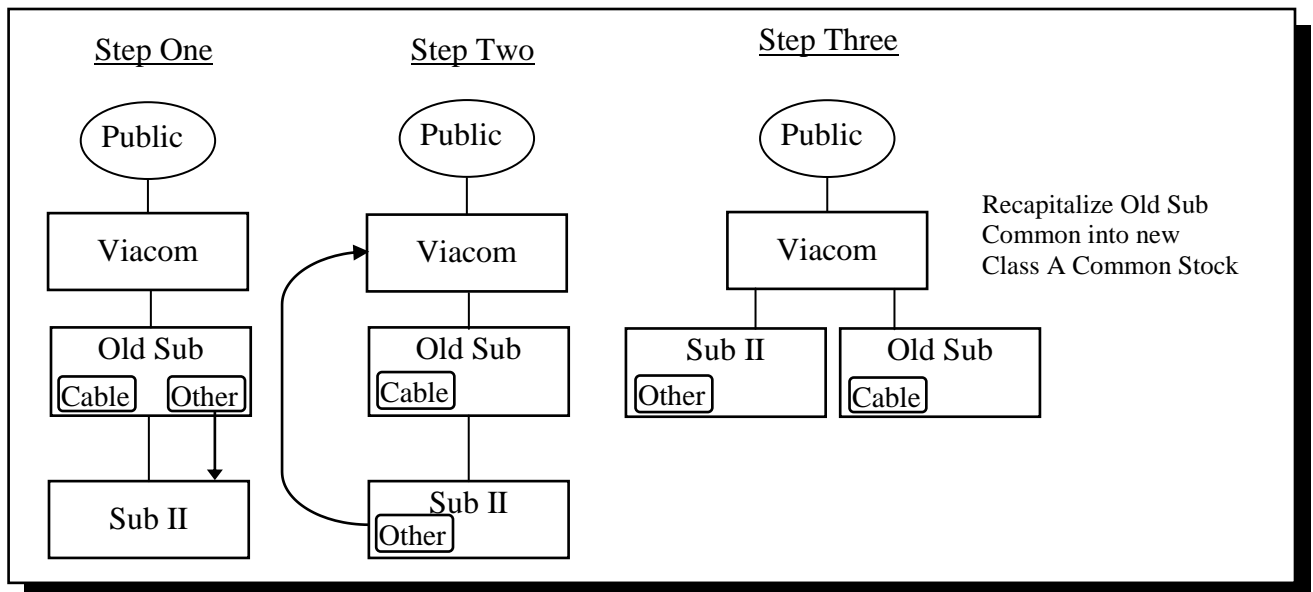
- c) The Service has concluded, in similar circumstances, that the distribution of Controlled qualifies under section 355. See P.L.R. 200736004 (June 12, 2007); P.L.R. 200215031 (Jan. 10, 2002); P.L.R. 200113019 (Dec. 27, 2000); P.L.R. 200104001 (Mar. 16, 2000).
- d) Variation—Liquidation of Controlled: Assume the facts above, except that S is a single-member limited liability company (“LLC”), and Controlled is a preexisting subsidiary of Distributing.
 - i) The merger of a corporation into a single-member LLC owned by the same parent is treated as a section 332 liquidation into the parent. See, e.g., P.L.R. 200104003 (Aug. 3, 2000); P.L.R. 9822037 (Feb. 27, 1998); see also Reg. § 301.7701-3(g)(1)(iii) (an association electing to be a disregarded entity is treated as distributing all of its assets and liabilities to its owner in complete liquidation).
 - ii) P.L.R. 199948032 (Sept. 2, 1999) involved essentially these facts. In that ruling, the Service cited Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966) and concluded that the merger of Controlled into a single-member LLC wholly owned by the parent would not prevent the spin-off from being tax-free. See also P.L.R. 200830003 (Apr. 15, 2008); P.L.R. 200638001 (June 6, 2006); P.L.R. 200211019 (Dec. 13, 2001).
 - (a) Note, however, that the ruling involved a preexisting controlled corporation. It is not clear that the Service would reach the same conclusion if Distributing formed Controlled as part of the transaction. In that case, the Service may step the transactions together and view it as

the distribution of assets from
Distributing to P.

f. In P.L.R. 201032017 (Aug. 13, 2010), the parent of an affiliated group of corporations (“Parent”), directly owned, among other companies, “Distributing 2” and all of the interests in a disregarded entity. Distributing 2 directly owned all the stock of “Distributing 1.” Distributing 1 dropped assets into a newly-formed controlled company (“Newco”), which was spun up to Distributing 2 and then to Parent. Newco was then merged upstream into a disregarded entity owned by Parent.

(1) The ruling concluded that the transaction constituted two spin-offs followed by a merger of Newco into Parent. The Service did not apply the step transaction doctrine to recast the transaction as a taxable asset distribution by Distributing 1 up the chain.

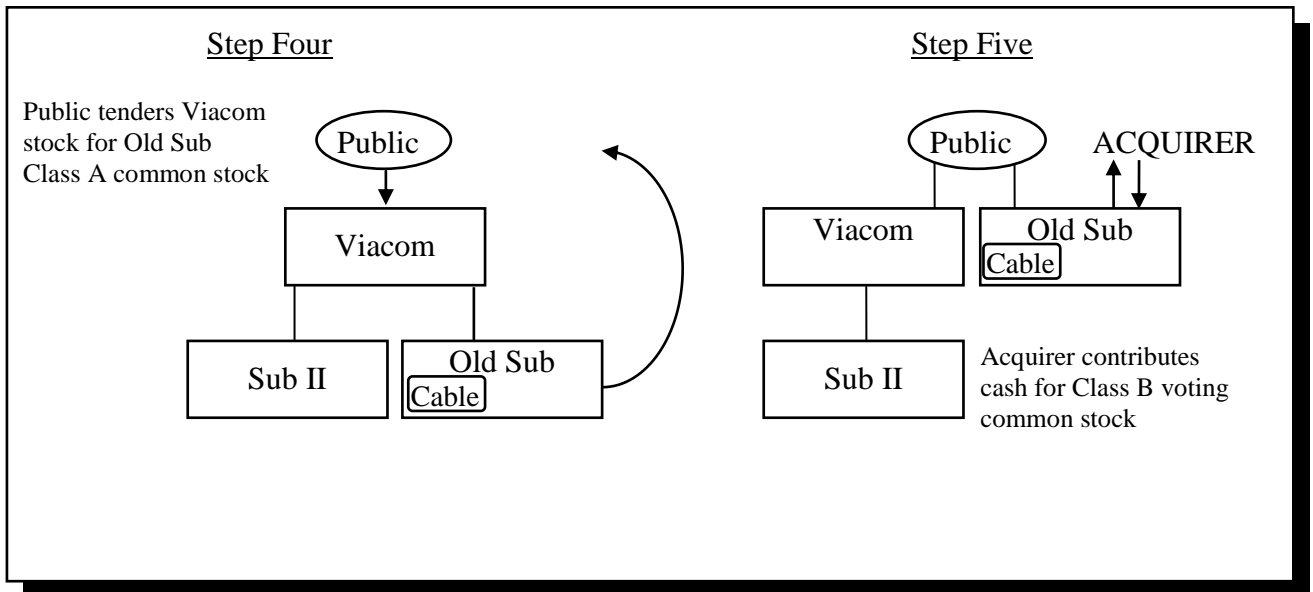
g. Example 5 -- Viacom



Subsequent to the issuance of Rev. Rul. 96-30, the Service issued a much publicized private ruling to Viacom, which is arguably inconsistent with Rev. Rul. 96-30.

(1) Facts: Through its wholly owned subsidiary, Old Sub, Viacom conducts a cable business and other businesses. Old Sub owns all of the stock of Sub II, which is engaged in the other businesses. Viacom wishes to dispose of the cable business (but not its other businesses) to Acquirer on a tax-free basis.

- a) Old Sub contributes its other businesses to Sub II. Sub II assumes substantially all of Old Sub's debt. Old Sub distributes Sub II to Viacom in a section 355 spin-off.
- b) Old Sub is recapitalized. Viacom exchanges its common stock for new Class A common stock that will automatically convert to nonvoting preferred stock upon Acquirer's investment in Old Sub (described below). The Old Sub preferred stock will be convertible by either the holder or the issuer into stock of Acquirer after five years.
- c) Viacom offers to exchange not less than all of its Old Sub stock upon tender of Viacom stock by the Viacom public shareholders. When sufficient shareholders accept the tender offer, Viacom distributes its Old Sub stock to the public in a section 355 distribution.



- d) Acquirer contributes a substantial amount of cash to Old Sub in exchange for newly issued Class B voting common stock. This causes the Class A common stock held by the public to convert to nonvoting preferred stock.
- e) On substantially these facts, the Service held that both the distribution of Sub II and the distribution of Old Sub qualified as tax free under section 355.

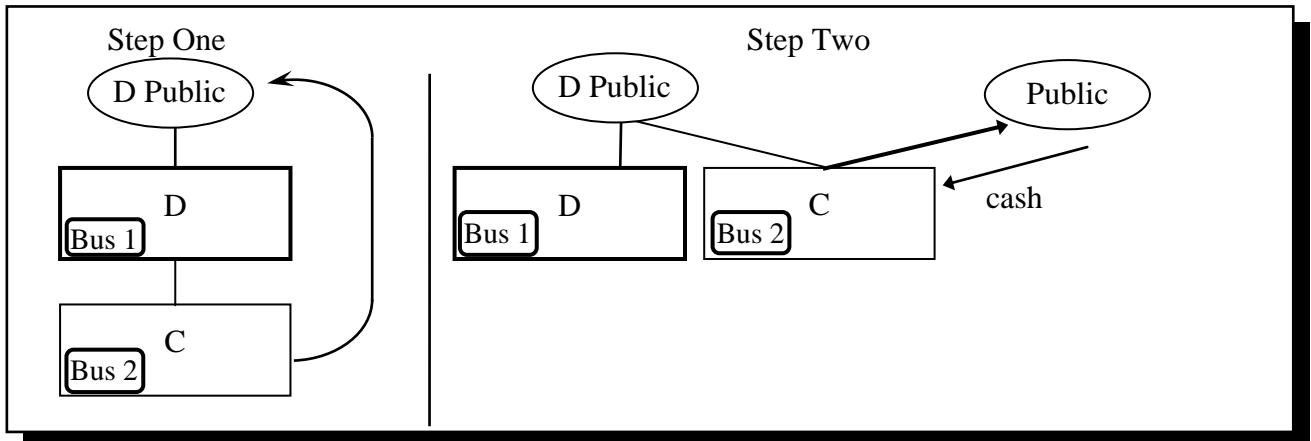
See P.L.R. 9637043 (June 17, 1996). But see Part III.J., infra, for an explanation of section 355(e) and (f), which effectively eliminates tax-free Morris Trust transactions and intragroup spins related to such transactions.

(2) Issues:

- a) If the form is respected, Acquirer effectively receives control and substantially all of the upside potential of Viacom's cable business in a tax-free transaction.
- b) In Rev. Rul. 75-406, the Service respected a section 355 distribution followed by a merger of the distributed corporation when the merger was approved by a separate vote of the public shareholders.
 - i) However, the Service clarified Rev. Rul. 75-406 in Rev. Rul. 96-30, stating that the result in Rev. Rul. 75-406 turned on the fact that the subsequent merger had not been prearranged by Distributing; i.e., the result was not based merely on the separate shareholder vote. Assuming Acquirer's investment in Old Sub is prearranged, it appears that the transactions must be viewed as part of a plan under Rev. Rul. 96-30.
 - ii) The Viacom ruling was arguably distinguishable from Rev. Rul. 96-30, because it involved a stock offering rather than a merger. However, under the Service's current position, the same results are obtained without the need to distinguish Rev. Rul. 96-30. See Rev. Rul. 98-27 (obsoleting Rev. Rul. 96-30).
 - iii) Note, however, that any such post-disposition acquisition or restructuring could result in a corporate-level tax under section 355(e).
- c) Because Old Sub is a preexisting subsidiary, the transaction is not a "D" reorganization. Therefore, Viacom must distribute control of Old Sub, but the

public shareholders are not required to retain control. See section 355(a)(1)(D). Thus, the disposition of control as a result of Acquirer's investment does not necessarily preclude tax-free treatment.

h. Example 6 -- IPO by Controlled without a "D" reorganization



(1) Facts: Distributing, a publicly traded corporation, is engaged in Business 1. Distributing owns all of the stock of Controlled, which is engaged in Business 2. Controlled wants to raise funds for use in Business 2. Accordingly, Distributing distributes the stock of Controlled to its shareholders pro rata. Following the spin-off, Controlled raises needed capital through an IPO of 55% of its stock.

(2) Issues:

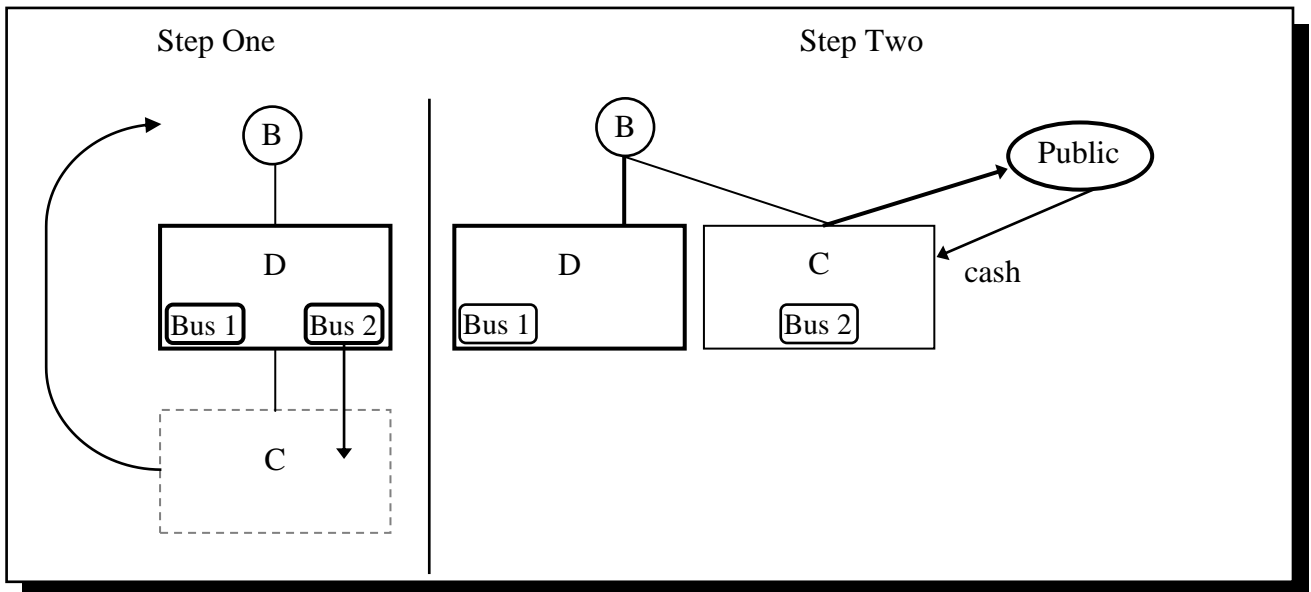
a) Rev. Proc. 96-30 specifically provides that facilitating a stock or debt offering is a valid business purpose for the distribution of Controlled. Provided the transaction is not a "D" reorganization (i.e., no assets are transferred to Controlled as part of the plan), one would argue that the "distribution of control" requirement of section 355(a)(1)(A) is met. The statute provides merely that Distributing must own and distribute "control."

b) Although subsequent Service announcements threw substantial doubt on this conclusion, the Service conceded this conclusion in Rev. Rul. 98-27, in which it stated that it would not apply the step-

transaction doctrine for purposes of determining whether Distributing owns and distributes “control,” solely because of post-distribution acquisitions or restructurings of Controlled.

- c) Note that the IPO will likely trigger a corporate-level gain under section 355(e), which applies when 50% or more of the stock of the distributing or any controlled corporation is acquired as part of the same plan. See Part III.J., infra, for a discussion of this provision.

i. Example 7 -- “D” reorganization followed by IPO



- (1) Facts: Assume the same facts as in Example 6, except that Business 2 is not already conducted in a separate subsidiary. Therefore, Distributing forms Controlled as part of the transaction (i.e., a “D” reorganization is necessary).

(2) Issues:

- a) The contribution of Business 2 to Controlled is a “D” reorganization, which requires the Distributing shareholders to be in control of Controlled “immediately after” the transaction.
- b) Note that in this situation, up to 20% of the Controlled stock could be offered in the IPO.

Under prior law, the sale of more than 20% would cause the transaction to fail the control requirement of a “D” reorganization. The control limitation imposed by a “D” reorganization would apply even if Controlled were a pre-existing subsidiary, as long as any property were transferred to Controlled as part of the transaction.

- c) There is an issue, however, as to whether aggregating the contribution of cash in the IPO with the contribution of property by Distributing would cause the Service to treat the transaction as if the public offering had occurred prior to the spin-off, in which case the distribution would fail, because Distributing would not have distributed stock constituting control of Controlled. Compare Rev. Rul. 73-246, 1973-1 C.B. 181 (spin-off of Controlled followed by contribution to capital of Controlled in exchange for 25% of Controlled stock was not recharacterized as contribution to capital followed by spin-off; accordingly stock constituting control of Controlled was distributed, and the spin-off qualified under section 355) with Rev. Rul. 70-225, 1970-1 C.B. 80, obsoleted, Rev. Rul. 98-44, 1998-2 C.B. 315 (“D” reorganization followed by exchange of Controlled stock for stock in X, an unrelated corporation, recharacterized as contribution of assets by Distributing to X for X stock, followed by distribution of the X stock by Distributing).
- i) This transaction, however, could have qualified as a transaction under sections 351 and 355 rather than a failed “D” reorganization and section 355 transaction. See Reg. § 1.351-1(a)(3) (stating that if a person acquires stock of a corporation from an underwriter in exchange for cash in a qualified underwriting transaction, for section 351 purposes, the person acquiring the stock from the underwriter is treated as transferring cash directly to the corporation in exchange for stock, and the underwriter is disregarded). See also Rev. Rul. 78-294, 1978-2 C.B. 141 (treating public who purchased shares from an underwriter as transferors for purposes of the section 351

control test), obsoleted by T.D. 8665, 61 Fed. Reg. 19,188 (1996) (promulgating Reg. § 1.351-1(a)(3)).

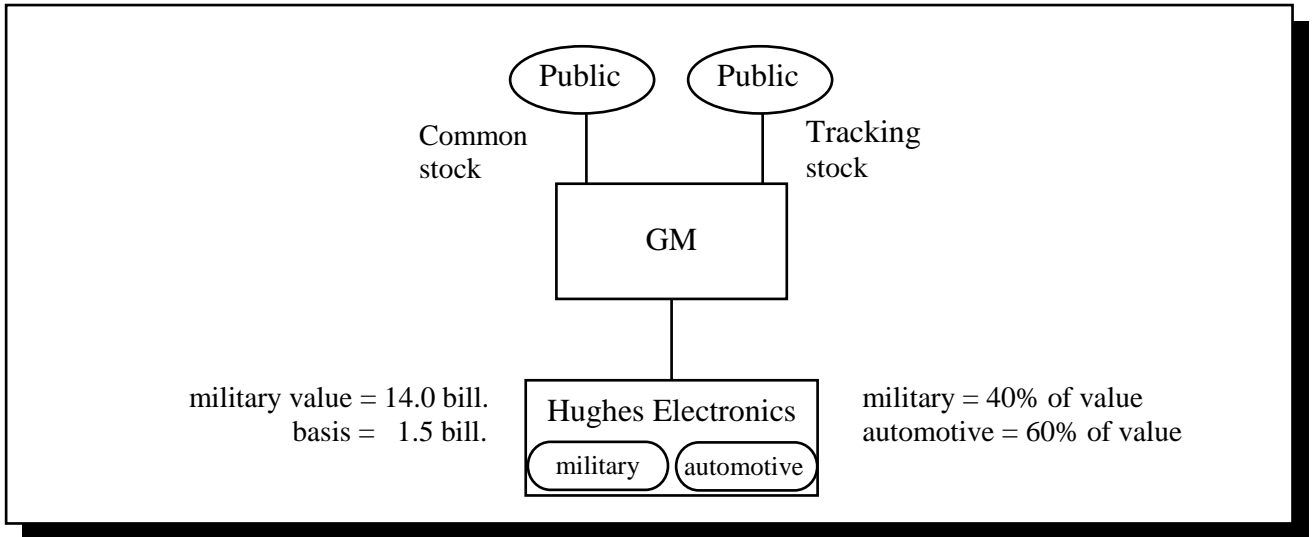
- ii) In Rev. Rul. 62-138, the Service treated the dropdown of assets and subsequent distributions as a section 351 transaction (not a “D” reorganization) followed by successive section 355 transactions (presumably to avoid the “D” reorganization control issue); see also section 351(c).
 - iii) Moreover, in P.L.R. 9236007 (Feb. 14, 1992), and P.L.R. 9141029 (July 11, 1991), “D” reorganizations followed by multiple spin-offs were approved.
- d) The Service appears to have adopted a contrary position on these issues within the space of a few months, which caused considerable confusion. First, in the private ruling issued to Viacom (described above), the Service, in effect, ruled that an issuance of stock following a section 355 distribution should not disqualify the distribution, even though Distributing’s shareholders were no longer in control of Controlled following the stock issuance. Almost immediately thereafter, however, the Service issued Rev. Proc. 96-39, 1996-2 C.B. 300.
- i) In Rev. Proc. 96-39, the Service announced that it would not issue advance rulings when there are “negotiations, plans or arrangements” to consummate a subsequent transaction that, if consummated before the distribution, would have precluded a distribution of control of the distributed corporation. The Revenue Procedure stated that the issue of post-distribution transactions was under extensive study.
 - ii) However, the no-rule position taken by the Service in Rev. Proc. 96-39 was revoked in Rev. Proc. 97-53, 1997-2 C.B. 528. It is unclear whether this revocation meant that the Service would no longer apply step-transaction principles to these types of

transactions or whether it would look to the facts of each case.

- iii) The new control test of section 368(a)(2)(H)(ii), which was added by the 1998 IRS Restructuring Act, did not initially resolve the issue in this example. Section 368(a)(2)(H)(ii) initially provided that, if the requirements of section 355 were met, the fact that the shareholders of Distributing dispose of all or part of their Controlled stock will not be taken into account in determining control under 368(a)(1)(D). The language did not refer to issuances of additional stock by Controlled itself. The Extension Act, however, contained a technical correction of section 368(a)(2)(H)(ii) so that it would provide, in addition, that the fact that Controlled issues additional stock will not be taken into account for purposes of determining whether the transaction qualifies under section 368(a)(1)(D).

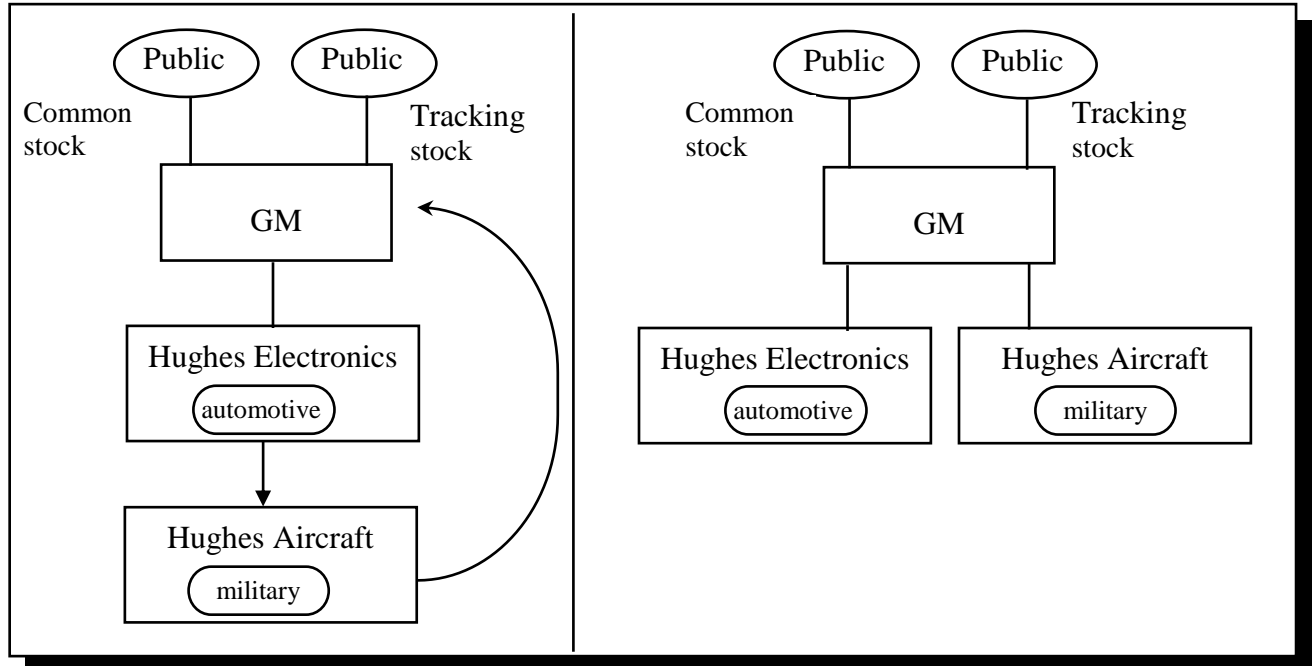
- e) Thus, the fact that Controlled issues 55% of its stock in an IPO will not affect whether the control requirement of section 368(a)(1)(D) is satisfied. See also P.L.R. 200926024 (Mar. 12, 2009) (issuance of an interest in a single-member limited liability company, Controlled's sole asset, thus converting it to a partnership, did not violate the control requirement by reason of Rev. Rul. 98-27).

j. Example 8 -- GM-Raytheon transaction (simplified)

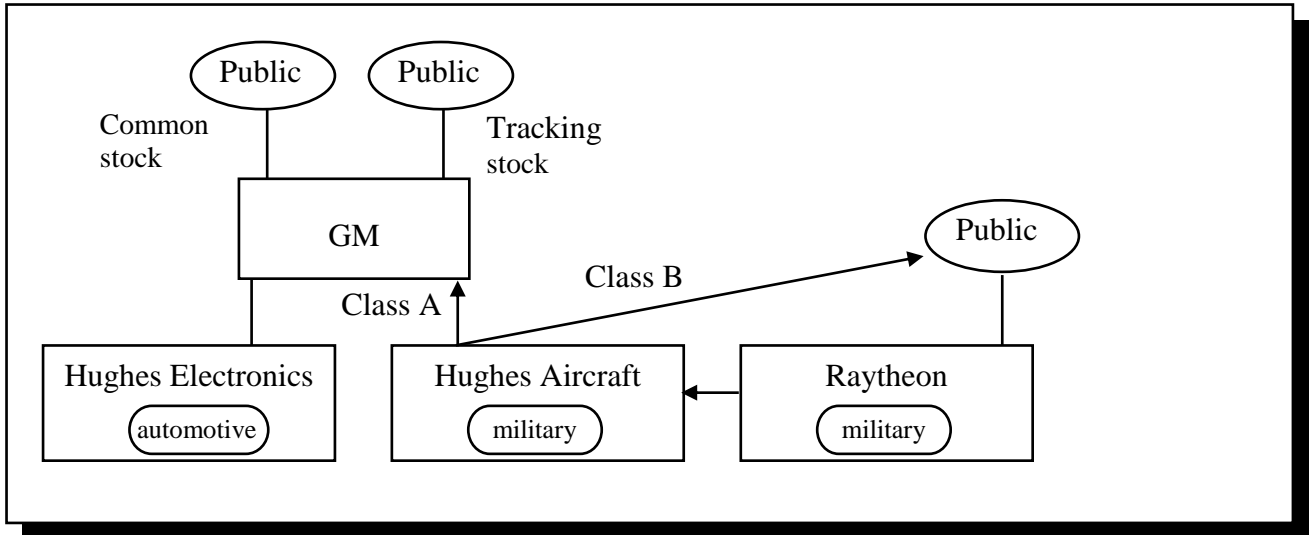


(1) Facts:

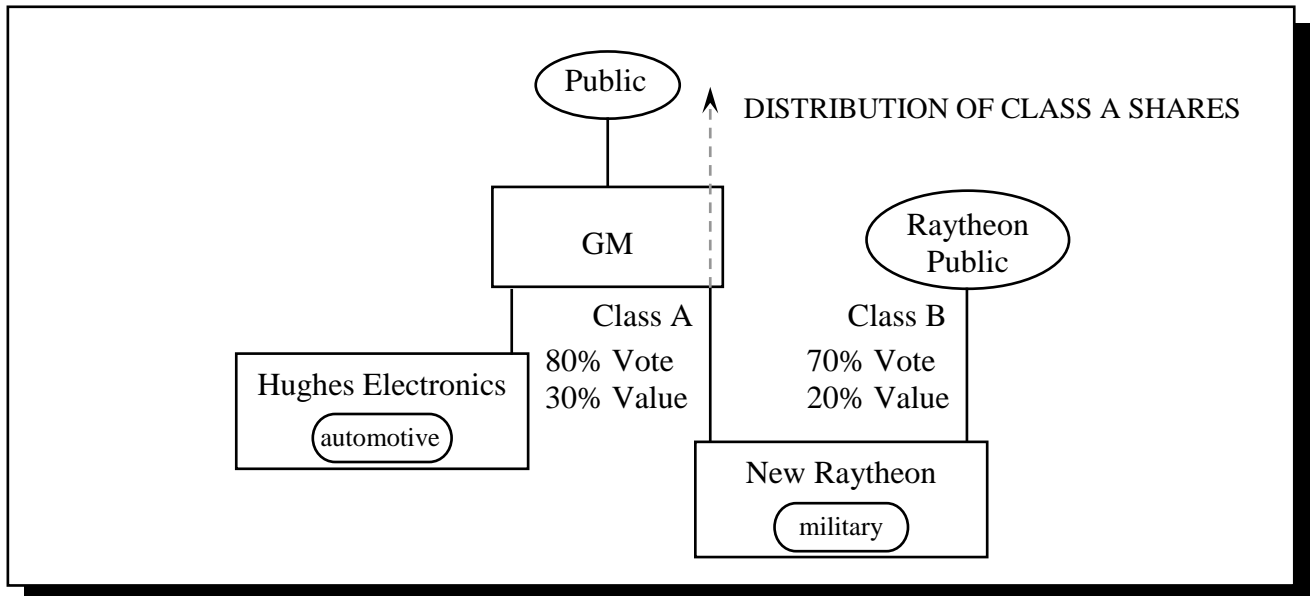
- a) General Motors ("GM") owns all of the stock of Hughes Electronics Corp. ("Hughes Electronics"). GM has stock outstanding that is held by public shareholders. In addition, GM has issued a class of tracking stock that tracks the performance of Hughes Electronics; the tracking stock entitles the holders to 24% of Hughes Electronics' hypothetical earnings. If GM disposes of a Hughes business, the tracking shares automatically convert to regular GM shares, at a ratio of 120% of the tracking share price divided by the GM share price.
- b) GM wishes to dispose of the military electronics ("military") business of Hughes Electronics, which accounts for about 40% of the subsidiary's value, to Raytheon Co. ("Raytheon") for approximately \$9.5 billion in cash and Raytheon shares. GM plans to keep Hughes Electronics' automotive electronics ("automotive") business. Hughes Electronics has a substantial unrealized gain in the military electronics business.
- c) GM therefore causes Hughes Electronics to contribute its military business to a new subsidiary, Hughes Aircraft, and distribute its shares of the new Hughes Aircraft to GM.



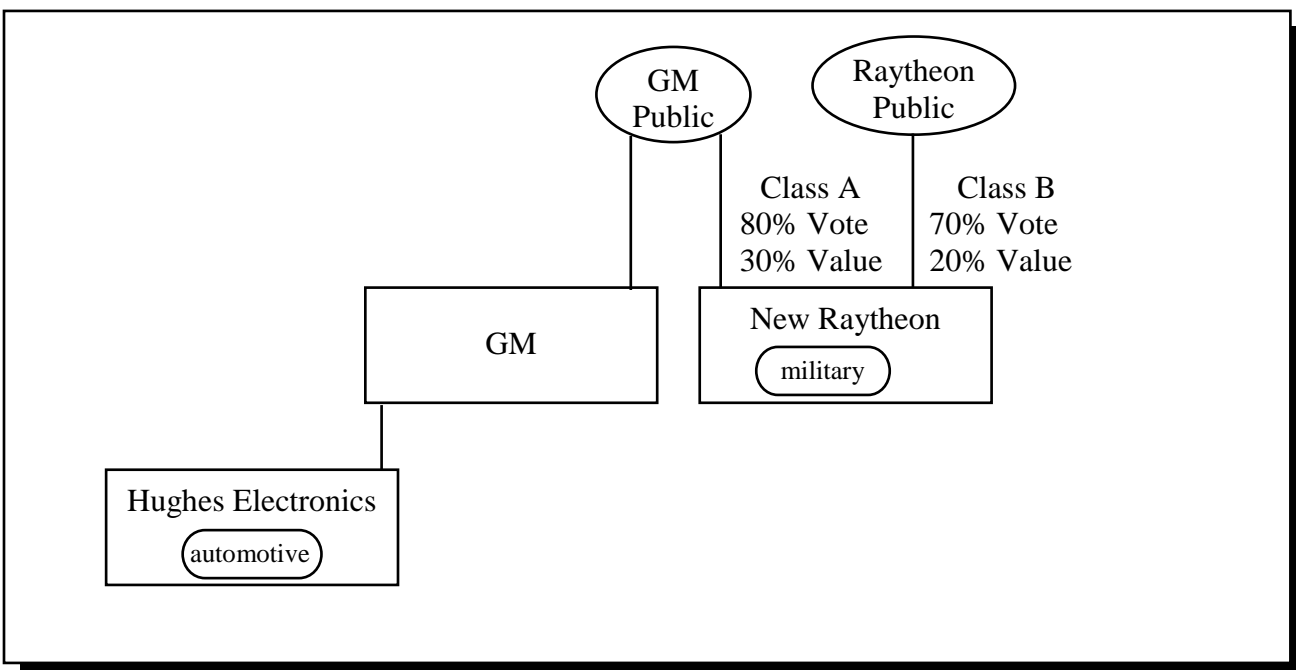
- d) Hughes Aircraft will borrow roughly \$4.4 billion and distribute the \$4.4 billion to GM. (Raytheon will effectively assume this liability when it merges into Hughes Aircraft as described below).
- e) Raytheon will then merge with and into Hughes Aircraft in a transaction governed by section 368(a)(1)(A). (Although the surviving entity will be Hughes Aircraft, the merged companies will be renamed Raytheon.) Hughes Aircraft will issue two classes of stock, Class A and Class B in the merger. Class A (supervoting) shares will have 80% of the voting power and 30% of the value of the combined companies. Class B shares will have 70% of the value and 20% of the voting power. GM will exchange its Hughes Aircraft stock for Class A stock. Raytheon shareholders will exchange their Raytheon shares for the Class B shares in the merger. The merger may cause the tracking stock to be converted into GM common stock.



- f) GM will distribute the Class A shares to its shareholders in a distribution intended to qualify under section 355.



- g) Following the transaction, Raytheon's historic shareholders will own 70% of the value of New Raytheon but only 20% of the vote. Historic GM shareholders will own 30% of the value but 80% of the vote.



(2) Issues:

- a) Section 355(a)(1)(A) requires that Distributing have “control,” defined in section 368(c), of Controlled immediately before the distribution. Under section 368(a)(1)(D), if the transaction also involves a “D” reorganization, Distributing and its shareholders must “control” the distributee corporation immediately after the distribution. In addition, Distributing must distribute all of its holdings in Controlled or distribute shares representing “control” of the distributed corporation, provided that the transaction does not have the principal purpose of tax avoidance.
- b) The distribution of Hughes Aircraft by Hughes Electronics to GM should qualify under section 355 and 368(a)(1)(D) despite the fact that Hughes Aircraft is distributed to the GM shareholders. See Rev. Rul. 62-138, 1962-2 C.B. 95 (second spin will not cause first spin to fail the “control” test).
- c) The key question is whether the second distribution of Hughes Aircraft Class A stock to the GM shareholders qualifies under sections 355 and 368(a)(1)(D). Control is defined as the ownership

of 80% of all classes of voting stock and 80% of each other class of stock. Here both Class A and Class B shares are voting stock and are accordingly aggregated for purposes of the test. Thus, if the form is respected, GM owns 80% of the voting stock prior to the distribution. There are no classes of nonvoting stock. GM distributes all of its Class A stock to the GM shareholders who presumably retain this stock. Technically, therefore, the various control tests appear to be met.

- d) One could view the transaction, however, as if Hughes Aircraft had acquired Raytheon for 70% of its sole class of common stock and Hughes Aircraft had then recapitalized into two classes of stock to provide GM with the requisite control for the second spin-off. The Service generally has approved recapitalizations intended to ensure the requisite control to permit a spin-off. See, e.g., Rev. Rul. 69-407, 1969-2 C.B. 50; Rev. Rul. 56-117, 1956-1 C.B. 180; G.C.M. 34,122 (May 8, 1969); P.L.R. 200007005 (Nov. 1, 1999). But see Rev. Rul. 63-260, 1963-1 C.B. 147 (in which the Service disqualified a spin-off preceded by a similar augmentation of voting power).
- e) Additional issues arise with respect to the cash distribution.
 - i) Should this be treated as boot in the first section 355 transaction? If so, under Reg. § 1.1502-13(f), it will be deemed to be a dividend occurring before the spin-off and will result in a reduction in the basis of the corporation distributing the cash. Reg. § 1.1502-13(f)(3) & (f)(7), Ex. 3(d).
 - ii) Query whether this cash distribution will trigger an excess loss account under Reg. § 1.1502-19 and if so, how this will be treated. An excess loss account in the stock of Hughes Aircraft should be triggered upon the deconsolidation of Hughes Aircraft. See Reg. § 1.1502-19(c)(1)(ii). Conversely, if Hughes Aircraft makes the distribution to Hughes Electronics before the first spin-off, arguably the resulting excess loss account

will not be triggered, because the first spin-off does not result in a deconsolidation of Hughes Aircraft. The excess loss account in the Hughes Aircraft stock may be wholly or partly eliminated when GM substitutes part of its basis in Hughes Electronics onto the stock it receives in Hughes Aircraft. See Reg. § 1.1502-19(g), Ex. 3.

- f) Note that this transaction would trigger corporate-level gain under section 355(e), because Raytheon shareholders acquired a 50% or greater interest (measured by vote or value) in Controlled. See Part III.J., infra, for an explanation of section 355(e) and (f), which effectively eliminates tax-free Morris Trust transactions and intragroup spins related to such transactions.

k. “North-South” Transactions

- (1) If Distributing’s shareholder (“Parent”) contributes assets to Distributing in connection with Distributing’s section 355 distribution of Controlled stock to Parent, assets are going into Distributing (“south”) at the same time assets are coming out of Distributing (“north”).
- (2) It is possible that the Service could integrate the transfers under the step-transaction doctrine as an exchange of the contributed assets for Controlled stock. See Commissioner v. Baan, 382 F.2d 485 (9th Cir. 1967) (holding that a transaction was not a “distribution with respect to stock” where Distributing’s shareholders were required to pay cash to receive Controlled stock), aff’d sub nom, Commissioner v. Gordon, 391 U.S. 83 (1968). If the fair market value of the contributed assets exceeds 20 percent of Controlled’s value, then Distributing would fail to satisfy the control requirement.
- (3) Up until recently the Service has not, however, sought to recharacterize such transfers; instead it has respected the form as a contribution and a section 355 distribution. See, e.g., P.L.R. 201136009 (May 23, 2011); P.L.R. 201034005 (May 20, 2010); P.L.R. 201030005 (Apr. 28, 2010); P.L.R. 201007050 (Nov. 13, 2009); P.L.R. 200815020 (Dec. 27, 2007); P.L.R. 200708017 (Nov. 15, 2006); P.L.R. 200644010 (July 12, 2006); P.L.R. 200411021 (Mar. 12, 2004); P.L.R. 200345049 (Nov. 7, 2003); P.L.R.

200215031 (Jan. 10, 2002); P.L.R. 200042024 (July 21, 2000); P.L.R. 9416008 (Nov. 3, 1993).

- a) Earlier rulings did not contain specific rulings or caveats on the north-south issue. See, e.g., P.L.R. 200815020 (Dec. 27, 2007); P.L.R. 200708017 (Nov. 15, 2006); P.L.R. 200644010 (July 12, 2006); P.L.R. 200411021 (Mar. 12, 2004); P.L.R. 200345049 (Nov. 7, 2003); P.L.R. 200215031 (Jan. 10, 2002); P.L.R. 200042024 (July 21, 2000); P.L.R. 9416008 (Nov. 3, 1993).
- b) Accordingly, it was not clear what the Service's reasoning is for respecting the form. Potential reasons include:
 - i) The contribution and distribution are independent transactions with separate business purposes—e.g., each is necessary to achieve fit and focus to align businesses within the group;
 - ii) Parent is not legally or economically compelled to contribute the assets—e.g., the assets are not necessary to satisfy the active trade or business requirement or to replace the value that Distributing loses upon the distribution of Controlled; or
 - iii) The transfer of assets to Distributing permanently altered its corporate structure.
- c) Later recent rulings, however, have required specific representations that there is no regulatory, legal, contractual or economic compulsion that the contribution be made as a condition to the distribution and whether the distribution could have occurred without regard to the value first contributed. See, e.g., P.L.R. 201034005 (May 20, 2010) (“There is no regulatory, legal, contractual, or economic compulsion or requirement that asset contributions be made as a condition of the Controlled 1 Distribution. The fact that the value of Distributing 1 will decrease as a result of the Controlled 1 Distribution was not a consideration in the decision to contribute property to Distributing 1. The Controlled 1 Distribution is not contingent on

there being contributed to Distributing 1 assets having a specified (or roughly specified) value.”); P.L.R. 201030005 (Apr. 28, 2010) (similar representation); P.L.R. 201007050 (Nov. 13, 2009) (similar representation).

- d) The most recent rulings have narrowed the representation mentioned above. See, e.g., P.L.R. 201136009 (May 23, 2011) (“There is no regulatory, legal, contractual, or economic compulsion or requirement that Distributing 1 make part or all of the Distributing 1 Contribution as a condition to the distribution by Controlled of the Cash Distribution.”); P.L.R. 201202007 (Sept. 30, 2011) (similar representation); P.L.R. 201149012 (Sept. 9, 2011) (similar representation).

- (4) In Rev. Proc. 2013-3; 2013-3 I.R. B. 133, the IRS stated that it will no longer rule on whether these steps will be respected as separate transactions for Federal income tax purposes.

C. Device Restriction

1. In general

In order for section 355 to apply to the distribution of Controlled’s stock, the distribution cannot be principally a device for the distribution of earnings and profits of Distributing, Controlled, or both corporations. Section 355(a)(1)(B); Reg. § 1.355-2(d)(1).

- a. As stated previously, the focus under section 355 has historically been whether the transaction was undertaken by the shareholders in order to bail out earnings and profits at favorable capital gains rates. Even in the absence of a rate disparity between ordinary income and capital gains, this issue remains relevant. The regulations specifically provide that a device can include a transaction that effects the recovery of basis. Reg. § 1.355-2(d)(1). Moreover, the regulations in some instances shift the focus of the device requirement from the avoidance of taxation at the shareholder level to the avoidance of taxation at the corporate level.
- b. Whether a transaction is used principally as a device for the distribution of earnings and profits is determined by a review of all the facts and circumstances surrounding the transaction. Reg. § 1.355-2(d)(1).

- (1) The regulations specifically enumerate various factors that are evidence of a device and that are evidence of the absence of a device. The strength of this evidence depends on all the facts and circumstances. The regulations also state that additional factors not expressly stated in the regulations bear on whether or not the transaction has been undertaken as a device. Reg. § 1.355-2(d)(1), (d)(2)(i).
 - (2) The regulations also provide that certain transactions are ordinarily not considered a device despite the existence of factors that evidence a device. Reg. § 1.355-2(d)(5)(i).
- c. In Rev. Proc. 2003-48, 2003-2 C.B. 86, the Service announced a change in its private letter ruling process. The Service will no longer rule on whether a proposed or completed distribution is used principally as a device. Rev. Proc. 2003-48 also indicates that the Service will not rule on whether a proposed or completed distribution of Controlled's stock is being carried out for one or more corporate business purposes or whether the distribution and an acquisition are part of a plan under section 355(e).
- (1) Rev. Proc. 2003-48 requires taxpayers to submit a representation regarding the device requirement: "The transaction is not used principally as a device for the distribution of earnings and profits of the distributing corporation or the controlled corporation or both."
 - (2) A determination of whether the transaction is used principally as a device will thus be made upon an examination of the taxpayer's return.
 - (3) This was established as a pilot program and applies to ruling requests received after August 8, 2003. Although Rev. Proc. 2003-48 indicated that this was a pilot program, representatives of the Service have indicated informally that unless it hears otherwise from taxpayers, it plans to continue this practice indefinitely.

2. Evidence of a device

a. Pro rata distribution

A distribution that is pro rata or substantially pro rata presents the greatest potential for the withdrawal of earnings and profits and is more likely to be undertaken as a device. Thus, the fact that a distribution is pro rata or substantially pro rata is evidence of a device. Reg. § 1.355-2(d)(2)(ii).

b. Subsequent sale or exchange of stock

(1) The regulations provide that a sale or exchange of stock of Distributing or Controlled after the distribution is evidence of a device. Reg. § 1.355-2(d)(2)(iii)(A).

a) A subsequent sale or exchange pursuant to an arrangement negotiated or agreed upon before the distribution is substantial evidence of a device. Reg. § 1.355-2(d)(2)(iii)(B).

b) A subsequent sale or exchange not pursuant to an agreement negotiated or agreed upon before the distribution is evidence of a device. Reg. § 1.355-2(d)(2)(iii)(C).

c) Generally, the greater the percentage of stock sold or exchanged after the distribution, the stronger the evidence of a device. Furthermore, the shorter the period of time between the distribution and the sale or exchange, the stronger the evidence of a device. Reg. § 1.355-2(d)(2)(iii)(A).

d) The regulations provide that a sale or exchange is always considered to be pursuant to an arrangement negotiated or agreed upon before the distribution if enforceable rights to buy or sell exist before the distribution. Furthermore, under these regulations, if the sale or exchange is discussed by the buyer and the seller before the distribution and is reasonably to be anticipated by both parties, such a sale is ordinarily considered as pursuant to an arrangement negotiated or agreed upon before the distribution. Reg. § 1.355-2(d)(2)(iii)(D).

e) Example

Corporation W is owned by individual A. W has one wholly owned subsidiary, X. Both corporations have been engaged in business for more than five years and have substantial accumulated earnings and profits. Under state law, W can no longer hold the stock of X. Individual B has offered to purchase the stock of X. This offer was rejected and it was determined that the stock of X would be distributed to A. Before the distribution, A agrees to sell to B one-half of his interest in X after the distribution.

Despite the existence of a non-tax reason for the distribution, the subsequent sale of stock is considered to be substantial evidence of a device.

- (2) Rev. Proc. 96-30, § 4.05(1)(b), 1996-1 C.B. 696, provided a safe harbor from the device test for corporations that, for a valid business reason, purchased their own stock after a section 355 distribution. In order to take advantage of the safe harbor, the taxpayer was required to represent in the ruling request that the following conditions were met with respect to both Distributing and Controlled:
- a) there was a sufficient business purpose for the stock purchase;
 - b) the stock to be purchased was widely held;
 - c) the stock purchases would be made in the open market; and
 - d) there was no plan or intention that the aggregate amount of stock purchases would equal or exceed 20% of the outstanding stock of the corporation.

Even if the stock purchases did not meet these requirements, the Service would consider ruling on whether the purchases violated the device requirement of section 355(a)(1)(B) after considering all of the facts and circumstances of each case. See, e.g., P.L.R. 200130003 (Apr. 3, 2001) (repurchase from one or more investment banks in connection with derivatives transactions between Controlled and such banks); P.L.R. 200023031 (Mar. 10, 2000) (repurchase using wholly owned subsidiary as broker); P.L.R. 9622016 (Feb. 28, 1996) (repurchase of up to 15% of outstanding stock).

Note, however, that Rev. Proc. 2003-48, which provides that the Service will no longer rule on the device requirement, removes this safe harbor from Rev. Proc. 96-30.

- (3) Subsequent sales or exchanges of stock (including those under Rev. Proc. 96-30) will also be scrutinized under the continuity of interest requirement applicable to a section 355 transaction. See Part III.G., infra.

- (4) For purposes of the device test, an exchange of stock pursuant to a plan of reorganization in which no gain or loss is recognized or only an insubstantial amount of gain is recognized is not considered to be an exchange and, thus, is not subject to the provisions relating to pre-arranged sales or exchanges. Reg. § 1.355-2(d)(2)(iii)(E).
- a) Thus, a corporate division preceding a tax-free acquisition of Distributing or Controlled should not violate the device restriction of section 355.
 - b) The Service has ruled that a corporate division under section 355 accomplished to facilitate a subsequent tax-free acquisition of Distributing or Controlled is not a device for the distribution of earnings and profits. Rev. Rul. 78-251, 1978-1 C.B. 89; Rev. Rul. 75-406, 1975-2 C.B. 125; Rev. Rul. 72-530, 1972-2 C.B. 212; Rev. Rul. 70-434, 1970-2 C.B. 83.
 - c) Nevertheless, a corporate division undertaken to facilitate the tax-free acquisition of Controlled may not meet the control requirements of section 355 as a result of the application of step-transaction principles. See Part III.B.4., *supra* (discussing Rev. Rul. 70-225, 1970-1 C.B. 80, obsoleted, Rev. Rul. 98-44, 1998-2 C.B. 315 and Rev. Rul. 96-30, 1996-1 C.B. 36, obsoleted, Rev. Rul. 98-27, 1998-1 C.B. 1159).
 - d) A section 355 transaction followed by a tax-free reorganization will also be scrutinized under the continuity of interest requirement. See Part III.G., *infra*.

c. Nature and use of assets

In determining whether a transaction is used principally as a device, consideration is given to the nature, kind, amount, and use of the assets of both Distributing and Controlled (and corporations controlled by them) immediately after the transaction. Reg. § 1.355-2(d)(2)(iv)(A).

- (1) The existence of assets that are not used in an active trade or business as described in section 355(b) is evidence of a device. Reg. § 1.355-2(d)(2)(iv)(B).

- a) This rule is broader than the rule contained in the proposed regulations that referred only to cash and other liquid assets and trades or businesses acquired within the five-year period ending on the date of the distribution. See Prop. Reg. § 1.355-2(c)(3), 42 Fed. Reg. 38,866 (1977).
 - b) The preamble to the regulations specifically refers to excess inventory as possibly evidencing a device. Preamble to Reg. § 1.355-2, 54 Fed. Reg. 283, 286 (1989). This was not covered by the proposed regulations. See Prop. Reg. § 1.355-2, 42 Fed. Reg. 38,866.
- (2) The existence of a device based on the nature of the assets depends in part on the ratio for each corporation of the value of the assets not used in an active trade or business to the value of the assets used in an active trade or business. Reg. § 1.355-2(d)(2)(iv)(B).
- a) Different ratios for Distributing and Controlled is not ordinarily evidence of a device if the distribution is not pro rata and such difference is attributable to a need to equalize the value of the stock distributed and the value of the stock and securities exchanged. Reg. § 1.355-2(d)(2)(iv)(B).
 - b) Evidence of a device presented by the transfer or retention of assets not used in an active trade or business can be outweighed by the existence of a corporate business purpose for those transfers or retentions. Reg. § 1.355-2(d)(3)(ii); see Part III.C.3.a., infra; see also Rev. Rul. 83-114, 1983-2 C.B. 66.
 - c) Query whether an imbalance in ratios as well as a transfer or retention of assets not used in an active trade or business, both being evidence of a device, results in section 355 being unavailable to a corporation with substantial assets not being used in an active trade or business?
 - i) It should be noted that the active business requirement may be satisfied if only five percent of a corporation's assets are used in the trade or business. See Part III.D.5., infra.

- d) Assets that are not used in an active trade or business include cash and other liquid assets that are not related to the reasonable needs of the business. Reg. § 1.355-2(d)(2)(iv)(B).
- (3) There is evidence of a device if a business of either Distributing or Controlled has the principal function of serving the activities of the other corporation for a significant period of time after the separation, and such business can be sold without adversely affecting the activities of the other corporation. Reg. § 1.355-2(d)(iv)(C).
- a) The proposed regulations provided a similar rule, except that it was not limited to a situation in which the related function could be sold without adversely affecting the activities of the other corporation. See Prop. Reg. § 1.355-2(c)(3)(iv), 42 Fed. Reg. 38,866; Preamble to Reg. § 1.355-2, 54 Fed. Reg. at 286.
 - b) The limitation added by the final regulations is apparently designed to limit this provision to situations in which the related function could be easily sold thereby permitting a bail-out of earnings and profits.
 - c) Although such a functional relationship may violate the device requirement, it should satisfy the active business requirement, which permits the horizontal division of a business. See Part III.D.8., infra.
- (4) Examples
- a) Corporation W is owned by individual A. W has one wholly owned subsidiary, X. Both corporations have been engaged in business for more than five years and have substantial accumulated earnings and profits. Under state law, W can no longer hold the stock of X. It is determined that the stock of X is to be distributed to A. Prior to the distribution of X to A, W transferred cash to X not related to the reasonable business needs of the business of X. As a result of the transfer of cash, the ratio of the value of the assets not used in an active trade or business to the value of the assets used in an active trade or business is substantially greater for X than for W. This is relatively strong evidence of a device. The

distribution is pro rata, which is also evidence of a device. The business purpose although normally evidence that the transaction was not undertaken as a device does not relate to the transfer of funds. The transaction is considered to be a device. Reg. § 1.355-2(d)(4), Ex. 3.

- b) For eight years, corporation K has been engaged in the manufacture and sale of steel and steel products. For six years, K's wholly owned subsidiary, L, has owned and operated a coal mine for the sole purpose of supplying K's coal requirements in the manufacture of its steel. It is proposed that the stock of L be distributed to the shareholders of K. If the coal mining business continued to operate in the same manner after the transaction, and the sale of the coal mine did not adversely affect the steel business, then the distribution of X would be considered evidence of a device. Reg. § 1.355-2(d)(2)(iv)(C).

3. Evidence of nondevice

a. Corporate business purpose

A corporate business purpose for a transaction is evidence that the transaction was not undertaken as a device. The stronger the evidence of a device, the stronger the corporate business purpose must be to overcome the evidence of a device. The assessment of the strength of a corporate business purpose is based on all the facts and circumstances, including the following:

- (1) The importance of achieving the purpose to the success of the business;
- (2) The extent to which the transaction is prompted by a person not having a proprietary interest in either corporation, or by other outside factors beyond the control of Distributing; and
- (3) The immediacy of the conditions prompting the transaction.

Reg. § 1.355-2(d)(3)(ii).

b. Distributing corporation publicly traded and widely held

The fact that Distributing is publicly traded and has no shareholder

who is directly or indirectly the beneficial owner of more than five percent of any class of stock is evidence that the transaction is not a device. Reg. § 1.355-2(d)(3)(iii).

c. Distribution to domestic corporate shareholders

The fact that stock of Controlled is distributed to one or more domestic corporations that, if section 355 did not apply, would be entitled to an 80% or 100% dividends-received-deduction under section 243(c) or section 243(a)(2) or (3) is evidence that the transaction is not a device. Reg. § 1.355-2(d)(3)(iv).

4. Transactions not ordinarily considered a device

a. Absence of earnings and profits

A distribution is ordinarily not considered to have been used principally as a device if Distributing and Controlled have no current or accumulated earnings and profits as of the date of the distribution, and no distribution of property immediately before the transaction by Distributing would require the recognition of gain resulting in current earnings and profits for the year of the distribution. Reg. § 1.355-2(d)(5)(ii); Rev. Rul. 71-384, 1971-2 C.B. 181.

- (1) The last requirement of this safe harbor (i.e., that Distributing hold no appreciated property) may effectively eliminate the viability of this rule as to C corporations, since few if any corporations own no appreciated property.
- (2) However, an S corporation with no preconversion earnings and profits may satisfy this safe harbor even if it does hold appreciated property. Thus, the safe harbor, while of limited utility for C corporations, may prove a valuable planning tool for S corporations. For example, an S corporation with a small amount of preconversion earnings and profits may choose to make a dividend distribution under section 1368(e)(3) in order to purge itself of earnings and profits prior to a divisive “D” reorganization.
- (3) In South Tulsa Pathology Laboratory, Inc. v. Commissioner, 118 T.C. No. 5 (Jan. 28, 2002), the Tax Court rejected the taxpayer’s argument that the presence of minimal earnings and profits should satisfy this safe harbor. The taxpayer argued that a small amount of earnings and profits does not provide a sufficient basis for bailout of earnings to avoid dividend treatment. However, the Tax

Court held that the safe harbor requires no earnings and profits.

b. Section 302 or 303 transaction

A distribution that would qualify for sale or exchange treatment under section 302(a) or 303(a), but for the application of section 355, is ordinarily not considered a device. Reg. § 1.355-2(d)(5)(iii), (iv). However, if such a transaction involves the distribution of the stock of more than one controlled corporation and facilitates the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation, this provision does not apply. Reg. § 1.355-2(d)(5)(i).

5. Additional factors not contained in the regulations

a. Prior sales of stock

(1) The regulations do not explicitly refer to a sale of stock of Distributing immediately prior to the section 355 transaction as evidence of a device. The Treasury has previously indicated that it will correct this omission. See Rev. Rul. 59-197, 1959-1 C.B. 77. But see Reg. § 1.355-2(c)(2), Ex. 2.

(2) Such a transaction may also run afoul of the continuity of interest requirement. See Part III.G., infra.

b. Earnings of one business invested in other business

If the earnings of one business are used to finance the growth of another business, it may not be possible to distribute either business in a section 355 transaction. In Rev. Rul 59-400, 1959-2 C.B. 114, the spin-off of a hotel business was not a valid section 355 transaction, because the earnings of the hotel business were used to finance the growth of a rental real estate business, which was retained by Distributing.

D. Five-Year Active Trade or Business Requirement

1. In general

a. With respect to spin-offs and split-offs, Distributing and Controlled must be engaged in the active conduct of a trade or business immediately after the distribution. Section 355(b)(1)(A).

- b. With respect to split-ups, Distributing must not hold any assets other than stock or securities in controlled corporations immediately before the distribution, and each of the controlled corporations must be engaged in the active conduct of a trade or business immediately after the distribution. Section 355(b)(1)(B). A de minimis test is applicable in determining whether Distributing holds prohibited assets. Reg. § 1.355-3(a)(1)(ii).
- c. As discussed further below, the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA 2005”) amended section 355 effective May 17, 2006, by adding section 355(b)(3), which simplifies the active trade or business requirement as it applies to affiliated groups. The Service and Treasury have issued proposed regulations (“proposed ATB regulations”) that interpret this provision and its effect on other aspects of the active trade or business requirement, including the expansion rule and section 355(b)(2)(C) and (D). Prop. Reg. § 1.355-3, 72 Fed. Reg. 26,012 (May 8, 2007). The proposed ATB regulations also update the current regulations by “codifying” several revenue rulings and administrative practices.

2. Statutory requirements for an active trade or business -- Generally

- a. A corporation is treated as engaged in the active conduct of a trade or business if each of the following four requirements is satisfied:
 - (1) The corporation is engaged in the active conduct of a trade or business. Section 355(b)(2)(A).
 - a) Prior to May 17, 2006, a corporation could satisfy the active trade or business requirement if “substantially all” of its assets consisted of stock or securities in corporations that it controlled that were engaged in an active trade or business. Thus, a corporation could conduct a business directly or it could hold the stock of subsidiaries that conduct an active business.
 - b) However, the statute was amended by the Tax Technical Corrections Act of 2007 (“2007 Technical Corrections Act”), P.L. 110-172 § 4(b)(1), to remove the substantially all test in light of the affiliated group rules of section 355(b)(3), discussed below.

- (2) The trade or business has been actively conducted throughout the five-year period ending on the date of the distribution. Section 355(b)(2)(B).
- (3) The trade or business was not acquired during the five-year period ending on the date of the distribution in a transaction in which any gain or loss was recognized. Section 355(b)(2)(C).
- (4) Control of a corporation conducting such trade or business was not acquired by Distributing or any distributee corporation directly or through one or more other corporations within the five-year period preceding the distribution in a transaction in which any gain or loss was recognized. Section 355(b)(2)(D).

b. SAG Rules

- (1) In the case of any distribution made after May 17, 2006, for purposes of determining whether a corporation meets the requirement of section 355(b)(2)(A), all members of the corporation's separate affiliated group ("SAG") are treated as one corporation. Section 355(b)(3)(A).
 - a) A corporation's SAG is the affiliated group that would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply. Section 355(b)(3)(B).
- (2) On May 7, 2007, the Service and Treasury issued the proposed ATB regulations interpreting section 355(b)(3). The proposed ATB regulations concluded that the SAG rule overrides the "substantially all" rule of section 355(b)(2)(A). Prop. Reg. § 1.355-3(b)(1)(i); see also Notice 2006-81, 2006-40 I.R.B. 1 (Sept. 8, 2006). The statute was amended by the 2007 Technical Corrections Act (retroactively to May 17, 2006) to remove the substantially all rule.
- (3) The proposed ATB regulations treat members of a corporation's SAG as divisions of that corporation. Prop. Reg. § 1.355-3(b)(1)(ii).
 - a) The corporation is treated as owning the assets and conducting the activities of its SAG members in much the same way as a disregarded entity is treated. As a consequence, transfers of assets (or activities) owned (or performed) by the SAG

immediately before and immediately after the transfer are disregarded. Id.

- b) The proposed ATB regulations therefore treat an acquisition of stock of a SAG member as an acquisition of its assets. Id. The 2007 Technical Corrections Act amended the statute (retroactively to May 17, 2006) to confirm this. Section 355(b)(3)(C) provides that if a corporation becomes a SAG member in a taxable transaction, then any trade or business conducted by that corporation is treated as acquired in a taxable transaction.
 - c) For example, the Service has ruled that the conversion of an LLC treated as a disregarded entity into a corporation that was a member of Controlled's SAG would not affect the active trade or business requirement. See P.L.R. 200710011 (Nov. 15, 2006).
- (4) The proposed ATB regulations also introduce the concept of separate SAGs for Distributing and Controlled. Prop. Reg. § 1.355-3(b)(1)(iii).
- a) "Separate affiliated group of Distributing" ("DSAG") means the affiliated group that consists of Distributing as the common parent and all corporations affiliated with Distributing through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)).
 - b) "Separate affiliated group of Controlled" ("CSAG") is determined in the same manner as the DSAG except Controlled is the common parent.
 - i) Prior to distribution, the DSAG may include CSAG members if the applicable affiliation requirements are satisfied.
 - ii) As a result, the proposed 355(b) regulations give five-year active trade or business credit regardless of how the assets and activities may be owned (and performed) by SAG members during the pre-distribution period. Preamble to Prop. Reg. § 1.355-3, 72 Fed. Reg. at 26,014.

3. Trade or business

The first criterion for satisfying the active trade or business requirement is the existence of a trade or business.

- a. The regulations provide a broad definition of what activities constitute a trade or business, primarily focusing on whether the purpose of the activities is to generate a profit. However, the regulations also provide that the activities must include all steps in the process of earning income, specifically noting that ordinarily these steps must include the collection of income and the payment of expenses. Reg. § 1.355-3(b)(2)(ii).
- b. In 1988, the Service revoked a number of older revenue rulings, which concluded without analysis that a trade or business existed. Rev. Rul. 88-19, 1988-1 C.B. 114.
- c. An aspect of the active trade or business requirement that is likely to generate increasing dissatisfaction on the part of taxpayers is the requirement that the business have generated gross receipts for the preceding five years.
 - (1) The Service apparently will not rule unless the taxpayer submits income statements demonstrating gross receipts. See Rev. Proc. 96-30, § 4.03(2)(h), 1996-1 C.B. 696. By contrast, the regulations merely state that “ordinarily” the active conduct of a business includes the collection of income. The regulations suggest that the determination of whether an active business exists should be made based on all the facts and circumstances.
 - (2) The Service has previously ruled on one occasion that an oil and gas exploration business did not meet the active conduct test, because it had not generated gross receipts during the relevant period. See Rev. Rul. 57-492, 1957-2 C.B. 247.
 - (3) However, Rev. Rul. 57-492 was issued under the old regulations. Prior to 1989, the regulations expressly stated that a group of activities comprising an active trade or business “does not include . . . [a] group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.” Old Reg. § 1.355-1(c)(3) (1955). That provision was removed when the

current regulations were issued in 1989, suggesting that the actual production of income is no longer required. The inclusion of the term “ordinarily” in the current regulations suggests that there are situations in which a corporation will be treated as engaged in the active conduct of a trade or business in the absence of the collection of income or the payment of expenses.

- (4) Gross receipts ordinarily are indicative of the active conduct of a business. However, the absence of such gross receipts should not preclude a finding of an active trade or business. The requirement that a business have gross receipts to be considered an “active trade or business” reflects outdated assumptions based on a manufacturing economy. Increasingly, high technology businesses may spend a number of years developing intangible assets through research and development before these assets can be translated into a viable product for sale to customers in the ordinary course of business. Given the commitment of capital and personnel, such start-up companies should be treated as engaged in the active conduct of a business, regardless of whether the business has gross receipts. In an increasingly knowledge-based economy, the Code should not discriminate between businesses that are in different stages of the product development cycle.
 - (5) The sharing of gross receipts through a revenue sharing arrangement will not preclude a taxpayer from satisfying the gross receipts requirement. See P.L.R. 200004035 (Aug. 3, 1999). In P.L.R. 200004035, Controlled derived the majority of its income from the rental of Product A. Controlled had developed a new business practice whereby it entered arrangements with its suppliers to procure Product A at a greatly reduced initial price in exchange for a portion of the rental revenue derived. The Service found that Controlled satisfied the active business requirement.
- d. The proposed ATB regulations would add that a corporation will not be treated as engaged in the active conduct of a trade or business unless it (or its SAG, or a partnership from which the trade or business assets and activities are attributed) is the principal owner of the goodwill and significant assets of the trade or business for federal income tax purposes. Prop. Reg. § 1.355-3(b)(2)(iii). The goal of this rule is to assist in determining who the true tax owner of an active trade or business where a business may be fragmented amongst an affiliated group.

4. Active conduct

In addition, the trade or business must be actively conducted. Whether a trade or business is actively conducted is a question of fact. Reg. § 1.355-3(b)(2)(iii).

- a. In order for a trade or business to be considered actively conducted, the corporation itself must perform active and substantial management and operational functions. Reg. § 1.355-3(b)(2)(iii); Rev. Rul. 88-19, 1988-1 C.B. 114. The Service has ruled that one managerial employee and one operating employee are sufficient. Rev. Rul. 73-234, 1973-1 C.B. 180, distinguished Rev. Rul. 86-126, 1986-2 C.B. 58.
- (1) Generally, activities of independent contractors or others outside the corporation are not taken into account. Reg. § 1.355-3(b)(2)(iii).
 - (2) The Service has ruled that the active business requirement is not met with regard to the rental of an office building where the building is managed by an unrelated management company acting as an independent contractor. Rev. Rul. 86-125, 1986-2 C.B. 57.
 - (3) The Service has also ruled that the activities of tenant farmers are not taken into account in determining whether the landlord farmer is actively engaged in the farming business. Rev. Rul. 86-126, 1986-1 C.B. 59; cf. Rev. Rul. 73-234, 1973-1 C.B. 180 (landlord who had employee performing substantial managerial and operational functions considered to be in an active business).
 - (4) However, the Service has ruled that a corporation may take into account the operational activities of employees of an affiliated entity, as long as the corporation's officers perform active and substantial management functions for that affiliated entity. See Rev. Rul. 79-394, 1979-2 C.B. 141, amplified by Rev. Rul. 80-181, 1980-2 C.B. 121 (ruling that Controlled with no paid employees of its own was engaged in an active business using employees of a sister corporation, where its officers performed substantial management functions).
- a) The proposed ATB regulations would expand the principles of Rev. Rul. 79-394 and apply them to both management and operational functions. Preamble to Prop. Reg. § 1.355-3, 72 Fed. Reg. at

26,023. Thus, management and operational activities performed by a corporation include activities performed by employees of an affiliate (including non-SAG members). Prop. Reg. § 1.355-3(b)(2)(iii).

b) Management and operational activities performed by a corporation may include activities performed by a shareholder if the corporation is closely held. Id.

(5) Similarly, a corporation that is a general partner in a partnership may be engaged in an active business, as long as its officers perform substantial management functions for the partnership. See Rev. Rul. 92-17, 1992-1 C.B. 142; P.L.R. 200044017 (Aug. 2, 2000); see also Prop. Reg. § 1.355-3(b)(2)(v). See Part III.D.9.g, infra, for a more detailed discussion of conducting an active business through a partnership.

b. The active conduct of a trade or business does not include the following:

(1) Holding stock, securities, land, or other property for investment purposes. Reg. § 1.355-3(b)(2)(iv)(A). This is true even if the corporation actively manages its investments. See Rev. Rul. 66-204, 1966-2 C.B. 113.

(2) The ownership and operation, including leasing, of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property. Reg. § 1.355-3(b)(2)(iv)(B); see also Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971), cert. denied, 400 U.S. 922 (1972) (net lease of real estate by subsidiary to parent corporation not viewed as an active business). But see P.L.R. 199909020 (Nov. 13, 1998) (rental real estate business viewed as an active business where company advertised vacancies, negotiated leases, handled tenant problems, maintained the books, and performed everyday carpentry, plumbing, and electrical work).

(3) Holding non-operating assets for use by a related corporation. See Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998).

- c. Further, the regulations provide that a separation of real property, which, before the distribution, is occupied or substantially occupied by either Distributing or Controlled (or by any corporation controlled directly or indirectly by either of those corporations) from the business occupying the real property will be carefully scrutinized in determining whether the active business requirement is satisfied. Reg. § 1.355-3(b)(2)(iii). Such a separation will also be scrutinized under the device requirement, because the real estate is a related function.

- d. The Service finally reversed its longstanding position that the rental activities of a real estate investment trust (“REIT”) could not constitute an active trade or business. Rev. Rul. 2001-29, 2001-1 C.B. 1348, obsoleting Rev. Rul. 73-236, 1973-1 C.B. 183.
 - (1) Section 856(d)(3), as in effect in 1973, excluded from the term “rents from real property” amounts received with respect to such property if the REIT rendered services to the tenants, or managed or operated such property, other than through an independent contractor.
 - (2) In Rev. Rul. 73-236, the Service ruled that, because the REIT’s rental activities were designed to qualify its income as “rents from real property” within the meaning of section 856(d), the REIT did not perform substantial management and operational activities.
 - (3) The Tax Reform Act of 1986 amended section 856(d) to permit REITs to render services to tenants if such services are not primarily for the convenience of the occupant and are customarily rendered in connection with the rental of real property.
 - (4) In Rev. Rul. 2001-29, the Service concluded that this amendment permits REITs to perform activities that can constitute active and substantial management and operational functions.
 - (5) In PLR 201337007 (September 28, 2012) the IRS allowed the tax-free spinoff where a C corporation spun off its real estate assets into a newly formed REIT. However, the ruling involved the spin-off of some additional business assets, so it was not just the distribution and lease back of real estate.

- e. Examples

- (1) Corporation D, a bank, has for the past seven years owned an 11-story building. D occupies the ground floor of this building to conduct its banking business. The remaining 10 floors of the building are rented to various tenants. This rental activity is managed and maintained by employees of the bank. D proposes to transfer the building to a new corporation and to distribute the stock of the new corporation to its shareholders. The new corporation will manage the building, negotiate leases, seek new tenants, and will repair and maintain the building. Immediately after the distribution the activities in connection with banking will constitute the active conduct of a trade or business, as will the activities in connection with the rental of the building. Reg. § 1.355-3(c), Ex. 12.
- (2) Corporation E, a bank, has for the past nine years owned a two-story building. E occupies the ground floor of the building and one-half of the second floor to conduct its banking business. The other one-half of the second floor is rented as storage space. E proposes to transfer the building to a new corporation and to distribute the stock of the new corporation to its shareholders. E will lease the space occupied by it from the new corporation and, under the lease, will repair and maintain its portion of the building and pay property taxes and insurance. The new corporation will not be engaged in the active conduct of a trade or business immediately after the distribution. Reg. § 1.355-3(c), Ex. 13.

5. Percentage of total assets that must be related to the active business

a. Old Law

- (1) Prior to the TIPRA 2005, the Service had noted that there was no requirement in section 355(b) that a specific percentage of a corporation's assets be devoted to the active conduct of a trade or business. See Rev. Rul. 73-44, 1973-1 C.B. 182, clarified, Rev. Rul. 76-54, 1976-1 C.B. 96. In this ruling, less than half of the value of Controlled was attributable to assets used in the corporation's active business. See also P.L.R. 200109027 (Nov. 30, 2000) (Distributing merged active subsidiaries into single-member LLCs to increase its active business from less than 5% to approximately 7%); P.L.R. 8712019 (Dec. 18, 1986) (6% of the corporation's assets devoted to the active conduct of its trade or business); G.C.M. 36,069 (Nov. 5,

1974) (16% of the corporation's assets devoted to the active conduct of its trade or business).

- (2) In G.C.M. 34,238 (Dec. 15, 1969), the Service concluded that a corporation (Eversharp) having assets attributable to its active business equal to only 5% of the corporation's net book value, and holding large blocks of stock in two publicly traded corporations (Schick and Technicolor), could be considered to be engaged in the active conduct of a trade or business.
- (3) For ruling purposes, the Service had indicated that it generally would not rule favorably if the gross assets of the trades or businesses relied on to satisfy the active trade or business requirement of section 355(b) would have had a fair market value that is less than 5% of the total fair market value of the gross assets of the corporation directly conducting the trades or businesses. Rev. Proc. 2003-48 deleted this requirement.
 - a) The Service may rule that the trades or businesses satisfy the active trade or business requirement of section 355(b) if it can be established that, based upon all relevant facts and circumstances, the trades or businesses are not de minimis compared with the other assets or activities of the corporation and its subsidiaries. See Rev. Proc. 96-43, 1996-2 C.B. 330.
 - b) For example, in P.L.R. 200025001 (July 9, 1999), Controlled was indirectly engaged in an active trade or business through its subsidiaries. Controlled contributed stock of Corporation to one of its subsidiaries. The value of the Corporation stock was very volatile, and an increase in the value could cause the relative value of the Subsidiary's active assets to fall below 5%. Nevertheless, the subsidiary established that even if the relative value of its active business fell below 5%, it was not de minimis compared with the subsidiary's other assets. See also P.L.R. 200419030 (Feb. 2, 2004) (taxpayer represented that the active trade or business would constitute either (i) 5% of the gross asset value, (ii) at least two of the following: 5% of the revenues, 5% of the customers, and 5% of the employees, or (iii) both (i) and (ii)); P.L.R. 200234021 (May 14, 2002) (taxpayer represented

that the active trade or business would constitute either (i) 5% of the gross asset value, (ii) 8% of the employees and 7.5% of the revenues, or (iii) both (i) and (ii)); P.L.R. 200137011 (June 4, 2001) (taxpayer represented that the active trade or business would constitute either (i) 5% of the gross asset value or (ii) 5.1% of the revenues, 5.5% of the customers, and 5.1% of the employees); P.L.R. 200131003 (Apr. 10, 2001) (same); P.L.R. 200121069 (Feb. 28, 2001) (an increase in C's value after the spin-off made it impossible to be certain that the active assets were worth 5% of the gross assets, but C submitted sufficient evidence that its active assets were not de minimis).

- (4) A high percentage of liquid or investment assets may, however, be evidence of a device.

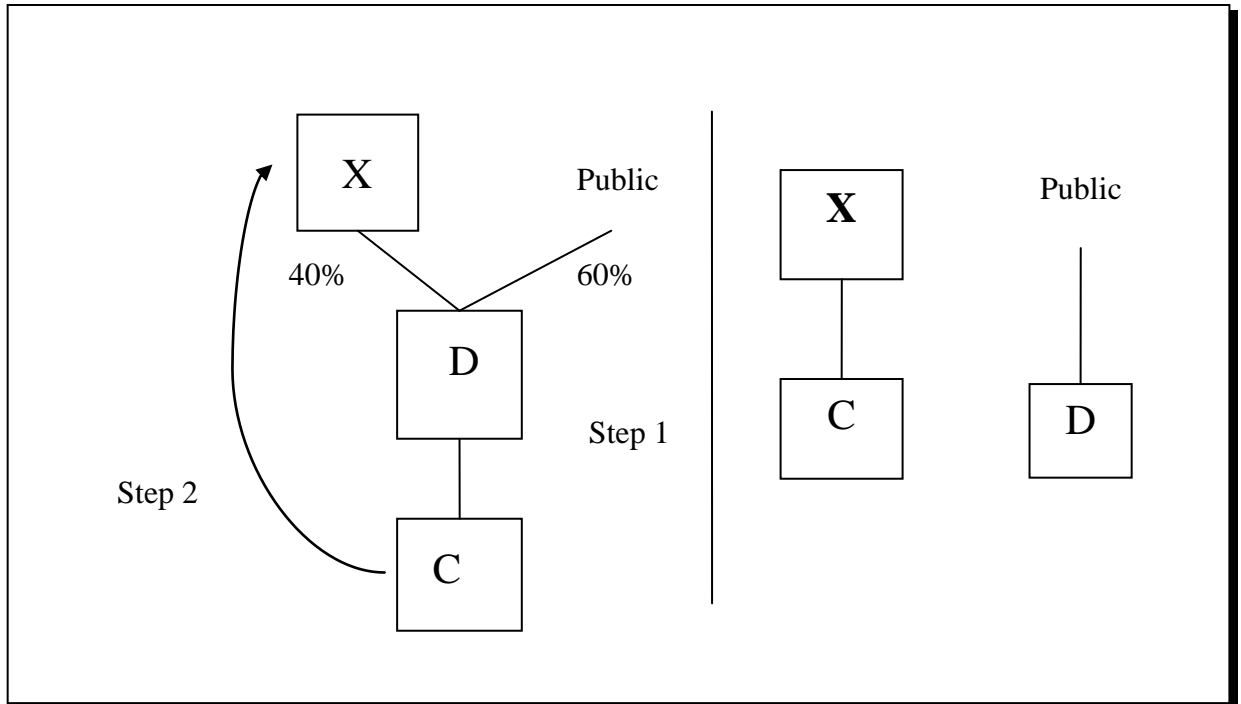
b. Current Law: Section 355(g) — Transactions Involving Disqualified Investment Corporations.

- (1) TIPRA 2005 added section 355(g) to the Code.
- (2) Under section 355(g), a transaction does not qualify under under section 355 if, immediately after the transaction:
 - a) Either Distributing or Controlled is a “disqualified investment corporation” and
 - b) Any person holds a 50% or greater interest of the disqualified investment corporation who did not hold such an interest prior to the transaction.
 - i) Thus, section 355(g) does not apply to pro rata distributions.
 - ii) A distribution may be non-pro rata and still not satisfy the 50% or greater interest requirement. For example, in P.L.R. 200905018 (Oct. 21, 2008), Distributing was a disqualified investment corporation owned by two shareholders, a minority shareholder and a greater-than-50% shareholder, and it split off Controlled to the minority shareholder. The Service ruled that section 355(g) did not apply, because the greater-than-50% shareholder would continue to own more than 50% of Distributing.

- iii) However, technically, this provision could apply where a newly formed Controlled is distributed, because Distributing could not have held 50% or more of a controlled corporation that does not exist.
- (3) A “disqualified investment corporation” is defined as any distributing or controlled corporation if the fair market value of the investment assets of the corporation is 2/3 or more of the fair market value of all assets of the corporation. Section 355(g)(2)(A)(i).
- a) There was a transitional rule for the first year after enactment that permitted a corporation to have up to 3/4 investment assets. Section 355(g)(2)(A)(ii).
- (4) The term “investment assets” includes: cash, stocks, securities, interests in a partnership, debt instruments, options, forwards, notional principal contracts, derivatives, foreign currency, and other similar assets.
- a) The following assets are specifically excluded from the term “investment assets.”
 - i) Assets used in active conduct of a lending, banking, or insurance business; and
 - ii) Securities marked to market.
 - b) Note that cash and other investment type assets that are related to the active trade or business (e.g., working capital and accounts receivable) are not excluded from the definition.
 - c) Certain other passive assets, such as passive real estate investments, are not included in the definition of investment assets.
 - d) The Service has authority to issue regulations regarding the treatment of assets unrelated to the active trade or business as investment assets if, prior to the distribution, investment assets were used to acquire such unrelated assets.
- (5) Rules relating to subsidiaries and partnerships owned by Distributing or Controlled:

- a) For purposes of computing percentages of investment assets, stocks or securities of a 20% subsidiary are not counted. Instead, Distributing or Controlled is treated as owning a ratable share of the subsidiary's assets.
 - b) Similarly, interests in a partnership are not counted if one or more of the businesses of the partnership (without regard to the 5-year requirement) would satisfy the active trade or business requirement.
- (6) The provisions contained in section 355(g) are effective for distributions after May 17, 2006, the date of enactment. However, section 355(g) does not apply to any transaction: (i) made pursuant to an agreement which was binding on the date of enactment; (ii) described in a ruling request submitted to the Service on or before such date; or (iii) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

c. Section 355(g) Example



- (1) Facts: X owns a 40% interest in D; the rest of the D stock is publicly traded. For valid business purposes, D would like to redeem X's interest. To accomplish this, D creates an new entity, C, contributing to it an active trade or business with a value of \$30 and cash of \$70. D then distributes its C stock to X in exchange for X's D stock.
- (2) Analysis: In 2006, the provisions of 355(g) will not apply to this transaction as it satisfies the 3/4 test because the percentage of investment assets contributed to C is only 70%. However, this distribution would fail in 2007 under the 2/3 test. The more stringent percentage requirement will not become effective until one year after the subsection's enactment.
- (3) Assume instead that D contributes to C an active trade or business worth \$10, rental real estate worth \$20, and cash of \$70. The answer should not change.

6. Five-year period

The trade or business must have been actively conducted for the five-year period preceding the distribution. Reg. § 1.355-3(b)(3).

- a. If the business has been acquired in a tax-free acquisition, the predecessor's business history is tacked in computing whether the business has been actively conducted for a five-year period. See Atlee v. Commissioner, 67 T.C. 395, 405 n.17 (1976), acq., 1977-1 C.B. 1; P.L.R. 9405022 (Nov. 8, 1993). Thus, for example, if the business were originally conducted by a partnership and then contributed to a corporation in a section 351 transaction, the business should be considered to have been actively conducted for the period of time that it was conducted by the partnership plus the period of time that it was conducted by the corporation.

b. Change in business

In determining whether a trade or business has been actively conducted for the five-year period preceding the distribution, the fact that during such period the trade or business underwent a change such as the addition of new, or the dropping of old, product lines or a change in production capacity is disregarded as long as the change is not of such a character as to constitute the acquisition of a new or different business. Reg. § 1.355-3(b)(3)(ii).

c. Expansion of business

- (1) The regulations provide that the expansion of an existing business generally constitutes the continuation of the existing business rather than the beginning of a new business. Reg. § 1.355-3(b)(3)(ii) states:

[I]f 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 actively conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business.

- (2) This appears to overrule Boettger v. Commissioner, 51 T.C. 324 (1968) (business acquired within five years of split-up not considered an expansion even though it was the same type as the acquiring corporation's business and it was integrated into the acquiring corporation's operations).
- (3) If the acquisition of a business constitutes an expansion, the expansion may qualify as a five-year trade or business even if the expansion itself has not been operated for five years. See Reg. § 1.355-3(c), Exs. 5 (eight months), 7 (three years), and 8 (two years).
- (4) Horizontal expansion – An expansion may involve acquiring or opening an additional facility to do the same thing the original facility does. See Reg. § 1.355-3(c), Exs. 5 (corporation operating an edible pork skin factory opens up new factory), 7 (corporation operating a department store constructs new department store), and 8 (corporation operating hardware stores purchases assets of another hardware store).
- (5) Vertical expansion – An expansion may involve entering into a new stage of the existing business.

- a) For example, a manufacturer may begin conducting distribution or marketing activities.
 - b) In P.L.R. 199937014 (June 15, 1999), Distributing created two new subsidiaries, Controlled and Sub. Prior to the proposed spin-off of Controlled, Distributing acquired the assets of Target and Target-Sub for cash and dropped the assets of Target into Sub and the assets of Target-Sub into Controlled. Target-Sub was engaged in the business of installing the types of products manufactured by Distributing. Prior to the acquisition, however, Distributing had not been engaged in the business of installing its products. The business purpose for the spin-off was to avoid competition with the Distributing group's customers, which resulted from the acquisition of Target-Sub. The Service ruled that the installation business was an expansion of Distributing's business.
- (6) An expansion of a business may occur in a different geographic location from that of the original operations of a qualifying business. See Estate of Lockwood v. Commissioner, 350 F.2d 712 (8th Cir. 1965) (expansion to multiple states); Reg. § 1.355-3(c), Exs. 7 (expansion from downtown location to suburbs) & 8 (expansion to different state); P.L.R. 200146020 (July 11, 2001) (expansion to different locations within foreign country); P.L.R. 200545001 (Aug. 12, 2005) (expansion of business and marketing efforts in specific states by merger to align efforts with regional and marketing strategy of parent).
- (7) An expansion may also occur through the incorporation of new technologies. In P.L.R. 9646019 (Aug. 16, 1996), the Service applied the expansion doctrine where Distributing expanded its business to introduce a new product line that incorporated new technological developments and complemented Distributing's current products.
- (8) Expansion Through Disregarded Entities
- a) The Service ruled that the 5-year active conduct of a trade or business requirement was satisfied when, during the 5-year period prior to a transaction that otherwise meets the requirements of section 355, a corporation holding a membership interest in a

member-managed limited liability company purchased the remaining interests in that limited liability company, contributed a portion of the business to a newly formed controlled subsidiary, and then distributed the stock of the controlled subsidiary to its shareholders. The corporation's purchase of the remaining interests, which causes the LLC to become disregarded as an entity separate from the corporation, does not result in the acquisition of a new or different business. Rev. Rul. 2002-49, 2002-2 C.B. 288.

- b) In P.L.R. 200410013 (Nov. 26, 2003), Controlled engaged in a business through a disregarded entity, LLC1. Controlled acquired the stock of a corporation engaged in the same business and subsequently caused the corporation to be merged into another disregarded entity owned by Controlled, LLC2. The assets of LLC2 were considered an expansion of the business conducted by Controlled's LLC1 division.
- (9) The regulations do not define when a business is in the "same line of business," but the regulations and other authorities do provide some guidance.
- a) The Eighth Circuit has attempted to define "same line of business," noting that the crucial question was whether the two corporations existing after the distribution were "doing the same type of work and using the same type of assets previously done and used." Estate of Lockwood v. Commissioner, 350 F.2d 712 (8th Cir. 1965).
 - b) The Service has been applying a factor analysis in determining whether a business is in the same line of business.
 - i) The Service has ruled that a dealer holding a franchise for the sale and service of a particular brand of automobile tires who acquired a franchise to sell and service another brand of tires is considered to have expanded the original business. Rev. Rul. 2003-18, 2003-1 C.B. 467, obsoleting Rev. Rul. 57-190, C.B. 1957-1 C.B. 121. The Service based its conclusion on the

following factors: (i) the products of the two dealerships are similar; (ii) the business activities associated with the two dealerships (i.e., sales and source) are the same; and (iii) the operation of the new dealership involves the use of the experience and know-how that the dealer developed in the operation of the original dealership.

- ii) The Service has also ruled that a shoe store's creation of an Internet website that sold shoes at retail constitutes an expansion of a single business. The Service relied on similar factors, namely that the product (i.e., shoes) and principal business activities of the retail shoe store business and the web site (i.e., purchasing shoes at wholesale and reselling them at retail) were the same. The Service stated that although selling shoes on a web site requires some know-how not associated with operating a retail store, such as different marketing approaches, distribution chains, and technical operations issues, the website's operation draws to a significant extent on existing experience and know-how and the web site's success will depend in large measure on goodwill associated with Distributing's name. Rev. Rul. 2003-38, 2003-1 C.B. 811.
 - iii) The proposed ATB regulations would codify the facts and circumstances analysis in Rev. Rul. 2003-18, 2003-1 CB 467 and Rev. Rul. 2003-38, 2003-1CB 811. See Prop. Reg. § 1.355-3(b)(3)(ii); Preamble to Prop. Reg. § 1.355-3, 72 Fed. Reg. at 26,024.
- (10) The regulations address only in part the acceptable methods of expansion.
- a) Distributing can expand its own business constructing a new facility. See Reg. § 1.355-3(c), Exs. 5 & 7.
 - b) Alternatively, Distributing can expand its business by acquiring the assets of an existing business from a third party. See Reg. § 1.355-3(c), Ex. 8.

- i) It is not clear how long Distributing must hold such assets before contributing them to a subsidiary. The regulations permit as little as eight months to elapse. See Reg. § 1.355-3(c), Ex. 5.
 - ii) The Service has also permitted immediate transfers of the acquired business assets to a subsidiary. See P.L.R. 199937014 (June 15, 1999).
- c) Distributing can even expand its business by beginning to operate assets that it already owns. In P.L.R. 200138025 (June 26, 2001), Distributing was engaged in an active trade or business at the time of the spin-off through its ownership and operation of X and Y. D had owned and operated X for more than five years, but had leased Y to an unrelated third party pursuant to a 10-year lease. The lease ended less than five years before the spin-off, and Distributing operated Y since then. The Service viewed Distributing's operation of Y as an expansion.
- d) The regulations do not address whether Distributing can expand its business through a "cause-to-be-directed" transfer in which Distributing acquires the assets of a business but causes the seller to transfer the assets directly to a subsidiary of Distributing. See P.L.R. 199937014 (June 15, 1999). The Service generally treats such acquisitions as a transfer of assets to Distributing followed by a contribution to Controlled, similar to the asset acquisition in Example 8 in the regulations.
- e) The regulations do not address whether Distributing may expand its business through the acquisition of stock of a subsidiary engaged in the same line of business.
 - i) The Tax Court has held, however, that a subsidiary's acquisition of a business using cash contributed by the parent may constitute an expansion of the parent corporation's qualifying business. See Athanasios v. Commissioner, 69 T.C.M. (CCH) 1902 (1995); cf. Rev. Rul. 79-394,

1979-2 C.B. 141, amplified by Rev. Rul. 80-181, 1980-2 C.B. 121 (ruling that Controlled with no paid employees of its own was engaged in an active business using employees of a sister corporation, where its officers performed substantial management functions); Rev. Rul. 92-17, 1992-1 C.B. 142 (ruling that a corporation that is a general partner in a limited partnership was engaged in an active business where its officers performed substantial management functions for the partnership).

- ii) The Service has taken the position that a stock acquisition cannot constitute an expansion. See P.L.R. 200109027 (Nov. 30, 2000) (suggesting no expansion with respect to a stock acquisition). However, if the target subsequently liquidates into Distributing, the target's business may be treated as an expansion of Distributing's business. See id.; Rev. Rul. 2002-49, 2002-2 C.B. 288.
- f) Section 355(b)(3) and the regulations proposed thereunder treat certain stock acquisitions as expansions.
- i) As discussed above, section 355(b)(3) treats all members of a corporation's SAG as one corporation for purposes of applying the active trade or business test.
 - ii) Prop. Reg. § 1.355-3(b)(1)(ii) provides that a transaction that results in a corporation becoming a SAG member is essentially treated as an asset acquisition notwithstanding that the stock of the acquired SAG member was acquired. Thus, where the acquiring SAG is in the same line of business as the acquired SAG member, it can be an expansion of the acquiring SAG's business.
 - iii) As a corollary, however, the proposed ATB regulations provide that an acquisition of stock of a non-SAG member cannot be an

expansion. Preamble to Prop. Reg. § 1.355-3, 72 Fed. Reg. at 26,024.

- d. It appears that Distributing can push-down a qualified five-year business to Controlled, which is not engaged in a qualifying business, so that Controlled satisfies the active business requirement. Rev. Rul. 73-44, 1973-1 C.B. 182, clarified, Rev. Rul. 76-54, 1976-1 C.B. 96.
- e. The Service has ruled that a temporary cessation of activities is not taken into account for purposes of the five-year requirement as long as Distributing maintains the separate identity of the business and makes an effort to resume activities. Rev. Rul. 57-126, 1957-1 C.B. 123; cf. Spheeris v. Commissioner, 461 F.2d 271 (7th Cir. 1972) (finding no active trade or business where the business was discontinued and no effort was made to rebuild the facility).

7. Acquisition of a trade or business, or of control of a corporation conducting a trade or business, in a transaction without any gain or loss

Section 355(b)(2)(C) requires that the trade or business not have been acquired in a transaction in which any gain or loss was recognized during the five-year period preceding the distribution. Similarly, section 355(b)(2)(D) requires that control of the corporation conducting the trade or business not have been acquired, directly or indirectly, by a corporate distributee or Distributing in a transaction in which any gain or loss was recognized during the same period.

- a. Section 355(b)(2)(D) was amended by the 1987 Act to preclude the use of section 355 in the following transaction:
 - (1) In Rev. Rul. 74-5, 1974-1 C.B. 82, obsoleted, Rev. Rul. 89-37, 1989-1 C.B. 107, corporation P purchased all of the stock of X, which owned all the stock of Y. Two years after P's purchase of X, X distributed the stock of Y to P. As of the time of the distribution, X had owned the Y stock for the requisite five-year period. One year after the distribution of Y to P, P distributed the same Y stock to its shareholders.
 - (2) The Service concluded that the first distribution (Y stock to P) qualified as a section 355 transaction. Even though P acquired control of Y indirectly within five years, the Service concluded that section 355(b)(2)(D) (as then in effect) did not prevent the application of section 355. Prior to 1987, section 355(b)(2)(D) provided that control of a corporation that conducted an active trade or business must

not have been acquired by “another corporation” within the five-year period before the distribution.

- (3) The Service reasoned that section 355(b)(2)(D) was intended to prevent a distributing corporation from accumulating excess funds to purchase stock of a corporation having an active trade or business and immediately distributing such stock to its shareholders.
 - (4) Thus, section 355(b)(2)(D) did not apply to P, because P was merely a shareholder and was not the distributing or controlled corporation. That is, P was not attempting to bail out its earnings through the distribution of Y stock.
 - (5) However, section 355(b)(2)(D) (as then in effect) did apply to the second distribution (Y stock distributed by P), since P had indirectly acquired the stock of Y in a taxable exchange (the purchase of X) within five years. Thus, under section 355(b)(2)(D), Y was not considered to be engaged in an active trade or business.
 - (6) As a result of the amendment to section 355(b)(2)(D) by the 1987 Act, the focus now is whether Distributing or the distributee corporation acquired control, either directly or indirectly, of the corporation that is being distributed in a transaction in which any gain or loss is recognized. Thus, the distribution by X of the Y stock in Rev. Rul. 74-5 is no longer tax free. Rev. Rul. 74-5 was rendered obsolete by Rev. Rul. 89-37, 1989-1 C.B. 107.
 - (7) It should be noted that the 1987 amendment to section 355(b)(2)(D) only applies to corporate distributees; i.e., it does not apply to individuals, partnerships, or trusts. Furthermore, the 1987 amendment only applies to the acquisition of control as defined in section 368(c).
 - a) Thus, under section 355(b)(2)(D), as amended by the 1987 Act, it is possible for a non-corporate purchaser to acquire control of Distributing or for a corporation to purchase less than an 80% interest in the distributee and distribute stock of Controlled tax free under section 355.
- b. Section 355(d) has further restricted the use of section 355 with respect to distributions made after October 9, 1990 to all distributees and not just corporate distributees. See Part III.I., infra.

- c. A redemption of stock owned by a minority shareholder, which results in Distributing's owning more than 80% of Controlled has been held to constitute a prohibited acquisition of control under section 355(b)(2)(D). See McLaulin v. Commissioner, 276 F.3d 1269 (11th Cir. 2001); Rev. Rul. 57-144, 1957-1 C.B. 123. But the Service has found that section 355(b)(2)(D) was not violated in a similar case when Distributing rescinded the redemption transaction. See P.L.R. 200716024 (Dec. 22, 2005).
- d. The May 8, 2007 proposed ATB regulations would significantly modify the application of section 355(b)(2)(C) and (D) in an effort to give effect to section 355(b)(3). See Section 355(b)(3)(D) (granting regulatory authority to modify section 355(b)(2)(C) and (D)).
 - (1) Note that these rules do not apply to an acquisition that constitutes an expansion.
 - (2) Because the acquisition of a subsidiary SAG member is treated as an asset acquisition, the SAG rule alters the application of section 355(b)(2)(C) and (D) with respect to the acquisition of stock of a corporation that is or becomes a subsidiary SAG member. See Preamble to Prop. Reg. § 1.355-3, 72 Fed. Reg. at 26,014.
 - a) Section 355(b)(2)(C) by its terms applies to asset acquisitions, while section 355(b)(2)(D) applies to stock acquisitions.
 - b) Acquisitions of subsidiary SAG members are treated as asset acquisitions and tested under section 355(b)(2)(C). See Prop. Reg. § 1.355-3(b)(4)(i)(A).
 - i) The 2007 Technical Corrections Act amended the statute (retroactively to May 17, 2006) to confirm this. Section 355(b)(3)(C) provides that if a corporation becomes a SAG member in a taxable transaction, then any trade or business conducted by that corporation is treated as acquired in a taxable transaction.
 - c) Acquisitions of either an interest in a partnership or stock of a corporation engaged in a trade or business that later becomes a subsidiary SAG member are also tested under section 355(b)(2)(C). See Prop. Reg. § 1.355-3(b)(4)(iv)(F).

- d) Acquisitions of stock constituting section 368(c) control, but not satisfying the section 1504(a)(2) requirement, are respected as stock acquisitions and are tested under section 355(b)(2)(D). See Prop. Reg. § 1.355-3(b)(4)(i)(B).
 - e) Acquisitions of stock satisfying the section 1504(a)(2) requirement once Distributing already owns section 368(c) control of Controlled could violate section 355(b)(2)(C), even though the acquisition does not violate section 355(b)(2)(D). See Prop. Reg. § 1.355-3(d)(2), Ex. 42; Notice 2007-60, 2007-2 C.B. 466.
 - i) This result seems strange since this fact pattern is usually within the province of the hot stock rule of section 355(a)(3)(B) (discussed at Part III.F., below), not the active trade or business requirement. Query whether this result is required by section 355(b)(3)(D) (requiring the Secretary to prescribe regulations modifying the application of the hot stock rule in connection with the application of the SAG rule).
 - ii) To provide taxpayers with transitional relief from this result, the Service will not challenge Distributing's (or its SAG's) acquisition of additional stock of Controlled as violating section 355(b)(2)(C) for distributions on or before the date the proposed ATB regulations are published as temporary or final regulations, provided that the transaction satisfies the requirements of section 355(b)(2)(D) as in effect before the enactment of section 355(b)(3). Notice 2007-60, 2007-2 C.B. 466.
- (3) The proposed ATB regulations interpret and apply section 355(b)(2)(C) and (D) in a manner consistent with their purpose, even if that interpretation is inconsistent with the literal language of the statute. Prop. Reg. § 1.355-3(b)(4)(iii); Preamble to Prop. Reg. § 1.355-3, 72 Fed. Reg. at 26,015.

- a) The purposes of section 355(b)(2)(C) and (D), as identified by the proposed ATB regulations, are:
- i) To prevent Distributing from using its assets (as opposed to its stock or stock of a corporation in control of Distributing) to acquire a new trade or business in anticipation of a distribution to which section 355 would otherwise apply.
 - ii) To ensure that Distributing and its shareholders have a historic relationship with the separated active trades or businesses.
 - iii) To prevent a distributee corporation from acquiring control of Distributing in anticipation of a distribution to which section 355 would otherwise apply.
- b) The proposed ATB regulations treat certain nonrecognition acquisitions as violating section 355(b)(2)(C) and (D) if the acquisition was made in exchange, either directly or indirectly, for Distributing's assets. See Prop. Reg. § 1.355-3(b)(4)(ii)(A), (B).
- i) Acquisition of an interest in a partnership in exchange for assets not constituting the trade or business to be relied upon in a section 721 transaction. Prop. Reg. § 1.355-3(b)(4)(ii)(A).
 - ii) Acquisition of stock in a corporation in exchange for assets not constituting the trade or business to be relied upon in a section 351 transaction. Prop. Reg. § 1.355-3(b)(4)(ii)(A).
 - iii) Acquisition of stock of a corporation engaged in the trade or business in a section 304(a) transaction. Prop. Reg. § 1.355-3(b)(4)(ii)(A).
 - iv) Acquisition of a trade or business in exchange for Distributing's stock and assets in a transaction in which no loss is

recognized by virtue of section 351(b).
Prop. Reg. § 1.355-3(b)(4)(ii)(A).

- v) Acquisition consisting of a distribution from a partnership. Prop. Reg. § 1.355-3(b)(4)(ii)(B).

- c) The proposed ATB regulations treat certain acquisitions in which gain or loss was actually recognized as not violating section 355(b)(2)(C) and (D), because the acquisition does not violate the purposes of the section. See Prop. Reg. § 1.355-3(b)(4)(iii).
 - i) Acquisitions by the CSAG from the DSAG, provided the DSAG controls Controlled immediately after the acquisition. Prop. Reg. § 1.355-3(b)(4)(iii)(A).

 - ii) Acquisitions where cash paid to shareholders for fractional shares represents a mere rounding off of the fractional shares and is not separately bargained for consideration. Prop. Reg. § 1.355-3(b)(4)(iii)(B); see Rev. Rul. 66-365, 1966-2 C.B. 116, amplified by Rev. Rul. 81-81, 1981-1 C.B. 122.

 - iii) Acquisitions where the distributee corporation acquires, directly or indirectly, control of Distributing 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. Prop. Reg. § 1.355-3(b)(4)(iii)(C).
 - (a) This exception is consistent with Rev. Rul. 74-5, 1974-1 C.B. 82, obsoleted by Rev. Rul. 89-37, 1989-1 C.B. 107, in that it is only applicable with respect to a distribution by the acquired Distributing, and does not apply for purposes of any subsequent distribution by any distributee

corporation. Preamble to Prop. Reg. § 1.355-3, 72 Fed. Reg. at 26,017.

- d) The proposed ATB regulations provide that certain nonrecognition acquisitions will be respected as such and not violate section 355(b)(2)(C) and (D). Prop. Reg. § 1.355-3(b)(4)(ii)(A), (B).
 - i) A section 355 spin-off (as long as the stock was not acquired in a transaction violating section 355(b)(2)(C) or (D)). Prop. Reg. § 1.355-3(b)(4)(ii)(A).
 - ii) A reorganization described in section 368(a)(1)(E) or (F). Prop. Reg. § 1.355-3(b)(4)(ii)(A).
 - iii) An exchange to which section 1036 applies. Prop. Reg. § 1.355-3(b)(4)(ii)(A).
 - iv) A pro rata distribution from a partnership of stock or an interest in a lower-tier partnership (as long as the partnership interest and the distributed stock or partnership interest was not acquired in a transaction violating section 355(b)(2)(C) or (D)). Prop. Reg. § 1.355-3(b)(4)(ii)(A), (B).
 - e) The ABA Section of Taxation filed comments in which it disagreed with the broad, irrebuttable nature of the purpose-based definition of taxable transaction. Instead, the ABA recommended incorporating the purpose-based rules as device and nondevice factors.
- (4) The proposed ATB regulations limit the affiliated group exception that is currently applied by the Service.
- a) Reg. § 1.355-3(b)(4)(iii) provides that, since a direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group is not the type of transaction to which section 355(b)(2)(C) and (D) is intended to apply, in applying section 355(b)(2)(C) or (D), such an acquisition, even though taxable, shall be disregarded.

- b) Although, by its terms, it only applies to acquisitions before 1987, the Service has continued to apply the exception administratively. See P.L.R. 200452003 (Sept. 15, 2004); P.L.R. 9621030 (Feb. 23, 1996); P.L.R. 9416008 (Nov. 3, 1993); P.L.R. 9224016 (Mar. 11, 1992).
 - c) The proposed ATB regulations apply this exception only to transfers between SAG members. Prop. Reg. § 1.355-3(b)(4)(iii).
 - d) To provide taxpayers with transitional relief from this result, the Service announced that it will not challenge the applicability of the affiliate rule to distributions on or before the date the proposed ATB regulations are published as temporary or final regulations. Notice 2007-60, 2007-2 C.B. 466.
- (5) Prop. Reg. § 1.355-3(b)(4)(iv)(B), (C), and (D) provide rules regarding the application of section 355(b)(2)(C) and (D) to certain multi-step, direct, and indirect acquisitions of stock of a corporation engaged in an active trade or business.

8. Division of a functionally integrated business

- a. The original regulations under section 355 provided that the division of a single business would not be tax free. Old Reg. § 1.355-1(a). This provision, however, was determined to be invalid in two Circuit Court cases. United States v. Marett, 325 F.2d 28 (5th Cir. 1963); Coady v. Commissioner, 289 F.2d 490 (6th Cir. 1961). The Service acquiesced in these decisions, Rev. Rul. 64-147, 1964-1 (Part 1) C.B. 136, and the final regulations permit the division of a single business, Reg. § 1.355-1(b).
 - (1) Vertical division

The regulations permit the vertical division of a functionally integrated business to satisfy the active trade or business requirement of section 355. See Reg. § 1.355-3(c), Ex. 4. The vertical division of a functionally integrated business is a separation in which Distributing and Controlled each conduct a business that includes all of the stages and functions of the larger business as it was conducted before the distribution.
 - (2) Horizontal division

- a) The regulations also provide that the horizontal division of a functionally integrated business satisfies the active trade or business requirement of section 355. See Reg. § 1.355-3(c), Ex. 9. The horizontal division of a functionally integrated business includes, for example, the separation of selling and manufacturing activities.
- b) Nevertheless, the horizontal division of a business may violate the device requirement. See Part III.C., supra.
- b. Because the division of a functionally integrated business can satisfy the active trade or business requirement, taxpayers will try to treat modifications to an existing business as a continuation of that business. See Part III.D.6.b., supra.

c. Examples

(1) Vertical division

Corporation M has been engaged in the single business of constructing sewage disposal plants and other facilities for the past five years. M proposes to transfer one-half of its assets to corporation N. These assets will include a contract for the construction of a sewage disposal plant in State X, construction equipment, cash, and other tangible assets. M will retain a contract for the construction of a sewage disposal plant in State Y, construction equipment, cash, and other intangible assets. The N stock will then be distributed to one of the M shareholders in exchange for all of his M stock. Both corporations will be engaged in the active conduct of the construction business immediately after the distribution. Reg. § 1.355-3(c), Ex. 4.

(2) Horizontal division

Corporation I has processed and sold meat products for eight years. It has no other income. I proposes to separate the selling from the processing activities by forming corporation J to purchase for resale the meats processed by I. I will transfer to J certain physical assets pertaining to the sales function, plus cash for working capital, in exchange for capital stock in J, which will be distributed to the shareholders of I. Immediately after the distribution, I will be engaged in the active conduct of a meat processing business, and J will be engaged in the active conduct of a

meat distribution business. The business of each corporation is deemed to have been actively conducted from the date I began its meat processing and sales businesses. Reg. § 1.355-3(c), Ex. 10.

9. Direct vs. indirect conduct of a business

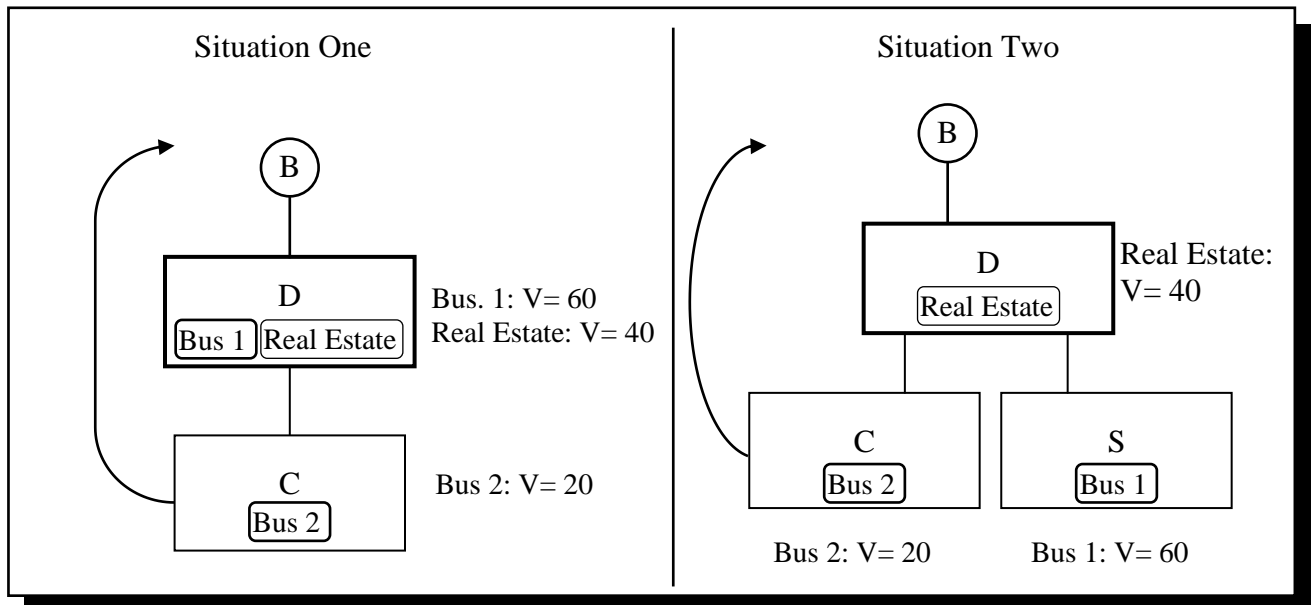
- a. A major source of uncertainty under the active business requirement is the often arbitrary distinction drawn between the direct and indirect conduct of a business.
- b. With respect to directly conducted trades or businesses, section 355(g) provides limitations on the magnitude of investment assets that Distributing or Controlled may own. Specifically, Distributing or Controlled may not hold assets that, by value, are 66% or more investment assets (75% for the first year of enactment).
 - (1) This limitation only applies in a non pro rata distribution where any person holds a 50% or greater interest of the disqualified investment corporation who did not hold such an interest prior to the transaction.
- c. Holding Company Rule – Prior to May 17, 2007, where a holding company was involved, section 355(b)(2)(A) required that substantially all the assets of the holding company must consist of stock or securities in a corporation engaged in the active conduct of a trade or business for it to be considered so engaged.
 - (1) For advance ruling purposes, “substantially all of its assets” in this context means 90% of the fair market value of the gross assets of the corporation (undiminished by liabilities). Rev. Proc. 77-37, § 3.04, 1977-2 C.B. 568.
 - (2) The Service also permitted a holding company to satisfy the active trade or business test if it held stock of active subsidiaries through an intermediate holding company, as long as substantially all of its assets consist of stock of the intermediate holding company, and substantially all of the intermediate holding company’s assets consist of stock of active subsidiaries. See P.L.R. 200140033 (July 3, 2001).
 - (3) As a result of the enactment of section 355(b)(3), the holding company rule was superceded.
 - a) On May 7, 2007, the Service and Treasury issued the proposed ATB regulations, which conclude that the SAG rule overrides the holding company rule of section 355(b)(2)(A). Prop. Reg. § 1.355-3(b)(1)(i);

see also Notice 2006-81, 2006-40 I.R.B. 1 (Sept. 8, 2006).

- b) The statute was later amended by the 2007 Technical Corrections Act (retroactively to May 17, 2007) to remove the holding company rule.
- d. SAG Rule – TIPRA 2005 added section 355(b)(3) to the Code and simplified the active trade or business test for affiliated groups.
- (1) Section 355(b)(3)(A) adopts an affiliated group rule that treats all members of a corporation’s separate affiliated group (SAG) as one corporation for purposes of satisfying the active trade or business requirement.
 - a) A corporation’s SAG is the affiliated group which would be determined under section 1504(a) if such corporation were the common parent (regardless of whether section 1504(b) applies).
 - (2) The provision applies to distributions occurring after May 17, 2006.
 - a) When section 355(b)(3) was enacted, it was not entirely clear whether section 355(b)(3) applied for purposes of determining whether the active trade or business requirement was satisfied for the 5-year period preceding the statute’s enactment.
 - b) The proposed ATB regulations would clarify that section 355(b)(3) applies for the pre-distribution period. Prop. Reg. § 1.355-3(b)(3)(i).

e. Example 9 -- Indirect conduct of active business

- (1) Facts: Distributing actively conducts two five-year businesses, Business 1 and Business 2. Business 2, which has a value of \$20, is conducted through C, a wholly owned subsidiary of D. Business 1 has a value of \$60. Distributing also has passive real estate investments with a value of \$40. Distributing wishes to distribute all of its C stock in a spin-off to permit C to conduct an IPO.
- (2) Situation 1. Assume first that Distributing directly conducts Business 1. The active business requirement should be met, because C conducts an active five-year business and Distributing conducts an active five-year business that constitutes 50% of D's net value (60% excluding the C stock).
- (3) Situation 2. Now assume that, with the exception of its real estate investments, Distributing is a pure holding company and that Business 1 is indirectly conducted through S, a wholly owned subsidiary of D.
 - a) Old Law. Distributing does not meet the active business requirement, because the S stock constitutes at most 60% of D's gross assets. Therefore, "substantially all" of D's assets do not consist of stock of subsidiaries with active five-year businesses.



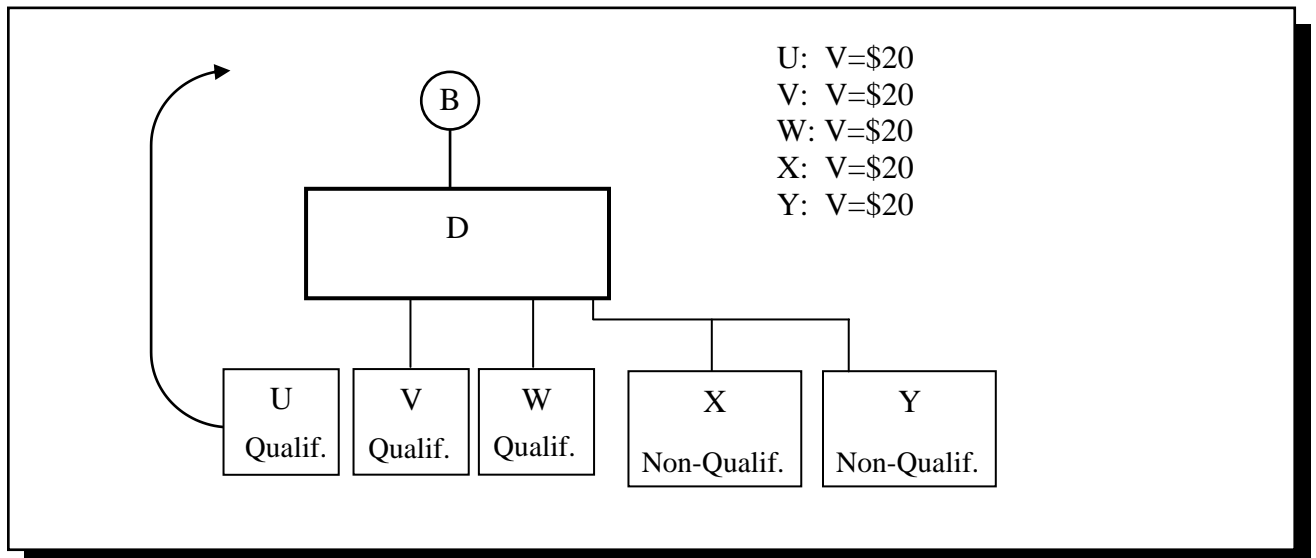
- b) As a consequence, it may be necessary for the holding company to restructure its holdings so that it satisfies this requirement.
 - i) If the holding company holds assets other than stock or securities (e.g., cash, accounts receivable, or passive real estate investments), it may fail the active business requirement.
 - ii) To avoid this consequence, it could push-down these assets to a subsidiary that is itself engaged in the active conduct of a trade or business. Thus, in Situation 2, Distributing could transfer the real estate to C or S.
 - (a) However, such a push-down to C might run afoul of the device requirement. See Part III.C., supra.
 - (b) The Service has stated that it will not rule on whether the active trade or business requirement is satisfied if, within the five-year period, Distributing acquired control of Controlled as a result of transferring cash or other liquid assets or inactive assets to Controlled in a transaction under section 351 or 368(a)(1)(D). Rev. Proc. 2013-3, § 4.01(28), 2013-1 I.R.B. 113.
 - iii) Alternatively, Distributing could liquidate S or merge S into a single-member LLC so that Distributing is considered to be directly conducting an active trade or business. See Example 10, infra.
 - (a) If the holding company has intercompany advances to, or accounts receivable from, its subsidiaries that are engaged in an active trade or business, it could convert them to securities, which would count toward the 90%

substantially all standard. See P.L.R. 200411021 (Dec. 8, 2003).

c) Current Law

- i) TIPRA 2005 reduced the need to restructure in order to meet the active trade or business requirement.
- ii) Section 355(b)(3)(A) adopts an affiliated group rule that treats all members of a corporation's SAG as one corporation for purposes of satisfying the active trade or business requirement.
- iii) Thus, Distributing and S are treated as one corporation for purposes of the active trade or business requirement, so Distributing satisfies the active trade or business requirement without the need to restructure its holdings.

f. Example 10 -- Satisfying active business requirement in an affiliated group



- (1) Facts: Distributing is a holding company. It has five subsidiaries U, V, W, X, and Y. U, V, and W are each actively engaged in a qualifying trade or business for purposes of section 355. X and Y were acquired in taxable transactions during the past five years and thus are not

considered to be actively engaged in a qualifying trade or business. Distributing would like to spin off U to D's shareholder, B.

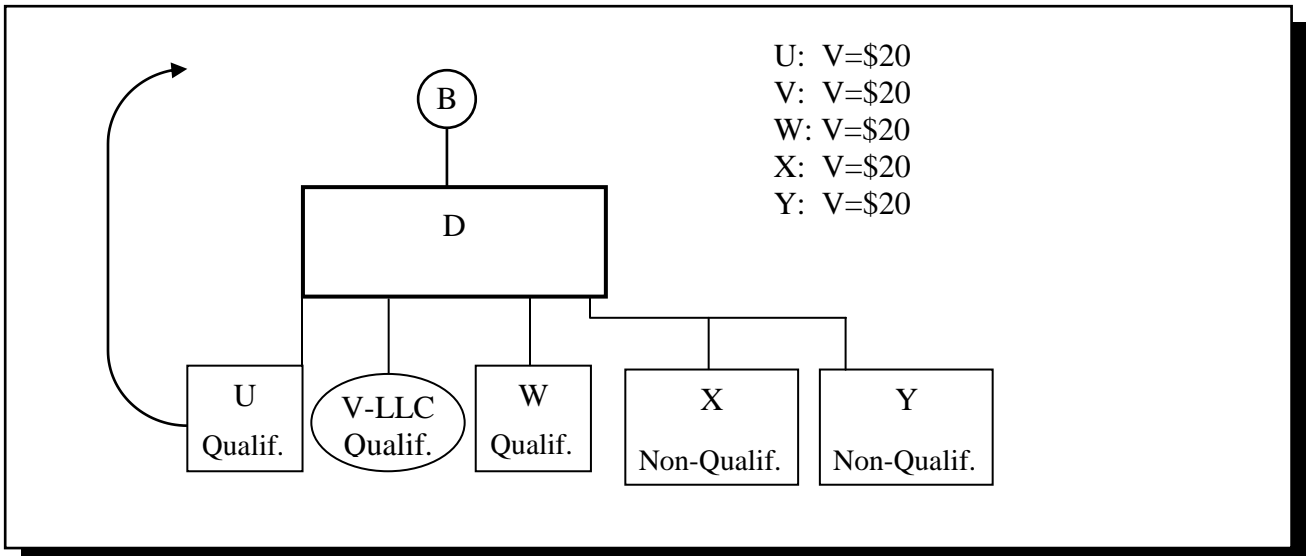
(2) Old Law

- a) Liquidation. Assuming that the value of X and Y exceeds 10% of Distributing's net value, Distributing will not be considered to be engaged in an active business, because "substantially all" of its assets are not stock or securities in subsidiaries that are so engaged. In order to satisfy the active business requirement, Distributing could liquidate V or W. Distributing will then be considered to be directly conducting an active business and will not be subject to the substantially all requirement. See Rev. Rul. 74-79, 1974-1 C.B. 8. Alternatively, V or W may merge upstream into the holding company. See, e.g., P.L.R. 8850065 (Dec. 16, 1988).
- b) Section 351 transfers. As an alternative to liquidation, Distributing could contribute the stock of X and Y to either V or W. After the contribution, Distributing would only hold stock in subsidiaries engaged in an active business and thus should be able to spin off U in a section 355 transaction. See, e.g., P.L.R. 9145020 (Aug. 6, 1991); P.L.R. 8705081 (Nov. 6, 1986).
- c) Intercompany mergers. In addition, Distributing could merge X and Y into either U, V, or W in tax-free mergers. See, e.g., P.L.R. 9749018 (Sept. 11, 1997); P.L.R. 8931076 (May 12, 1989); P.L.R. 8850065 (Sept. 23, 1988); P.L.R. 8737076 (June 18, 1987); P.L.R. 8712019 (Dec. 18, 1986); P.L.R. 8421046 (Feb. 17, 1984).
- d) Such restructurings may not be possible, however, if the subsidiaries conducting the qualifying businesses are subject to significant contingent liabilities. In that event, Distributing may not want the other assets to be subject to such liabilities. For example, if V has significant contingent environmental liabilities, liquidating or merging V may subject all of the transferee's assets to those liabilities. Similarly, transferring stock of X and Y to V may resolve the active business requirement

problem, but it provides additional value to V's creditors.

i) Such problems may be minimized through the use of an LLC that is wholly owned by Distributing. Thus, V could merge into an LLC. Under the check-the-box rules, such a single-member LLC is disregarded as an entity separate from Distributing. See Reg. § 301.7701-2(a), -3(b)(1). Thus, although the LLC should provide similar protection against liability, it would be analyzed as a business conducted (or assets held) directly by Distributing rather than indirectly. Therefore, the "active conduct" test should be met. See, e.g., P.L.R. 200004026 (Oct. 29, 1999).

(3) Current Law. As discussed above, section 355(b)(3) adopts an affiliated group rule that treats all members of a corporation's SAG as one corporation for purposes of the active trade or business requirement. Thus, Distributing and U, V, W, X, and Y are all treated as one corporation and Distributing satisfies the active trade or business requirement.



g. Conduct of a business through a partnership

Another area of uncertainty involves businesses conducted through

partnerships. It is not clear in all cases whether a partner in a partnership is considered to be engaged in the active conduct of the business of the partnership for purposes of section 355.

- (1) In other contexts, authorities have concluded that a partner may be considered to be engaged in the business of the partnership. See Gruse v. Commissioner, 59 T.C.M. (CCH) 368 (1990) (partner engaged in the business of his partnership for purposes of determining requisite profit objective under sections 162 and 212); Butler v. Commissioner, 36 T.C. 1097 (1961) (limited partner deemed to be in the business of the partnership for purposes of a business bad debt); Rev. Rul. 75-23, 1975-1 C.B. 290, obsoleted on other grounds, Rev. Rul. 87-80, 1987-2 C.B. 292 (partner that was a foreign corporation deemed to be in the business of the partnership for purposes of determining United States tax liability).
- (2) In Rev. Rul. 92-17, 1992-1 C.B. 142, the Service ruled that a corporate general partner holding a 20% interest in a limited partnership, which owned several properties, was engaged in an active trade or business for purposes of section 355.
 - a) Although not entirely clear, it seems that the trade or business arose from the corporation's contractual obligation to provide management services to the limited partnership. The limited partnership provided day-to-day upkeep and maintenance, negotiated leases, kept expense records, and dealt with the tenants. The officers of the general partner supervised certain of the activities of the limited partnership's employees and made significant business decisions. The general partner had no employees other than its officers. This activity, however, was sufficient to constitute the conduct of an active trade or business. See also P.L.R. 200107008 (Nov. 9, 2000); P.L.R. 200033042 (May 23, 2000).
 - i) Some commentators had questioned whether the trade or business is that of the partnership (the rental real estate business), which is then attributed to the corporate general partner. For example, if the corporation had been a 98% limited partner instead of a 20% general partner, it is

questionable whether, under the ruling, the corporation would be deemed to be engaged in the active conduct of a business through the partnership. See P.L.R. 200109027 (Nov. 30, 2000).

- ii) In Rev. Rul. 2002-49, 2002-2 C.B. 288, the Service seemed to conclude that the business of the partnership is attributed to the partner. It concluded that Distributing's acquisition of all of the partnership interests, which resulted in a conversion of the partnership to a disregarded entity, constituted an expansion of Distributing's business.
 - iii) Indeed, in Rev. Rul. 2007-42, 2007-2 C.B. 44, the Service modified Rev. Rul. 92-17 to clarify that a corporate partner need not perform management functions in order to be treated as engaged in the active conduct of the trade or business of the partnership, as long as it owns a significant interest in the partnership.
- b) In addition, it was unclear the extent to which Rev. Rul. 92-17 would apply to an entity that is not the sole managing partner of the partnership.
- i) In P.L.R. 200227016 (Mar. 29, 2002), Controlled was the sole general partner of an LLC treated as a partnership.
 - ii) Nonetheless, the Service appears to have adopted the principles of Rev. Rul. 92-17 in the context of a general partnership with two equal general partners.

In P.L.R. 200044017 (July 14, 2000), business A was conducted through a general partnership in which two of Distributing's indirect subsidiaries, Sub 1 and Sub 2, each held a 50% general partnership interest. Sub 2 had acquired its 50% interest from Unrelated Partner in two separate transactions in Year 1 and Year 2. Prior to the Year 1 acquisition, Sub 1 and Unrelated Partner had equal say in the policy decisions

and overall supervision of the partnership. Officers of Sub 1 (and employees of a corporation affiliated with Sub 1) performed the day-to-day management of one of the functions of business A. After the Year 1 acquisition, officers of Sub 1 provided full-time management functions for business A of the partnership. The facts stated that the first day of Year 1 was less than five years from the date of the letter ruling.

The Service concluded that Sub 1 had been engaged in the active conduct of business A for each of the past five years under Rev. Rul. 92-17. The date of the Year 1 acquisition and the precise facts relied on by the Service in reaching this conclusion are unclear.

- iii) In Rev. Rul. 2002-49, 2002-2 C.B. 288, the Service amplified Rev. Rul. 92-17 to apply in the context of a managing member of an LLC, even if members jointly manage the LLC.
- (3) The proposed ATB regulations provide guidance on the conduct of an active trade or business through a partnership. The proposed ATB regulations generally “codify” Rev. Ruls. 92-17 and 2002-49 and also expand the rules to adopt an approach that is consistent with the continuity of business enterprise regulations. See Reg. § 1.368-1(d).
- a) Prop. Reg. § 1.355-3(b)(2)(v) provides that trade or business assets and activities of a partnership can be attributed to a partner if:
 - i) The partner (or a member of its SAG) owns a meaningful interest and performs (either directly or through an affiliate) active and substantial management functions, Prop. Reg. § 1.355-3(b)(2)(v)(C); or
 - (a) The proposed ATB regulations, like Rev. Rul. 92-17, conclude that a 20% interest is meaningful. See Prop. Reg. § 1.355-3(d)(2), Ex. 22.

- (b) In the context of a closely held corporation, activities of shareholders may also be considered. See Prop. Reg. § 1.355-3(b)(2)(v)(A); P.L.R. 200850013 (Sept. 10, 2008).
 - ii) The partner (or a member of its SAG) owns a significant interest, Prop. Reg. § 1.355-3(b)(2)(v)(B).
 - (a) The proposed ATB regulations conclude that a 33-1/3% interest is significant. See Prop. Reg. § 1.355-3(d)(2), Exs. 23 and 24.
 - (b) Steps may be taken in advance of the spin-off to acquire a significant interest. For example, in P.L.R. 200905018 (Oct. 21, 2008), the majority corporate shareholder of Distributing and a second-tier subsidiary of Distributing held interests in an LLC taxed as a partnership. Prior to the distribution, the majority shareholder of Distributing merged downstream into Distributing, after which the ruling noted Distributing and members of its SAG held a significant interest in the LLC.
- b) Subsequent to the proposed ATB regulations, the Service issued Rev. Rul. 2007-42, which reached the same conclusions as the proposed ATB regulations. Specifically, it concludes that a corporate partner may be engaged in an active trade or business even if it does not perform active and substantial management functions, as long as it owns a significant (i.e., 33-1/3%) interest.
 - i) The ruling also concluded that if the corporation's partnership interest is not significant, it cannot satisfy the active trade or business requirement without performing active and substantial management functions.

- ii) Presumably the Service issued the revenue ruling in order to provide immediate guidance before the proposed ATB regulations are finalized.

c) Examples

- i) X and Y are unrelated. P is a partnership that is engaged in manufacturing power equipment. X has a 20% general partner interest in P and Y has a 33-1/3% limited partner interest in P. X performs all of the management functions for P's business. Based on these facts, X is attributed P's business activities (and business assets) for purposes of the active trade or business requirement because X owns a meaningful interest in P and performs active and substantial management functions for P's business. Therefore, X is in the power equipment business. Even though Y is attributed P's business activities because Y owns a significant interest in P, because neither P nor Y perform active and substantial management functions, Y is not in the power equipment business. X's management functions are not attributed to Y because X is not in Y's affiliated group.
- ii) Same facts, except that P performs all of the management functions for its business. In this case, X is not attributed P's business, because it has neither a significant interest in P nor a meaningful interest coupled with active and substantial management functions. Y has a significant interest in P and therefore is attributed P's business activities (including management activities) and business assets for purposes of the active trade or business requirement.
- iii) X owns all of the stock of Y. P is a partnership that is engaged in manufacturing power equipment. Y has a 20% partner interest in P. X has a 5% interest in P and performs all of the management functions for P's business. Here, X and Y should be

attributed P's business activities and assets for purposes of the active trade or business requirement because together X and Y have a meaningful interest in P coupled with active and substantial management functions. X is attributed Y's 20% interest in P because Y is in X's SAG. Y is attributed X's management functions because they are members of the same affiliated group.

- (4) Just as a holding company may conduct an active trade or business through an intermediate holding company, Distributing or Controlled may conduct an active trade or business through tiers of partnerships.
- a) For example, in P.L.R. 200107008 (Nov. 9, 2000), Distributing was the general partner of Partnership. The limited partner interests were held by two other subsidiaries of Distributing. Partnership owned more than 90% of LLC. D was engaged in substantial management functions for Partnership, and Partnership was able to appoint three out of four directors of LLC, all of whom were employees of Distributing.
 - b) There appears to be no reason to distinguish between satisfying the active business requirement through corporate subsidiaries or through limited partnerships. Increasingly, corporations engage in a variety of businesses through partnership or joint venture arrangements to avoid additional layers of corporate-level tax.
 - c) In September 1998, the government issued final continuity of business enterprise regulations that resolved the "remote continuity" concerns presented by drop-downs to partnerships following acquisitive reorganizations. Reg. § 1.368-1(d).
 - i) However, the 1998 regulations still presented an uncertainty under Example 3 of Reg. § 1.368-2(k), which concluded that the step-transaction doctrine could apply to characterize such a drop-down. In October 2007, the government amended these regulations to remove this example.

ii) The preamble to the 1998 regulations states that the regulations are not limited to transactions enumerated in section 368(a)(2)(C), but rather they apply to all reorganizations for which continuity of business enterprise is relevant. Thus, these regulations should resolve the remote continuity problem in the context of section 355 transactions.

d) The Service should issue guidance that clarifies in what circumstances indirectly conducted businesses should be treated as meeting the active business requirement.

E. Distribution of All or Substantial Ownership in the Controlled Corporation

1. In general, in order for section 355 to apply to the distribution of stock of Controlled, Distributing must generally distribute all of the stock and securities in Controlled held by it immediately before the distribution. Section 355(a)(1)(D)(i).

a. Stock in Controlled must be distributed to Distributing's shareholders with respect to their stock, or received in exchange for Distributing's securities by the holders of such securities. Section 355(a)(1)(A). For distributions occurring on or after March 9, 1998, the term "securities" includes warrants, convertible debt instruments, or other rights to purchase stock in Distributing or Controlled. Reg. § 1.355-1(c).

b. Distributing's security holders can exchange securities in Distributing for securities in Controlled up to the same principal amount tax free. Section 355(a)(3)(A).

(1) If the principal amount of the securities in Controlled received exceeds the principal amount of the securities surrendered, the fair market value of the excess amount is taxable to the recipient under section 356. Reg. § 1.355-2(f)(1).

(2) Furthermore, if no securities are surrendered, the recipient is taxable on the fair market value of the securities distributed under section 356. Reg. § 1.355-2(f)(1).

(3) Neither of these situations should cause Distributing to incur a tax liability, however. Section 355(c) treats only a distribution of property not in pursuance of a plan of reorganization as a distribution for purposes of section 311.

See H.R. Rep. No. 100-795, at 373 (1988). Thus, even if Distributing transfers securities of Controlled that have appreciated in value to its security holders, it should not recognize any gain. This transfer is part of the plan of reorganization. But see Rev. Rul. 70-271, 1970-1 C.B. 166, distinguished, Rev. Rul. 75-450, 1975-2 C.B. 328 (indebtedness satisfied in a “C” reorganization using appreciated property resulted in gain under section 1001).

- c. Section 355 does not require that stock or securities of Controlled held by an entity related to Distributing be distributed. Thus, presumably if P owns 80% of X and 100% of Y, and Y owns 20% of X, section 355 will apply to a distribution by P of its X stock even though Y continues to hold 20% of X.
2. A limited exception to the general rule that Distributing must distribute all of the stock and securities of Controlled is provided if Distributing distributes an amount of stock in Controlled constituting control, and it can establish to the satisfaction of the Service that the retention of stock or securities in Controlled does not have the principal purpose of avoiding federal income tax. Section 355(a)(1)(D)(ii); see also Reg. § 1.355-2(e).
 - a. The regulations provide, however, that ordinarily the corporate business purpose or purposes for the distribution require that all of Controlled’s stock and securities be distributed. Reg. § 1.355-2(e)(2).
 - b. The Service has found the requisite non-tax reason for permitting the retention of a portion of the stock or securities of Controlled where the stock or securities are necessary to serve as collateral for bank financing. See, e.g., P.L.R. 200712026 (Dec. 20, 2006).
 - (1) In Rev. Rul. 75-321, 1975-2 C.B. 126, the Service determined that the distribution of 95% of Controlled’s stock to comply with federal banking law satisfied the requirements of section 355(a)(1)(D)(ii) where the remaining 5% of Controlled’s stock was retained to serve as collateral for short-term financing necessary to Distributing’s remaining business enterprise.
 - (2) In Rev. Rul. 75-469, 1975-2 C.B. 126, the Service determined that retention of Controlled’s debenture by Distributing, where the debenture was used as collateral by Distributing to secure a loan from a bank, satisfied the requirements of section 355(a)(1)(D)(ii). See also P.L.R. 8927020 (Apr. 4, 1989); P.L.R. 8908075 (Dec. 2, 1988).

- c. The retention of stock or securities may also be permissible if the stock or securities are retained to satisfy the requirements of a stock option plan or the requirements of state law. See, e.g., P.L.R. 200239005 (June 19, 2002) (satisfy stock option awards); P.L.R. 200243049 (Aug. 1, 2002) (satisfy certain legal requirements).
 - d. The Service has also held that the retention of stock was permissible to send a positive signal to the market and to Controlled's employees, customers, and investors by demonstrating Distributing's continued confidence in Controlled's business and that the split was amicable. See P.L.R. 200736019 (May 17, 2007).
 - e. The Service also concluded that the retention of stock was permissible to avoid confusion, too many Controlled shareholders holding too few Controlled shares, and pricing inefficiencies in Distributing's debt exchange. P.L.R. 200841021 (Apr. 29, 2008).
 - f. The Service has also ruled favorably where the business purpose for Distributing's retention of shares is to "improve Distributing's debt-equity ratio, to solidify its credit rating, and to provide Distributing with a source of cash for working capital needs." P.L.R. 201123030 (Nov. 15, 2010). Similarly, in P.L.R. 200944026 (June 29, 2009), Distributing retained stock of Controlled "in order to ensure investment grade debt ratings for both companies, provide capital flexibility to enable both companies to achieve their strategic objectives, avoid increased future financing costs and avoid raising future capital." See also P.L.R. 201034005 (May 20, 2010) (stock retention was permitted to provide Distributing with "additional regulatory capital and improve the credit rating of Business A" and "help Business A fund various corporate purposes and improve the credit rating of Business A.").
3. For ruling purposes, the Service has stated that it will issue a favorable ruling regarding the retention of stock or options or any stock acquired upon the exercise of the options in Controlled by a widely held distributing corporation if Distributing establishes that the following requirements are satisfied:
- a. A sufficient business purpose exists for the retention of the stock, options, and any stock acquired on the exercise of the options;
 - b. None of Distributing's directors or officers will serve as directors or officers of Controlled as long as Distributing retains the stock, options, or any stock acquired on the exercise of the options;

- (1) Under appropriate facts and circumstances, the Service may issue a favorable ruling in cases in which the directors or officers of Distributing will serve as directors or officers of Controlled.
 - (2) For example, the Service may issue a favorable ruling if a director or officer of Distributing serves as a director or officer of Controlled solely to accommodate Controlled's business needs.
- c. The retained stock, options, and any stock acquired upon exercise of the options will be disposed of as soon as a disposition is warranted consistent with the business purpose given for the retention of the stock or options, but in any event, not later than five years after the distribution; and
- d. Distributing will vote the retained stock and any stock acquired on exercise of the options in proportion to the votes cast by Controlled's other shareholders.
- (1) For example, if after the distribution the other shareholders of Controlled vote 70% in favor of a matter and 30% against, Distributing would be required to vote the stock 70% in favor and 30% against the matter.

See Rev. Proc. 96-30, Appendix B. In other cases, the Service may issue favorable rulings, based upon all relevant facts and circumstances, regarding the application of section 355(a)(1)(D)(ii). For example, the Service will rule favorably if the transaction is covered by Rev. Rul. 75-321, 1975-2 C.B. 123 (discussed above).

F. Hot Stock Rule

1. General Rule – Under section 355(a)(3)(B), stock in Controlled that was acquired in a taxable transaction by Distributing within five years of the distribution of Controlled's stock ("hot stock") is treated as boot taxable to the distributee under section 356 and taxable to Distributing under section 311(b) to the extent of any appreciation. Section 355(c); see also H.R. Rep. No. 100-795, at 373 (1988).
 - a. Stock tainted by section 355(a)(3)(B) may, however, be considered in determining whether the other requirements of section 355 (e.g., distribution of control) are satisfied. See Reg. § 1.355-2(g)(1).
 - b. Furthermore, if a portion of the stock of Controlled is tainted stock, then the retention of stock by Distributing tends to establish that the retention is in pursuance of a plan having one of its principal purposes as the avoidance of federal income tax. Reg. § 1.355-

2(e)(2). Nonetheless, the Service has permitted such a retention if there are business reasons for the retention. See P.L.R. 200837027 (Sept. 12, 2008) (supplemented by P.L.R. 200850016 (Aug. 28, 2008)).

- c. Distributing may be able to specifically identify hot stock and dispose of it to avoid treatment as boot. See P.L.R. 200830005 (Apr. 16, 2008).
- (1) In P.L.R. 200830005, Distributing first purchased shares of Controlled's Series 1 voting preferred stock (the "Hot Stock"). On a later date, Distributing acquired a percentage of all nonemployee-owned Controlled stock in exchange for Distributing stock in a reverse merger. The acquired shares were then cancelled, leaving nearly all of Controlled's equity as Controlled's Series 1 voting preferred stock.
- a) During year 2, Distributing contributed additional capital for additional shares (Series 2 voting preferred and Class A common stock) of Controlled in a transaction that qualified for tax-free treatment under section 351(a). Distributing also converted a certain amount of convertible indebtedness in shares of Class A common stock. Distributing then held two blocks of stock in Controlled; one block had been acquired in a taxable transaction (the Hot Stock) and the other block had been acquired in a tax-free section 351 exchange.
- b) Controlled underwent a recapitalization in which all of the Series 1 preferred stock, Series 2 preferred stock, and Class A common stock held by Distributing was exchanged for shares of Class B (high vote) common stock and the minority shareholders of Controlled exchanged their shares for Class A (low vote) common stock. Controlled then effected a reverse stock split and sold shares of Class A common stock in an initial public offering.
- c) On a later date, Distributing sold shares of Class B common stock in a public offering and, under the terms of the Class B common stock, the stock automatically converted into Class A common stock (in the hands of the transferees). The stock sold by D was specifically identified to include the Hot Stock.

- d) Distributing then distributed the Controlled stock to its shareholders pro rata. The Service ruled that the transaction qualified as tax-free under section 355.
- (2) However, exchanging the hot stock for new stock certificates in a recapitalization is not sufficient to cleanse the hot stock. Rev. Rul. 65-286, 1965-2 C.B. 92.

2. Coordination with the SAG Rules

- a. The proposed active trade or business regulations do not apply for purposes of section 355(a)(3)(B). Thus, although the acquisition of a SAG member is treated as an asset acquisition, and therefore does not violate section 355(b)(2)(D), it could have still been tainted under section 355(a)(3)(B).
- b. However, on October 20, 2011, the Service and Treasury Department issued final regulations modifying the application of the section 355(a)(3)(B) hot stock rule to harmonize it with the active trade or business rules of section 355(b)(3). Reg. § 1.355-2(g); T.D. 9548 (Oct. 20, 2011). The final regulations adopt without change the substantive rules of temporary regulations issued December 15, 2008. T.D. 9435, 73 Fed. Reg. 75,496 (Dec. 15, 2008); see also Section 355(b)(3)(D) (granting authority to issue regulations to apply section 355(a)(3)(B) in connection with section 355(b)(3)).
 - (1) The final regulations apply to distributions occurring after October 20, 2011. The temporary regulations were effective for distributions occurring after December 15, 2008, although taxpayers were permitted to elect to apply them retroactively to distributions occurring after May 17, 2006, the effective date of section 355(b)(3).
 - (2) The final regulations provide that Controlled stock acquired in a taxable transaction by Distributing's SAG within the five year pre-distribution period constitutes hot stock, unless Controlled is a member of Distributing's SAG at any time after the acquisition (but prior to the distribution of Controlled). Reg. § 1.355-2(g)(2)(i).
 - a) This rule resolves conflicts that would otherwise arise between section 355(a)(3)(B) and 355(b). For example, if Distributing acquired all of Controlled's stock in a taxable transaction that qualified as an expansion of Distributing's business under the SAG rule, a distribution of Controlled within five years

would satisfy the active trade or business requirement, but could be fully taxable under the hot stock rule. Preamble to Temp. Reg. § 1.355-2T(g), 73 Fed. Reg. at 75,947.

- b) For example, assume that D owned stock constituting section 368(c) control of C for 5 years. In year 6, D purchased some additional shares, but did not own section 1504(a)(2) control of C (so that C was not a member of the DSAG). The C stock purchased in year 6 is thus treated as hot stock. See Reg. § 1.355-2(g)(5), Ex. 1.
 - i) If, instead, the year 6 purchase gave D section 1504(a)(2) control of C, it would not be treated as hot stock. This is true even if D did not have preexisting section 368(c) control of C (i.e., the purchase brought D's ownership in C from zero to 100%). See Reg. § 1.355-2(g)(5), Ex. 2.
- (3) Consistent with the SAG rules, the final regulations also disregard transfers of Controlled stock between members of Distributing's SAG for purposes of the hot stock rule. Reg. § 1.355-2(g)(1); cf. Prop. Reg. § 1.355-3(b)(1)(ii) (applying a similar rule for the active trade or business requirement).
- (4) The final regulations retain the affiliate exception of former Treas. Reg. § 1.355-2(g), which generally provides that the hot stock rule does not apply to Distributing's acquisition of Controlled stock from a member of Distributing's affiliated group (as defined in Reg. § 1.355-3(b)(4)(iv)), even if the affiliate is not a member of the DSAG. Reg. § 1.355-2(g)(2)(ii).
 - a) The proposed ATB regulations would limit the affiliate exception to acquisitions between SAG members. Prop. Reg. § 1.355-3(b)(1)(ii).
 - b) However, the preamble to the temporary hot stock regulations stated that the Service and Treasury anticipate that the affiliate exception should apply consistently for purposes of the hot stock rule and the active trade or business requirement once the proposed ATB regulations are finalized. Preamble to Temp. Reg. § 1.355-2T(g), 73 Fed. Reg. at 75,948.

3. Definition of Taxable Transaction

- a. As discussed above, the proposed ATB regulations treat certain nonrecognition transactions as taxable transactions and certain taxable transactions as nonrecognition transactions for purposes of determining whether there has been a taxable acquisition of Controlled stock or assets in violation of section 355(b)(2)(C) and (D).
 - (1) The Service and Treasury did not incorporate these rules in the final hot stock regulations. The preamble to the temporary hot stock regulations had requested comments as to whether the same definition should be used. Preamble to Temp. Reg. § 1.355-2T(g), 73 Fed. Reg. at 75,949.
- b. The Service and Treasury are also considering additional guidance under section 355(a)(3)(B) regarding indirect taxable acquisitions and acquisitions by predecessors.
 - (1) For example, the Service and Treasury are considering a rule to limit Dunn Trust v. Commissioner, 86 T.C. 745 (1986), acq. in result only, 1998-1 C.B. 5. In Dunn Trust, AT&T acquired stock of Pacific in a taxable transaction in 1982 (the hot stock). Then, in 1983, in settlement of an antitrust suit, AT&T transferred all of its Pacific stock, along with other assets, to PacTel, and in 1984, distributed its PacTel stock to its shareholders.
 - a) The Tax Court concluded that section 355(a)(3)(B) did not apply to that portion of the PacTel stock attributable to the Pacific hot stock contributed to PacTel, because the hot stock was not that of “Controlled” and neither the statute nor the legislative history look through Controlled to stock of an underlying subsidiary.
 - b) The Tax Court also reasoned that Pacific stock remained in corporate solution and the government’s interests were adequately protected by the device requirement.
 - c) The Service acquiesced in result only, reasoning that the Pacific stock was among numerous other assets being contributed to PacTel.
 - d) The preamble to the temporary hot stock regulations expressed concern that in cases where Controlled has few or no other assets, and thus must rely on the

hot stock contributed to satisfy the active trade or business requirement, Controlled should properly be ignored and looked through to the hot stock held by Controlled. Preamble to Temp. Reg. § 1.355-2T(g), 73 Fed. Reg. at 75,948.

- e) Although neither the final regulations nor the temporary regulations adopted such a “real Controlled” test to limit Dunn Trust, the Service and Treasury are further considering such a rule. Id.
- (2) Similarly, the Service and Treasury are considering rules to address other predecessor type issues. Id.
- a) For example, if Distributing acquires stock of a corporation in a taxable transaction and then merges that corporation into Controlled;
 - b) If a corporation that owns Controlled stock joins the DSAG in a taxable transaction;
 - c) If a corporation that acquires Controlled stock in a taxable transaction joins the DSAG in a tax-free transaction; or
 - d) If a parent of Distributing acquires Controlled stock in a taxable transaction and then merges downstream into Distributing.
- (3) The preamble to the temporary hot stock regulations also indicated that the Service and Treasury are considering treating issuances of Controlled stock to Distributing in a taxable transaction as nontaxable. For example, a transaction to which section 357(c) applies. Id. at 75,949; see Rev. Rul. 78-442, 1978-2 C.B. 143; cf. Prop. Reg. § 1.355-3(b)(4)(iii)(A) (adopting the same rule).
- (4) The preamble also stated that the Service and Treasury are considering treating redemptions of Controlled stock as not giving rise to hot stock, unless Distributing is the source of the funds for the redemption. Preamble to Temp. Reg. § 1.355-2T(g), 73 Fed. Reg. at 75,949. Such a rule is in contrast to section 355(b)(2)(D). See McLaulin, 276 F.3d 1269; Rev. Rul. 57-144.

- (5) The final hot stock regulations, however, did not address these open issues. See Reg. 1.355-2(g); T.D. 9548 (Oct. 20, 2011).

G. Business Purpose Requirement

1. In general

- a. The regulations under section 355 make the business purpose requirement of paramount importance. Not only is a valid business purpose an independent prerequisite for a tax-free spin-off but the strength of the business purpose will also be taken into account in determining whether the transaction satisfies the device test. See Reg. § 1.355-2(d)(3)(ii).
- b. In Gregory v. Helvering, 293 U.S. 465 (1935), the Supreme Court set forth the principle that literal compliance with the express statutory requirements of section 355 is not sufficient -- a valid business purpose for the transaction must also be present.
- c. The regulations, following this principle, specifically state that the transaction must be “carried out for one or more corporate business purposes” in order to fall within the nonrecognition rules of section 355. Reg. § 1.355-2(b)(1).
 - (1) The regulations provide that a transaction is carried out for a corporate business purpose if it is motivated, in whole or in substantial part, by such purpose. Reg. § 1.355-2(b)(1).
 - (2) The regulations further provide that the corporate business purpose must be real and substantial and germane to the business of the corporation. The reduction of federal taxes does not qualify as a corporate business purpose. Reg. § 1.355-2(b)(2).
 - (3) The potential for avoiding federal taxes is relevant in determining whether a corporate business purpose motivated the distribution. Reg. § 1.355-2(b)(1).
 - a) This caveat may become problematic. For example, assume that a publicly held corporation spins off its subsidiary to maximize shareholder value. However, part of the increased value is attributable to the tax savings resulting from the tax-free distribution of property.
 - b) Query whether this transaction is supported by a valid business purpose. See Part III.F.2., infra,

(addressing shareholder v. corporate business purpose). For ruling purposes, at least, it appears that nonrecognition as a result of sections 355 and 361 arguably is ignored. See Rev. Proc. 96-30, § 4.04(5)(d), 1996-1 C.B. 696.

- c) The Service confirmed this in Rev. Rul. 2003-110, 2003-2 C.B. 1083. In Rev. Rul. 2003-110, the Service held that the fact that section 355 permits Distributing to distribute the stock of Controlled without the recognition of gain does not present a potential for the avoidance of federal taxes under Reg. § 1.355-2(b). The Service believed that this confirmation was necessary after Rev. Proc. 2003-48 deleted § 4.04(5)(d) of Rev. Proc. 96-30.
- (4) The principal reason for the business purpose requirement is to limit the application of section 355 to transactions that satisfy each of the following requirements:
- a) Transactions that are incident to readjustments of corporate structures required by “business exigencies;” and
 - b) Transactions that effect only a readjustment of continuing interests in property under modified corporate forms.
 - i) This aspect of the business purpose requirement, appears to overlap with the continuity of interest requirement.
 - ii) It also overlaps, to some extent, with the device requirement in that subsequent dispositions of stock in Distributing or Controlled indicate a device as well as the lack of continuing corporate interests.

Reg. § 1.355-2(b)(1).

- (5) The regulations indicate that the business purpose must be an existing purpose. This is in accordance with several court cases.
- a) In Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971), cert. denied, 400 U.S. 922 (1972), a closely-held corporation distributed all of the stock of a leasing subsidiary to its shareholders. The Tax

Court had found that the primary purpose of the distribution was to facilitate the shareholder's desire to exclude his daughters and future sons-in-law from the management of Distributing's business, and to provide his daughters with an investment in a relatively safe enterprise (through subsequent bequests of Controlled's stock to his daughters).

- b) The taxpayers attempted to cast this estate planning purpose as a corporate business purpose in that the distribution would avoid possible interference with management by future sons-in-law.
- c) However, the First Circuit noted that, from a corporate perspective, this was not an immediate business purpose. The envisaged possibility of future interference by in-laws was "so remote and so completely under the taxpayers' control" that it could not prevent the transaction from being a device.
- d) Thus, the possibility of future management conflict apparently would not be acceptable for section 355 purposes.
- e) Conversely, a valid business purpose would be present if the shareholders were already in conflict with respect to the management of the enterprise and separation was necessary to prevent further disruption. See Coady v. Commissioner, 33 T.C. 771 (1960), aff'd per curiam, 289 F.2d 490 (6th Cir. 1961).
- f) In Rev. Rul. 75-337, 1975-2 C.B. 124, the Service indicated that a purpose germane to the continuation of the business in the "reasonably foreseeable future" would be acceptable.
- g) The requirement for an existing business purpose does not necessarily mean that such business purpose must actually be satisfied by the distribution. In Rev. Rul. 2003-55, the Service ruled that the business purpose requirement was satisfied if the distribution of the stock of Controlled is, at the time of the distribution, motivated, in whole or substantial part, by a corporate business purpose, but that purpose cannot

be achieved as the result of an unexpected change in circumstances following the distribution.

- (6) It is understood that, in adopting the regulations, Treasury considered a “principal purpose” standard (i.e., that the principal purpose of the section 355 distribution must be the business purpose), but rejected this approach in favor of a facts-and-circumstances approach.

2. Corporate vs. shareholder purpose

The regulations provide that the business purpose must be a corporate purpose. Reg. § 1.355-2(b)(2). An issue often arises as to whether a proffered business purpose constitutes a corporate business purpose or a shareholder business purpose.

- a. In Estate of Parshelsky v. Commissioner, 34 T.C. 946 (1960), rev'd and remanded, 303 F.2d 14 (2d Cir. 1962), the Tax Court held that, since the only business purpose proffered was a shareholder purpose, the distribution in question could not qualify for tax-free treatment under the predecessor of section 355.
 - (1) In reversing the Tax Court, the Second Circuit held that a shareholder purpose may satisfy the business purpose requirement.
 - (2) However, the First Circuit, in Rafferty, 452 F.2d at 770, expressly refused to follow the Second Circuit's approach. According to the Rafferty court, although personal motives are not to be excluded from consideration, such motives will not prevent the transaction from being a device, unless they are “germane to the continuance of the corporate business” (emphasis added). The court also indicated that a transaction should be scrutinized more closely in the absence of a direct benefit to the corporation.
- b. Although the regulations require a corporate business purpose, they recognize that a shareholder purpose may rise to the level of a corporate purpose, stating that “depending upon the facts of a particular case, . . . a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them.” Reg. § 1.355-2(b)(2).
 - (1) The regulations provide as an example of a non-corporate purpose the personal planning purposes of a shareholder. Reg. § 1.355-2(b)(2). In Rev. Rul. 75-337, the shareholder's estate planning goals also served the corporate business purpose of ensuring smooth and

continued operation of the corporation after the death of the shareholder.

- (2) In Rev. Rul. 2003-52, 2003-1 C.B. 960, the Service stated that although a distribution was intended, in part, to promote family harmony and to further the personal estate planning goals of the father and mother, the distribution was also intended to eliminate disagreement between the son and daughter and to allow each child to focus exclusively on a particular business. The Service therefore ruled the distribution was motivated in substantial part by a real and substantial non-federal tax purpose and the business purpose requirement was satisfied.
- (3) In Rev. Rul. 2004-23, 2004-1 C.B. 585, the Service presented two situations where the distribution was intended to increase the price of Distributing stock. The Service ruled that in these two situations increasing the share price was a valid business purpose, even though it benefited shareholders, because the increased value was expected to serve a corporate business purpose.
 - a) In Situation 1, Distributing used equity based incentives as part of its employee compensation and wished to increase the value of such incentives. Distributing expected that separating its Business 2 from Business 1 would increase its stock value and provide a real and substantial benefit by increasing the value of the incentives. Distributing determined that granting additional shares would dilute current shareholders and granting cash bonuses would be unduly expensive.
 - b) In Situation 2, Distributing had a history of using its stock to acquire other corporations and expected to continue to make such acquisitions in the future. Distributing determined that separating its Business 2 from Business 1 would increase its stock value, thereby expanding acquisition opportunities in a manner that preserves capital without diluting the interests of existing shareholders.
 - c) In each situation, increasing share value and lack of dilution provided shareholder benefits. However, these benefits alone would not satisfy the business purpose requirement—some corporate-level benefit must be shown. In Rev. Rul. 2004-23, the

corporate-level benefits were enhancing the value of equity-based compensation and preserving capital.

- (4) Business purposes that benefit both the corporation and the shareholder will be reviewed closely by the Service.

3. Business purpose for the distribution

In order to qualify for section 355 treatment, it must not be possible to achieve the business purpose by another nontaxable transaction. However, if the other nontaxable means of achieving the corporate business purpose are impractical or unduly expensive, then the business purpose will support a distribution. Reg. § 1.355-2(b)(3).

- a. In Gada v. United States, 460 F. Supp. 859 (D. Conn. 1978), the court found that the purpose of shielding assets from risks of the other business cannot support the distribution of stock, because such a purpose could be accomplished simply by transferring the business assets to a new subsidiary (e.g., in a section 351 transaction). The subsequent distribution of stock does not further the stated business purpose. See also Reg. § 1.355-2(b)(5), Ex. 3.
- b. In Rev. Rul. 69-460, 1969-2 C.B. 51 (situation one), the Service ruled that a distribution of a subsidiary's stock to an employee to give him a proprietary interest in the subsidiary was not a valid business purpose for a section 355 transaction because the distribution was not necessary for this purpose. The employer could have given the employee an interest in the subsidiary without making a distribution.

It should be noted that the Service has frequently issued favorable rulings in similar situations where it has been represented that the employee does not wish to own stock in a controlled subsidiary. Cf. Rev. Proc. 96-30, Appendix A, § 2.01, 1996-1 C.B. 696.

4. Relation to device test

- a. The business purpose requirement, although closely related to the device test, is nevertheless a distinct requirement. Reg. § 1.355-2(b)(1).

- (1) The device test serves to protect the dividend provisions of the Code by focusing upon post-distribution sales or liquidations (or the likelihood thereof) of either Distributing or Controlled's stock. As indicated above, such events evince a tax avoidance motive to bail out earnings and profits of either corporation.

- (2) The business purpose requirement, on the other hand, serves to prevent the tax avoidance intent from arising in the first instance.
- b. Thus, the taxpayer has the “negative” burden to show that the transaction is not a device and the “affirmative” burden to show a valid business purpose.
- c. The discrete nature of these two tests was demonstrated by the Ninth Circuit in Commissioner v. Wilson, 353 F.2d 184 (9th Cir. 1965), rev’g, 42 T.C. 914 (1964).
- (1) In Wilson, the Tax Court rejected the taxpayer’s proffered business reasons for the distribution in issue, but nevertheless found that the transaction qualified for section 355 treatment because the transaction was not a device. No sale or liquidation of either Distributing or Controlled occurred within the five-year period after the distribution and before trial, and there was nothing to suggest any intent to sell or liquidate either corporation.
 - (2) In other words, Wilson was a unique case where there was no tax avoidance motive present, but neither was there a business purpose. The Ninth Circuit, reversing the Tax Court, ruled that section 355 was not available because of the lack of a business purpose.
 - (3) The appellate court reasoned that without a business purpose requirement, a corporation could distribute investment assets to its shareholders who could hold such assets for retirement purposes without subjecting them to the risks of the business. Although the shareholder would not have “cashed out” his corporate investment until future retirement, such treatment would be unfair to shareholders who simply received such assets as a dividend.
 - (4) According to the Ninth Circuit, Congress was willing to concede some tax advantages to a distribution when it serves a business purpose; otherwise, it should be taxable like any other dividend to a shareholder.
 - (5) It seems that both the “active trade or business” and the “device” requirements should be adequate to address the Ninth Circuit’s concern.
 - (6) Notwithstanding the Wilson decision, the First Circuit, in Rafferty, 452 F.2d at 769, took a different approach. The

First Circuit viewed the business purpose requirement as bearing on the issue of whether a distribution was a device.

- a) In Rafferty, the First Circuit framed the issue as whether the shareholder's estate planning goals constituted a sufficient business purpose to prevent the transaction from being a device.
 - b) The appellate court stated that personal goals will not support a distribution that has considerable potential for use as a device for distributing earnings and profits unless such purposes are germane to the continuance of the corporate business.
 - c) The court noted that since the shareholder's alleged business purpose could be satisfied by a bail-out of dividends, that purpose was not sufficient to prove that the transaction was not being used as a device.
 - d) The court concluded that in the absence of a direct benefit to the business of the original corporation (i.e., a corporate business purpose), and given evidence that the distribution put saleable assets in the shareholder's hands, no business purpose was present that was sufficient to overcome the Commissioner's determination that the transaction was a device.
- (7) As the above cases indicate, the interrelationship between the business purpose test and the device test has not been clearly delineated.
- a) The regulations provide that a corporate business purpose is evidence of the absence of a device. Reg. § 1.355-2(b)(4). The stronger the evidence of a device, the stronger the corporate business purpose necessary to overcome that evidence. Reg. § 1.355-2(d)(3)(ii).
 - b) It is understood that when there is evidence of a device, the Service may require independent third-party verification and substantiation as proof of the alleged business purpose.
 - i) For example, in Rev. Rul. 82-130, 1982-2 C.B. 83, a closely held parent distributed the stock of its subsidiary in order to facilitate a

public offering of the parent's stock. The spin-off of the subsidiary was recommended by the parent's underwriters.

- ii) In Rev. Rul. 82-131, 1982-2 C.B. 83, a distribution by a public utility of its subsidiary was recommended by the utility's independent counsel.

5. Ruling guidelines

a. Pre-1996 ruling position of the Service

- (1) The adverse tax consequences of a spin-off that fails the requirements of section 355 generally are dramatic. Distributing will recognize gain to the extent of the appreciation in the stock of Controlled. In addition, the full value of Controlled stock distributed may be taxed to the recipient shareholders as a dividend. Because the law is so intricate and confusing, few companies have wanted to risk engaging in such a transaction without a favorable advance ruling from the Service.
- (2) As a consequence, in many respects the Service's ruling standards and positions have become the "law" of section 355 for practical purposes. This is particularly apparent in the case of the "business purpose" requirement. Under the case law, the primary function of the business purpose requirement is to ensure that there are legitimate reasons for the transaction other than reduction of federal income tax.
- (3) The Service has always taken the position that the existence of such a purpose is inherently a factual determination, the resolution of which is more appropriately the province of the Field Service on audit. Prior to 1996, there were a number of business purposes on which the Service would not rule, because it felt unable to determine as a factual matter whether the asserted purpose was genuine. Consequently, there was a relatively short list of purposes that were generally accepted by the Service, and taxpayers had an incentive to fit their proposed transaction into one of these pigeonholes.

b. Revenue Procedure 96-30

- (1) In early 1996, the Service issued new ruling guidelines, which set forth the requirements that must be met in

seeking a favorable ruling. See Rev. Proc. 96-30, 1996-1 C.B. 696. In general, these guidelines restate the Service's prior ruling position set forth in Rev. Proc. 86-41, 1986-2 C.B. 716, with minor changes. However, they significantly altered the Service's approach to the business purpose requirement. The Service stated that it would now entertain any business purpose that can be adequately substantiated by the taxpayer. See Rev. Proc. 96-30, Appendix A, § 1.

- (2) The price of the Service's purportedly more flexible approach to the business purpose requirement was the more burdensome substantiation that may be requested. See Appendix A, attached, for a list of requirements for the business purposes listed in Rev. Proc. 96-30.
- (3) The guidelines under Rev. Proc. 96-30 required taxpayers to explain why each asserted corporate business purpose cannot be achieved through a nontaxable transaction that does not involve the distribution of stock of Controlled and is neither impractical nor unduly expensive. For example, in appropriate cases, possible alternative transactions might include the transfer of assets to a partnership or limited liability company. However, an alternative transaction that will cause the loss of a favorable special tax status, such as an existing S corporation election, will ordinarily be viewed as unduly expensive.
- (4) If the transaction would effect a reduction in federal taxes, or if it appeared that the transaction would achieve one or more other non-corporate business purposes, the taxpayer was required to convince the Service by "clear and convincing evidence" that the distribution was motivated in whole or substantial part by one or more corporate business purposes in order to obtain a favorable ruling.
 - a) Nonrecognition of income or gain to the shareholders or corporation resulting from the application of sections 355 or 361 was disregarded in determining the purposes for the transaction.
 - b) Thus, it appeared the Service would "weigh" the various purposes asserted by the taxpayer to determine which was the real or primary purpose.
- (5) Taxpayers were required to submit extensive documentation to provide factual support for the asserted business purpose. The type and extent of the documentary

substantiation required varied depending on the described business purpose and facts of the particular case.

- a) Third-party documentation. If the transaction was being undertaken at the request of, or pursuant to the advice or analysis of, persons other than Distributing or Controlled, documentation of such third-party requests, advice, or analysis was required to be provided. Such documentation was required to include an explanation of the third party's qualifications to speak to the matter.
 - i) Business purposes for which such third-party documentation may have been necessary included: risk reduction, cost savings, facilitating a stock or debt offering, other borrowing, obtaining regulatory relief, improving credit, and preserving a franchise.
 - ii) Third-party documentation prepared specifically for submission with the taxpayer's ruling request was required to contain an acknowledgment that the documentation will be submitted to the Service for use in determining the federal tax consequences of the transaction.

- b) Additional documents. Other documents that could have been required by the Service included:
 - i) Regulatory filings, such as any proxy statements, information statements, or prospectuses filed or prepared in connection with the distribution or any related transaction, and any other documents that have been filed with any federal, state, local, or foreign regulatory body (such as the Securities and Exchange Commission) by the taxpayer;
 - ii) Materials that relate to the purpose for the distribution and were prepared for, or presented to, the taxpayer's board of directors, and any relevant portions of the board's minutes;

- iii) Communications to shareholders and employees, such as any press releases relating to the distribution, letters or memoranda relating to the distribution that the taxpayer or its officers sent to the taxpayer's shareholders, or written statements to employees that discuss any purpose for the distribution.

c. Revenue Procedure 2003-48

- (1) In 2003, the Service issued Rev. Proc. 2003-48, 2003-2 C.B. 86, which modifies and amplifies Rev. Proc. 96-30. Rev. Proc. 2003-48 establishes a one-year pilot program under which the national office will not determine whether a proposed or completed distribution of Controlled's stock is being carried out for one or more corporate business purposes, whether the transaction is used principally as a device, or whether the distribution and acquisition are part of a plan under section 355(e). Instead, Rev. Proc. 2003-48 requires taxpayers to submit representations regarding the business purpose and device requirements and whether there is a plan under section 355(e).
- (2) Rev. Proc. 96-30 is modified by Rev. Proc. 2003-48 to require the taxpayer to describe in narrative form each corporate business purpose for the distribution of the stock of Controlled. The taxpayer is instructed not to provide any documentation or substantiation in support of the narrative.
- (3) To be considered, a ruling request must contain the following representation: "The distribution of the stock, or stock and securities, of Controlled is carried out for the following corporate business purposes: [list these corporate business purposes]. The distribution of the stock, or stock and securities, of Controlled is motivated, in whole or substantial part, by one or more of these corporate business purposes."
- (4) A determination of whether the distribution is being carried out for one or more corporate business purposes will not be made in a ruling by the national office, but may be made upon an examination of the taxpayer's return.
- (5) This pilot program applies to ruling requests postmarked or, if not mailed, received after August 8, 2003. Rev. Proc.

2003-48 states that the pilot program is intended to operate for at least for at least a year, after which the Service may consider further changes, including ruling only on significant issues like it currently does in the reorganization area.

- a) Although Rev. Proc. 2003-48 was only a one-year pilot program, representatives of the Service have indicated informally that they plan to continue this practice indefinitely.
- b) The Service issued Rev. Proc. 2009-25, which announced a pilot program in which the Service will rule on significant issues or on part of a transaction occurring in the context of a section 355 distribution.
- c) The Service issued Rev. Proc. 2013-32, which provides that the Service will no longer rule on whether transactions qualify under section 355, but will only rule on significant issues presented in the such transactions.

6. Specific business purposes

Appendix A of Rev. Proc. 96-30 sets forth certain specific business purposes that the Service stated it would entertain and special requirements for substantiating such purposes. Many of these purposes are ones that the Service would not consider prior to the issuance of Rev. Proc. 96-30. The guidelines emphasize, however, that this list is not exclusive. Thus, business purposes that were formerly acceptable should continue to be acceptable, provided the more onerous substantiation requirements imposed by the guidelines are met. While Rev. Proc. 2003-48 dictates that such substantiation is no longer required for a ruling request, the types of substantiation previously required may be relevant in the event a business purpose is challenged during the examination of a taxpayer's return. The following business purposes are specifically discussed in Appendix A of Rev. Proc. 96-30 (see also Appendix A, attached):

- a. Fit and Focus. The Service stated it would entertain ruling requests for distributions motivated by "fit and focus" concerns. See Rev. Proc. 96-30, Appendix A, § 2.05. The successful conduct of different trades or businesses within a single corporation or affiliated group depends on the existence of synergy between the businesses. When this synergy disappears, business considerations may dictate a separation of the businesses. Many large, publicly

traded corporations seek to focus on their “core” business and to dispose of those other operations that do not fit with this focus. This strategy, referred to generically as “fit and focus,” may occur for a number of reasons.

- (1) Example 1. P owns Business 1, its primary business, and Business 2, a much smaller business, which P’s top management believes is unlikely to generate significant future growth. The managers of Business 2 are dissatisfied, because the needs of its business are subordinated to the needs of Business 1, especially because the businesses are in competition for scarce capital. The Business 2 management is also frustrated because senior management lacks expertise in running Business 2. The separation of the businesses would permit P’s management to focus on the core Business 1, while the Business 2 managers can focus on Business 2 and be rewarded accordingly. In theory, this should enhance the value of the separate entities in the aggregate. See, e.g., Rev. Rul. 2003-74, 2003-2 C.B. 77.
- (2) Example 2. The public capital markets view Business 2 as a burden on the earnings of Business 1. However, Business 2 has some valuable patents and other intangible assets and potentially could be reoriented as a high-tech growth business. Management believes Business 2 would be attractive to venture capital markets if it were a separate corporation. Venture capitalists may be unwilling to accept a small minority stake in P or an entity controlled by P. Further, Business 2 is capital-intensive while Business 1 is not. The businesses have different hurdle rates (i.e., rates at which potential investments become profitable), resulting in inherent conflicts regarding when and how to raise capital. Similarly, as a mature business, Business 1 may prefer to distribute earnings while Business 2 needs to retain earnings to finance expansion. See, e.g., Rev. Rul. 2003-75, 2003-2 C.B. 79.
- (3) Example 3. The businesses may no longer exhibit positive synergy. For example, the different businesses may find themselves in direct or indirect competition with one another. Similarly, there may be little or no overlap of products, distribution channels, technology, or manufacturing processes. Alternatively, the businesses may operate in different labor, regulatory, or operational environments.

- (4) Example 4. A group of corporations would like to organize along functional or geographic lines in order to improve management's focus. This is typically a reason to undertake a purely intragroup spin-off. See, e.g., P.L.R. 200411021 (Dec. 8, 2003); P.L.R. 9810012 (Dec. 4, 1997); P.L.R. 9745034 (May 13, 1997); P.L.R. 9542013 (July 20, 1995); P.L.R. 9404009 (Aug. 9, 1993); P.L.R. 9222059 (June 13, 1991); P.L.R. 8838012 (Oct. 13, 1987).
- (5) In the circumstances described above, separating the different businesses enhances the ability of each business to attract capital and operate with maximum profitability. These business advantages may be offset or eliminated, however, if the separation triggers significant tax liability. In most cases, therefore, the taxpayer will seek to treat the transaction as tax free under section 355 of the Code. In the past, however, the Service has been unwilling to rule unless the reason for the transaction could be restated in a more acceptable form such as "cost savings."
- (6) Although the Service stated it would entertain rulings on distributions to improve "fit and focus," there were a number of restrictions.
 - a) If Distributing was not publicly traded -- or was publicly traded, but had a significant shareholder -- the Service ordinarily would not rule unless the distribution (a) was non-pro rata, or (b) effected an internal restructuring within an affiliated group.
 - i) A significant shareholder is defined as any person who is directly or indirectly, or together with related persons, the owner of 5% or more of any class of stock and who actively participates in the management or operation of Distributing or Controlled. Rev. Proc. 96-30, Appendix A § 2.05(3), 1996-1 C.B. 696.
 - ii) It appears that the Service would apply a facts-and-circumstances analysis in determining whether a shareholder was a significant shareholder.
 - iii) In P.L.R. 200039032 (June 30, 2000) (supplementing P.L.R. 200029037 (Aug. 3, 1999)), the Service noted that if F, the son of

A, a 5% shareholder of Distributing, had actively participated in the management of Distributing, it could have prevented the Service from ruling favorably on the fit and focus business purpose. For a variety of factual reasons, however, the Service did not treat F as a significant shareholder:

- (a) F directly owned less than .01% of the Distributing stock;
 - (b) A owned only slightly more than 5% of the Distributing stock;
 - (c) A's estate plan had been in place for at least three years;
 - (d) F was an outside director;
 - (e) F did not (and does not) propose strategic initiatives;
 - (f) The transaction in issue was proposed by others;
 - (g) F had questions regarding the transaction; and
 - (h) F abstained from the vote to approve the transaction.
- iv) Similarly, in P.L.R. 200422018 (Feb. 6, 2004), Distributing had three institutional investors who owned more than 5% of Distributing's stock. The Service looked to a number of factors in determining whether the institutional investors were significant shareholders:
- (a) None had a representative on the board of directors;
 - (b) None had participated in the management or control of the Distributing group;

- (c) None had been notified or informed by management of Distributing of its plan for the distribution;
 - (d) None had acted in a manner designed to influence the decision to make the distribution;
 - (e) None had suggested to any officer or director of Distributing before the announcement of the distribution that it favored or otherwise supported a distribution; and
 - (f) None had participated in the negotiation or execution of any of the agreements related to the distribution.
- v) See also Rev. Rul. 2003-74, 2003-2 C.B. 77 (shareholder owned 8% of the stock of Distributing but did not actively participate in the management or operations of Distributing or Controlled); Rev. Rul. 2003-75, 2003-2 C.B. 79 (shareholder owned 6% of the stock of Distributing but did not actively participate in the management or operations of Distributing or Controlled).
- vi) Often, a family of investment funds would own more than 5% of the stock of Distributing. However, as long as no single fund or group of funds managed by the same individual owned more than 5% of Distributing, the Service was generally willing to give a favorable fit and focus ruling. See, e.g., P.L.R. 200105060 (Dec. 2, 2001); P.L.R. 200146020 (July 11, 2001); P.L.R. 200139001 (Oct. 11, 2000); P.L.R. 9843015 (July 21, 1998).
- b) The taxpayer was required to submit documentation describing in detail the problems associated with the current corporate structure and demonstrate why the distribution will lessen or eliminate these problems. Examples of probative documentation given by the new guidelines include internal reports and studies,

and professional analyses (such as an opinion or reports prepared by investment bankers or management consultants). However, in the case of a non-pro rata distribution made to enable a significant shareholder or shareholder group to concentrate on a particular business, the Service ordinarily would not require third-party documentation or detailed studies.

- c) The Service has closely scrutinized situations involving:
 - i) Except for cases involving an internal restructuring of an affiliated group, any continuing cross-ownership of Distributing and Controlled, and
 - ii) Any internal restructuring where the distributee would not otherwise be entitled to a 100% dividends-received deduction.
 - iii) Any continuing relationship between Distributing and Controlled. The Service will permit certain continuing relationships if they are not otherwise inconsistent with the business purpose.
 - (a) Continuing relationships could be in the form of shared employees, officers, or directors. The Service will generally permit sharing if it is of support employees or of officers and directors that constitute only a minority in number. See, e.g., Rev. Rul. 2003-74, 2003-2 C.B. 77 (ruling the fact that two of Distributing's directors will also temporarily serve as directors of Controlled did not conflict with the business purpose, because such directors will constitute a minority of the board and assist with the separation of the businesses);

P.L.R. 201142003 (July 20, 2011)
(Directors and officers of

Distributing will serve as directors and officers of Controlled);

P.L.R.201129006 (Apr. 13, 2011)
(Distributing executives will serve on Controlled's board of directors);

P.L.R. 201108004 (Nov. 18, 2010)
(certain officers of Distributing will serve as officers of Controlled);

P.L.R. 201104028 (Oct. 20, 2010)
(Officers and directors of Distributing (including the two shareholders together holding 100% of Distributing) will initially serve as the officers and directors of Controlled);

P.L.R. 201034005 (May 20, 2010)
(Certain individuals will serve as officers/board members for both Controlled and Distributing);

P.L.R. 20103005 (Apr. 28, 2010)
(Former parent of both Distributing and Controlled may share a common chairman of the board "for a period of time"; parent, Distributing, Controlled, and their subsidiaries will continue to provide certain operating services to other members of the parent group and the Distributing group that are now provided between the companies under existing contracts);

P.L.R. 201015029 (Jan. 7, 2010)
(Certain shareholders and individuals will serve on both the Distributing board of directors and the Controlled board of directors, along with five independent directors that will not overlap between the two boards; Distributing will provide information technology services to Controlled for one year or less and Controlled will

reimburse Distributing for the cost of services provided; under an indefinite shared services agreement, Distributing will provide certain administrative functions to Controlled that are not core revenue functions and for which duplication of costs is not justified and Controlled will reimburse Distributing for the costs incurred in providing these services);

P.L.R. 200922028 (Feb. 20, 2009) (Distributing and Controlled would share a general counsel and Distributing's president would serve as vice chairman of Controlled's board of directors; Distributing would pay salaries and Controlled would reimburse Distributing at amount that approximates fair market value);

P.L.R. 200906032 (Oct. 29, 2008) (Distributing and Controlled would form an administrative management company that would employ administrative employees formerly employed by Distributing and lease employees to Distributing and Controlled for an arm's-length fee);

P.L.R. 200850013 (Sept. 10, 2008) (partnership between Distributing, Controlled, and the sole shareholder-officers of each company would provide management and operational services to Distributing and Controlled for an arm's-length fee);

P.L.R. 200825036 (Mar. 19, 2008) (in a split-up transaction between shareholders A, B, and C, C would be a shareholder of both C1 and C2 and would manage the day-to-day affairs of each; shareholder A would

make key decisions for C1, and shareholder B would make key decisions for C2);

P.L.R. 200743007 (Jul. 10, 2007)
(Distributing and Controlled would share Person A as an officer of Distributing and a director of Controlled for no more than 18 months, to avoid insufficient executive level guidance when another of Distributing's officers retires in 6 months);

P.L.R. 200608016 (Nov. 22, 2005)
(Distributing and Controlled would share the chairman and nonexecutive vice chairman of the board, one or more additional directors, at least one senior executive officer and some shared employees; the number of directors would constitute a minority of the board);

P.L.R. 200422018 (Feb. 6, 2004)
(Distributing and Controlled would share directors constituting less than half of Controlled's board but all of Distributing's board, including the chairman of the board (who was also the chief executive officer of Distributing); taxpayer represented that overlapping directors would provide a sense of continuity and assist with the transition and within four years Distributing anticipated that the overlapping directors would constitute a minority of Distributing's board);

P.L.R. 200420019 (Feb. 5, 2004)
(parent of Distributing and Controlled in an intragroup spin-off would form a new subsidiary to provide administrative and support functions to both Distributing and

Controlled);

P.L.R. 200411013 (Dec. 4, 2003)
(Distributing and Controlled would share a number of directors constituting a minority of the board, the chief financial officer, and employees who perform secretarial, accounting, and technical support functions);

P.L.R. 200410013 (Nov. 26, 2003)
(Distributing and Controlled would share two individuals as directors and executive officers out of at least five directors and executive officers).

- (b) Continuing relationships could also be in the form of contractual relationships. The Service will generally permit such relationships if they are for a transitional period of time and/or at arm's length terms. See, e.g., Rev. Rul. 2003-75, 2003-2 C.B. 79 (ruling the limited continuing relationship between Distributing and Controlled evidenced by various administrative agreements and a loan for working capital was not incompatible with the separation of the businesses, because the agreements and loan were transitional, short-term, and designed to facilitate the separation of the businesses);

P.L.R. 201111003 (Dec. 15, 2010)
(Distributing will provide certain intercompany employee services involving the administration of various retirement, benefit, and insurance plans for a transitional period);

P.L.R. 201034005 (May 20, 2010)
(involving transitional and administrative support services that

Distributing may provide to Controlled or vice versa for an interim period after the distribution and on-going operational and business services that Controlled may obtain from Distributing or vice versa. The payments made for the services will be for fair market value);

P.L.R. 200944026 (June 29, 2009) (Distributing and Controlled would enter into intercompany agreements to provide manufacturing, distribution, and packaging activities at arm's length, lease agreements at arm's length (or in some instances on terms similar to the primary lease), and royalty-free and royalty-bearing licenses);

P.L.R. 200936022 (Sept. 10, 2008) (Distributing and Controlled would enter into a joint venture to provide technical and management services to members of the DSAG in connection with Business B and provide support and operational services to members of the CSAG in connection with Business D as well as to third parties; members of the DSAG would provide management and administrative services to the joint venture);

P.L.R. 200921002 (Feb. 12, 2009) (Parent and Controlled would extend and modify certain pre-existing commercial agreements and enter into an IP agreement; P would also make a bridge loan to Controlled);

P.L.R. 200823022 (Feb. 29, 2008) (involving a 2-year transition services agreement and sublease to Controlled, nonexclusive license to C of business name and trade

symbol, and agreements involving retransmission rights and cross-promotion all for fair market value; also some overlap (less than majority) on board of directors);

P.L.R. 200805011 (Oct. 30, 2007) (involving a number of continuing agreements between Distributing and Controlled, including the continued provision of letters of credit and guarantees up to a certain amount, a transitional services agreement at cost during the transition period but at market if the service period is extended, a cost sharing arrangement associated with operating Asset Z for a portion of the fixed and variable costs, and the sharing of certain officers and directors);

P.L.R. 200737017 (May 31, 2007) (involving a number of continuing agreements between Distributing and Controlled, including a transitional services agreement under a cost reimbursement arrangement, intercompany funding arrangements, a royalty-free license, subleases for shared facilities for an arm's length rent, and the provision of certain Business A services by Distributing to Controlled on arm's length terms);

P.L.R. 200717012 (Jan. 22, 2007) (involving continuing tax, finance, human resource, facilities and property management, and legal services by Distributing at arm's-length pricing);

P.L.R. 200709050 (Nov. 16, 2006) (involving mutually beneficial commercial arrangements and transitional services, including tax support and treasury services, for 12-

month period);

P.L.R. 200704018 (Oct. 12, 2006)
(involving cross guarantees of
Distributing and Controlled loans for
arm's-length guarantee fee);

P.L.R. 200532011 (Apr. 29, 2005)
(involving a transitional contract
manufacturing agreement and
various transitional agreements for
administrative services; payment
were represented to be at arm's
length);

P.L.R. 200536008 (Jun. 6, 2005)
(involving a transitional back office
services agreement not expected to
exceed 2 years, which may be
compensated on a cost basis during
the 2-year period but on an arm's
length basis if extended);

P.L.R. 200350002 (Sept. 5, 2003)
(other than royalty-free licenses of
incidental intellectual property,
taxpayer represented that payments
made in connection with continuing
transactions would be arm's length);

P.L.R. 200243049 (Aug. 1, 2002)
(Distributing and Controlled entered
into an agreement for the sharing of
corporate and administrative services
under a cost reimbursement formula
and certain other agreements, which
it excluded from the representation
that continuing transactions would be
at arm's length);

P.L.R. 200234021 (May 14, 2002)
(involving an exclusive
manufacturing and integrated service
contract through a date certain, an
exclusive perpetual license, and a
transitional agreement to provide

corporate services between Distributing and Controlled);

P.L.R. 200146020 (July 11, 2001) (involving a number of continuing agreements between C and D or its subsidiaries; the agreements were represented to be either for a limited term or at arm's length).

L.A.F.A. 20100301F (May 15, 2009) (involving a lease of hourly employees by Distributing to Controlled in order to comply with a collective bargaining agreement; concluding that payments by Controlled to Distributing were taxable to Distributing under the terms of the tax-sharing agreement and that Arrowsmith did not apply because the employment agreement was not sufficiently tied to the spin-off).

- (c) Finally, the Service has permitted certain continuing payments between Distributing and Controlled. See, e.g., P.L.R. 200826032 (Mar. 21, 2008) (involving the formation of a partnership in which Controlled received an interest entitling to a percentage of future net sales for a period of time);

P.L.R. 200805010 (Nov. 7, 2007) (involving a judgment sharing arrangement relating to certain uninsured litigation claims);

P.L.R. 200752017 (Sept. 26, 2007) (where amounts invoiced to customers by a disregarded entity owned by Distributing would not be settled as of the date of the spin-off, the receivables would be collected from customers by Distributing and remitted to Controlled);

P.L.R. 200752023 (Sept. 21, 2007) (where below-market lease associated with Business X was nonassignable, Distributing agreed to pay Controlled the benefit of the below-market rates based on a formula).

- (7) The Service has issued a number of favorable rulings based on a fit and focus business purpose for a section 355 transaction. See, e.g., P.L.R. 200420019 (Feb. 5, 2004); P.L.R. 200419030 (Feb. 2, 2004); P.L.R. 200243027 (Jul. 24, 2002); P.L.R. 200234025 (May 15, 2002); P.L.R. 200215031 (Jan. 10, 2002); P.L.R. 200225005 (Mar. 22, 2002); P.L.R. 200107016 (Nov. 15, 2000); P.L.R. 200103057 (Oct. 24, 2000); P.L.R. 200023040 (Mar. 14, 2000); P.L.R. 199919025 (Feb. 12, 1999); P.L.R. 199906007 (Nov. 2, 1998); P.L.R. 9843033 (Oct. 23, 1998); P.L.R. 9828017 (Apr. 9, 1998); P.L.R. 9812012 (Dec. 12, 1997); P.L.R. 9809035 (Nov. 25, 1997); P.L.R. 9804049 (Oct. 28, 1997).

b. Risk Reduction. In the past, the Service also entertained ruling requests in the case of distributions motivated by risk reduction. See Rev. Proc. 96-30, Appendix A, § 2.09.

- (1) The Service considered the nature and magnitude of the risks faced by the risky business. The taxpayer was required to submit information regarding the claims history of the risky business, or information regarding the typical risk experience of similar businesses in that industry.
- (2) The Service considered whether the assets and insurance associated with the risky business were sufficient to meet reasonably expected claims arising from the conduct of the risky business.
- a) The taxpayer was required to submit the book value and approximate fair market value of the net assets, including intangibles, of the risky business and describe any other factors, such as liabilities that are not included on the taxpayer's balance sheet, that affect the value of the net assets of the risky business.

- b) Facts regarding the cost and availability of insurance generally required third-party substantiation.
- (3) The Service considered whether, under applicable law, the distribution would significantly enhance the protection of the other businesses from the risks of the risky business and, whether, under applicable law, an alternative nontaxable transaction that did not involve the distribution of Controlled's stock and was neither impractical nor unduly expensive (for example, creating a parent/subsidiary or holding company structure) would provide similar protection.
- a) The taxpayer was required to include an analysis of the law and the application of the law to the relevant facts of the proposed transaction. An opinion of counsel may have been required.
 - b) However, it was not necessary for the taxpayer to establish conclusively that, under applicable law, the proposed transaction would afford adequate protection or that an alternative transaction would not afford adequate protection.
 - c) The Service could require additional substantiation that the distribution would enhance the protection against the risky business where both Distributing and Controlled (or both controlled corporations in a split-up) each retain a risky business. See Official Summary of P.L.R. 9852039 (Sept. 29, 1998), 1999 TNT 107-40.
 - d) Until recently, the Service would generally not issue rulings where the asserted business purpose was risk reduction, despite concerns of environmental lawyers that liability for hazardous waste clean-ups under CERCLA may be imposed on any member of an affiliated group. The Service would, however, issue rulings in limited cases where the risky business was already contained in Distributing and the safe business was operated by Controlled, since the creditors of the risky business could reach the assets of the safe business through the stock of Controlled. See Rev. Rul. 78-383, 1978-2 C.B. 142.

(4) In P.L.R. 9726012 (Mar. 28, 1997), the Service allowed a double spin of Controlled in order to reduce the exposure of Controlled to the environmental liabilities of related corporations.

a) In P.L.R. 9726012, a parent corporation (“P”) owned a subsidiary corporation (“S”), which in turn owned six subsidiaries -- five of which engaged in hazardous businesses that could have resulted in “significant environmental liabilities under various state and federal statutes,” including CERCLA.

b) Because the insurance policies excluded coverage for pollution-related liability, and because the hazardous business could produce liabilities in excess of the value of the five subsidiaries, P and S wanted to spin off the remaining subsidiary (“C”) in order to reduce its exposure to the liabilities inherent in the other five subsidiaries.

c) Thus, S spun off C to P, and P spun off C to its shareholders. The Service held that both spins were valid section 355 transactions, with the corporate business purpose being “risk reduction.”

(5) Other rulings in which the Service has permitted risk reduction as a valid business purpose include P.L.R. 200306033 (Nov. 5, 2002) (environmental liabilities); P.L.R. 200243028 (Jul. 24, 2002) (potential liability claims); P.L.R. 200215027 (Jan. 10, 2002) (potential tort liabilities); P.L.R. 199923011 (Mar. 2, 1999) (toxic or explosive materials); P.L.R. 199915018 (Jan. 7, 1999) (potential liability claims); P.L.R. 9852039 (Dec. 24, 1998) (assets located in city subject to environmental hazards); P.L.R. 9827031 (Apr. 3, 1998) (contingent liabilities); P.L.R. 9744008 (July 30, 1997) (environmental liabilities); P.L.R. 9730014 (Apr. 24, 1997) (litigation risks).

c. Facilitating an acquisition “of” Distributing. The Service would entertain ruling requests where the asserted purpose for the distribution was to facilitate a proposed acquisition that would not be consummated unless unwanted assets were first distributed. See Rev. Proc. 96-30, Appendix A, § 2.07. Importantly, this recognized that facilitating a subsequent reorganization may be a valid business reason for a spin-off. See, e.g., Rev. Rul. 68-603, 1968-2 C.B. 148; P.L.R. 200350002 (Dec. 12, 2003); P.L.R. 200245012 (July 30, 2002); P.L.R. 200301011 (July 2, 2002);

P.L.R. 200015028 (Jan. 12, 2000); P.L.R. 9751043 (Sept. 25, 1997); P.L.R. 9306010 (Nov. 10, 1992); P.L.R. 9117054 (Jan. 30, 1991).

- (1) To establish that a corporate business purpose for the distribution is to tailor Distributing's assets to facilitate a subsequent tax-free acquisition of Distributing by another corporation, ordinarily the taxpayer was required to demonstrate to the satisfaction of the Service that:
 - a) The acquisition would not be completed unless Distributing and Controlled are separated;
 - b) The acquisition could be accomplished by an alternative nontaxable transaction that does not involve the distribution of Ccontrolled stock and is neither impractical nor unduly expensive;
 - c) The acquiring corporation would not be related to Distributing or Controlled;
 - d) The acquisition would be completed within one year of the distribution.

Note, however, that in cases involving an acquisition of 50% or more of the stock of Distributing, reliance on this business purpose would likely indicate the existence of a plan, which would trigger a corporate-level tax to Distributing under section 355(e). See Part III.J., *infra*.

- (2) For example, in Rev. Rul. 76-527, 1976-2 C.B. 103, a subsidiary of a publicly held corporation offered to acquire the assets of a target in exchange for its own stock. However, the management of the target declined the stock offer, because the subsidiary's parent was engaged in an unrelated industry, and target management was reluctant to accept stock of a corporation controlled by such a parent. In order to enable the subsidiary to use its own stock in making acquisitions, the parent distributed the subsidiary's stock, pro rata, to its shareholders. The Service approved the transaction.
- (3) On numerous occasions the Service has publicly ruled that Distributing may distribute assets not wanted by the acquirer in a section 355 transaction so that Distributing could be acquired in a reorganization. See, e.g., *Mary Archer W. Morris Trust*, 42 T.C. 779, 791 (1964), *aff'd* 367

F.2d 794 (4th Cir. 1965), acq. Rev. Rul. 68-603, 1968-2 C.B. 148; Rev. Rul. 70-434, 1970-2 C.B. 83; Rev. Rul. 78-251, 1978-1 C.B. 89. But see section 355(e). (As discussed in Part III.G., below, these transactions raise continuity of interest issues.)

- (4) As discussed in Part III.B.4., above, since the enactment of section 355(e), the Service will no longer apply the step-transaction doctrine to conclude that the control requirements are not satisfied where Controlled rather than Distributing is acquired. See Rev. Rul. 98-44, 1998-2 C.B. 315; Rev. Rul. 98-27, 1998-1 C.B. 1159. As a result, a distribution to facilitate an acquisition of Controlled is now a valid business purpose, although an acquisition of greater than 50% can also trigger a corporate-level tax under section 355(e). See, e.g., P.L.R. 200350002 (Sept. 5, 2003); P.L.R. 200239005 (Jun. 19, 2002).
- (5) In P.L.R. 8921065 (Feb. 28, 1989) (supplemented by P.L.R. 8933038), the Service approved the following spin-off. Affiliated Publications, owners of the Boston Globe also owned 47% of McCaw Cellular. The stock in McCaw had appreciated substantially and the shareholders of Affiliated wished to sell the McCaw stock. McCaw, as a less-than-80% subsidiary, could not be spun-off to the shareholders under section 355; therefore, if Affiliated sold the stock and distributed the proceeds to the shareholders there would be corporate and shareholder-level tax. In order to avoid this, a Morris Trust transaction was used. Affiliated Publications dropped the Boston Globe into a new Controlled corporation, and spun off Controlled. Affiliated Publications then merged into McCaw, with McCaw as the surviving corporation. The former Affiliated Publications shareholders received McCaw stock in return for Affiliated stock and thus held shares directly in McCaw and in Controlled. See also P.L.R. 9117054 (Jan. 30, 1991).
- (6) Arguably, the distribution of unwanted assets as a business purpose could have been adversely affected by the repeal of General Utilities. However, the Service continued to issue private letter rulings under section 355 where facilitating a tax-free acquisition of Distributing is the business purpose for the spin-off. See, e.g., P.L.R. 199904010 (Oct. 27, 1998); P.L.R. 9347023 (Aug. 30, 1993); P.L.R. 9306010 (Nov. 10, 1992); P.L.R. 9117054 (Jan. 30, 1991); P.L.R.

8923039 (Mar. 14, 1989); see also Rev. Proc. 96-30, Appendix A, § 2.07.

- d. Facilitating an acquisition “by” Distributing or Controlled. The Service continued to entertain ruling requests where the asserted purpose for the distribution is to facilitate a subsequent acquisition of a target by Distributing or Controlled using stock. See Rev. Proc. 96-30, Appendix A, § 2.08.
- (1) Again, this recognized that facilitating a subsequent acquisition may be a valid reason for a spin-off. For example, in Rev. Rul. 72-530, 1972-2 C.B. 112, the Service approved of a distribution that facilitated an acquisition by the distributing parent corporation. See also P.L.R. 200243032 (July 26, 2002); P.L.R. 200033029 (May 18, 2000); P.L.R. 199910026 (Dec. 10, 1998); P.L.R. 9833003 (May 8, 1998); P.L.R. 9821052 (Feb. 24, 1998); P.L.R. 9813015 (Dec. 22, 1997). Similarly, the Service has approved of distributions that facilitated an acquisition by Controlled. See, e.g., Rev. Rul. 76-527, 1976-2 C.B. 103; P.L.R. 200024002 (Feb. 28, 2000); P.L.R. 200006047 (Nov. 17, 1999).
 - (2) To establish such a purpose, ordinarily, the taxpayer was required to demonstrate to the satisfaction of the Service that:
 - a) The combination of the target corporation with Distributing or Controlled will not be undertaken unless Distributing and Controlled are separated;
 - b) The acquisition cannot be accomplished by an alternative nontaxable transaction that does not involve the distribution of Controlled stock and is neither impractical nor unduly expensive;
 - c) The target corporation is not related to Distributing or Controlled;
 - d) The acquisition will be completed within one year of the distribution. But see Rev. Rul. 2004-23, 2004-1 C.B. 585 (approving a business purpose to increase stock value to enable D to make acquisitions using its stock in a manner that preserves capital without diluting shareholders’ interests, where D had a history of making such

acquisitions but did not have a specific acquisition in mind).

- e. Competition. The Service entertained ruling requests involving distributions intended to eliminate direct competition of a business with customers or suppliers. See Rev. Proc. 96-30, Appendix A, § 2.06.
- (1) Ordinarily, the taxpayer was required to demonstrate to the satisfaction of the Service that:
 - a) One or more customers or suppliers had significantly reduced (or will significantly reduce) their purchases from, or sales to, Distributing or Controlled because of the competing business;
 - b) Because of the distribution, these customers or suppliers would significantly increase (or will not implement a planned significant reduction in) their purchases from, or sales to, Distributing or Controlled after the distribution;
 - c) These customers or suppliers did not object to the Distributing shareholders' ownership of stock of Controlled after the distribution;
 - d) Sales to these customers, or purchases from these suppliers, would represent a meaningful amount of sales or purchases by Distributing or Controlled after the distribution.
 - (2) In Rev. Rul. 56-450, 1956-2 C.B. 201, the Service permitted a tax-free spin-off where the customers of a subsidiary were in direct competition with the subsidiary's parent. As a result, the customers were reluctant to place orders with the subsidiary.
 - (3) Similarly, the Service has approved the distribution of the subsidiary in order to separate competing businesses. Rev. Rul. 59-197, 1959-1 C.B. 77; see also P.L.R. 200223002 (Feb. 13, 2002); P.L.R. 200034012 (May 24, 2000); P.L.R. 200021044 (Feb. 25, 2000); P.L.R. 200004026 (Oct. 29, 1999); P.L.R. 199926001 (Jan. 12, 1999); P.L.R. 9317033; P.L.R. 9317028; P.L.R. 9308026; P.L.R. 9240028; P.L.R. 9214013; P.L.R. 9121068; P.L.R. 9051044.
 - (4) In order to obtain a favorable ruling from the Service, in most cases it was necessary to provide corroboration from

customers/competitors describing the business tension and how it would be relieved as a result of a spin-off. See Rev. Proc. 96-30, Appendix A, § 2.06.

- a) Such corroboration could at times be difficult to obtain.
 - b) Furthermore, in the case of a closely held corporation, it may have been difficult to convince the Service that a spin-off would resolve the situation, since the same individuals would continue to own and run both businesses.
 - c) A possible alternative to substantiating this business purpose through direct corroboration from customers/competitors is to obtain advice from a management consultant. For example, in Rev. Rul. 2003-110, 2003-2 C.B. 1083, Distributing conducted a pesticides business and Controlled conducted a baby food business. A significant number of potential customers of the baby food business refused to buy from Controlled because of its affiliation with Distributing's pesticides business. Distributing's management consultant advised it that separating the two businesses would relieve the baby food business of the adverse market perception caused by its association with the pesticides business. The Service concluded that the business purpose requirement was satisfied.
- f. Key Employees. The taxpayer may wish to give a key employee equity in only part of the business. See Rev. Proc. 96-30, Appendix A, § 2.01.
- (1) To establish that a corporate business purpose for the distribution is to provide an equity interest in a business of Distributing or Controlled to a current or prospective employee, ordinarily the taxpayer was required to demonstrate to the satisfaction of the Service that:
 - a) The transfer of Distributing or Controlled stock to this employee will accomplish a "real and substantial purpose germane to the business" of Distributing, Controlled, or the affiliated group to which Distributing belongs. Among other things, the taxpayer must explain why the individual is considered a key employee, and why it is necessary

to give the individual, or each individual, an equity interest of the type and amount proposed in the transaction.

- b) Generally within one year of the distribution, the employee or employees must receive a “significant amount” of stock, unless this would be prohibitively expensive for the employee.
 - i) The Service appears generally to require that the key employee(s) acquire at least 5% of the stock. See, e.g., P.L.R. 200133034 (May 15, 2001) (five percent); P.L.R. 200116025 (Jan. 19, 2001) (four employees acquired an aggregate of at least 5%); P.L.R. 9546013 (Nov. 17, 1995) (15%); P.L.R. 9311022 (Mar. 19, 1993) (20%); P.L.R. 9138038 (Sept. 20, 1991) (9%); P.L.R. 9037047 (Sept. 14, 1990) (5.8%; the key employee acquired an additional 1% to get over 5%); P.L.R. 9028098 (July 13, 1990) (two employees acquired an aggregate of 15%); P.L.R. 9027031 (July 6, 1990) (between 5-10%); P.L.R. 8942013 (Oct. 20, 1989) (at least 5%); P.L.R. 8950064 (Dec. 16, 1988) (5%); P.L.R. 8612039 (Dec. 20, 1985) (11 key employees acquired an aggregate of 10%).
 - ii) However, we understand that the Service has issued such a ruling when the stock to be issued constituted as little as 2% of the outstanding stock of a publicly traded company.
 - iii) Nonetheless, where the taxpayer contends that a transaction involving a distribution will provide the employee with voting power representing a meaningful voice in the governance of their employer’s business that is not available through an alternative transaction, the Service will consider such cases on a case-by-case basis, taking into account factors such as the distribution of voting power among the shareholders, family relationships, and competing economic interests.

- iv) In certain cases, the Service may consider the value of the stock to be purchased, relative to the employee's salary. The Service has, for example, considered this factor when the purchase price for the shares was payable over a long period of time. Compare Official Summary of P.L.R. 9830016 (Apr. 24, 1998), 2000 TNT 250-64 (stock purchased with 10-year note), with Official Summary of P.L.R. 9826045 (Mar. 31, 1998), 2000 TNT 250-62 (stock purchased with 3-year note). See also P.L.R. 9818061 (May 1, 1998) (acquire 20-33% over not more than five years); P.L.R. 9211044 (Mar. 13, 1992) (option to purchase 20% in three installments).
 - v) Generally, the Service will only take into account stock that is to be purchased by the employee for this purpose -- not options or other rights to purchase stock in the future. Nonetheless, the Service will permit the corporation to have certain repurchase rights. See, e.g., P.L.R. 9011033 (Dec. 19, 1989) (repurchase right in the nature of a right of first refusal); P.L.R. 8612039 (Dec. 20, 1985) (repurchase right if employee desires to dispose of shares or if employee terminates employment, dies, or becomes disabled).
 - vi) However, the Service ruled in P.L.R. 200214014 (Dec. 21, 2001) that a transaction had a valid business purpose where employees, in exchange for previously held stock options in Distributing, received stock options in Controlled in order to motivate such employees by tying compensation to the market performance of Controlled's common stock. In addition, the Service permitted Distributing and Controlled to distribute stock to the key employees. P.L.R. 200422020 (Feb. 9, 2004).
- c) The taxpayer must demonstrate that the purpose cannot be accomplished by an alternative

nontaxable transaction that does not involve the distribution of Controlled stock and is neither impractical nor unduly expensive.

- i) For example, a key employee may not want to purchase stock in a corporation that is controlled by another corporation. See, e.g., P.L.R. 9636034 (June 12, 1990); P.L.R. 9211044 (Mar. 13, 1992); P.L.R. 8924041 (Mar. 20, 1989); see also P.L.R. 9312003 (Dec. 17, 1992) (key employee desired interest in Controlled alone, because executives of Distributing had not shown a great interest in Controlled's business and may allow it to flounder); P.L.R. 9037047 (June 20, 1990) (same); P.L.R. 8712058 (Dec. 23, 1986) (key employees did not wish to purchase stock in Controlled while it had a corporate shareholder, because a corporate shareholder would be entitled to a dividends-received deduction, which is unavailable to an individual shareholder); P.L.R. 8548011 (Aug. 23, 1985) (key employee did not wish to purchase an interest in Distributing while it was affiliated with a company engaged in the distribution of tobacco and tobacco related products).
- ii) It appears that the Service will no longer accept the argument that a limited liability company is per se a risky form of doing business because of, for example, lack of established law or potential to pierce the veil. See Official Summary of P.L.R. 9849013 (Sept. 4, 1998), 2000 TNT 250-67.
- d) If the key employee already owns stock in Distributing, the Service appears to require that the key employee surrender his Distributing stock in the transaction, absent a compelling reason not to. See Official Summary of P.L.R. 9849013 (Sept. 4, 1998), 2000 TNT 250-67; see also P.L.R. 200129007 (Apr. 16, 2001); P.L.R. 200033037 (Aug. 18, 2000); P.L.R. 8752030 (Sept. 28, 1987). But see P.L.R. 199924013 (June 18, 1999) (key employee permitted to retain 3.69% interest in Distributing).

- (2) Distributions designed to transfer an equity interest in Distributing to key employees have been, and continue to be, approved by the Service. See Rev. Proc. 96-30, Appendix A, § 2.01; Rev. Rul. 69-460, 1969-2 C.B. 51 (situation two); Rev. Rul. 85-127, 1985-2 C.B. 119; Rev. Rul. 88-34, 1988-1 C.B. 115 (pro rata distribution to enable shareholders to hire new president is for a valid business purpose); see also P.L.R. 200411013 (Dec. 4, 2003); P.L.R. 200037035 (June 16, 2000); P.L.R. 200033037 (May 23, 2000); P.L.R. 200020032 (Feb. 16, 2000); P.L.R. 199924013 (Mar. 16, 1999); P.L.R. 199917026 (Jan. 27, 1999); P.L.R. 9849013 (Dec. 4, 1998); P.L.R. 9326016 (Mar. 31, 1996); P.L.R. 9249021 (Sept. 8, 1992); P.L.R. 9147043 (Aug. 20, 1991); P.L.R. 9037047 (June 20, 1990); P.L.R. 8931017 (May 3, 1989).

g. Stock ownership plans.

- (1) The same principles that apply to key employees also apply if the asserted business purpose is to transfer Distributing or Controlled stock to an ESOP. See Rev. Proc. 96-30, Appendix A, § 2.01. For purposes of this analysis, the ESOP is treated as a group of key employees. The distribution of Controlled stock in these transactions is made necessary, because section 409(1) requires an ESOP to invest in stock of a parent corporation rather than stock of a subsidiary, if the parent stock is publicly traded and the subsidiary stock is not publicly traded.
- (2) The Service has previously ruled favorably on spin-offs undertaken to establish separate ESOPs for different types of businesses. See P.L.R. 200138015 (June 25, 2001); P.L.R. 199926017 (Mar. 30, 1999); P.L.R. 9752034 (Sept. 24, 1997); P.L.R. 9324004 (Mar. 11, 1993); P.L.R. 9250046 (June 11, 1992); P.L.R. 9149042 (Sept. 5, 1991); P.L.R. 9020048 (Feb. 23, 1990).

h. Raising Capital. In the past, the Service has entertained ruling requests for distributions intended to enhance the ability of Controlled to raise capital more effectively. See Rev. Proc. 96-30, Appendix A, §§ 2.02 and 2.03. The taxpayer may believe capital can more effectively be raised if the businesses are separated.

- (1) In Rev. Rul. 2003-75, 2003-29 C.B. 79, the Service ruled that a corporation's distribution of Controlled's stock to resolve a capital allocation problem between Distributing and Controlled satisfied the business purpose requirement.

Prior to the distribution, Distributing did all of the borrowing for both Distributing and Controlled and made all the decisions regarding the allocation of capital spending between two existing businesses. The competition for capital prevented both businesses from consistently pursuing development strategies that the management of each business believed were appropriate. The ruling stated that the distribution of Controlled's stock to separate the two businesses and provide each with direct access to capital markets satisfied the corporate business purpose requirement.

- (2) According to investment bankers, a spin-off before an IPO of Controlled can result in an IPO raising up to 10% more than it would if Controlled had not been traded and the underwriters had set the price at a discount to ensure success in the stock sale.
 - a) This is due in part to the fact that where Distributing is a publicly traded corporation, a distribution prior to the IPO allows the market to establish a trading range for Controlled.
 - b) A distribution prior to the IPO also eliminates the need for a minority discount, which would occur in an offering where a single shareholder (Distributing) owns a majority of Controlled's stock.
 - c) The Service has issued a number of favorable rulings where the business purpose for the spin-off is to facilitate a post-distribution IPO of Controlled. See, e.g., P.L.R. 200001011 (Sept. 30, 1999); P.L.R. 199926026 (Apr. 1, 1999); P.L.R. 9846028 (Nov. 13, 1998); P.L.R. 9840030 (Oct. 2, 1998); P.L.R. 9836019 (Sept. 4, 1998); P.L.R. 8520096 (Feb. 20, 1985).
 - d) Similarly, where Distributing announces that the spin-off will occur shortly after the IPO of Controlled, the Service has ruled favorably with respect to pre-distribution IPOs. See, e.g., P.L.R. 200219025 (Feb. 8, 2002); P.L.R. 200133011 (May 14, 2001); P.L.R. 200103037 (Oct. 20, 2000); P.L.R. 200104003 (Aug. 3, 2000).

- (3) In Rev. Rul. 82-130, 1980-2 C.B. 83, the Service held that a distribution to facilitate a public offering of Distributing stock was supported by a valid business reason. See also P.L.R. 200046001 (Nov. 17, 1999); P.L.R. 200020030 (Feb. 16, 2000); P.L.R. 199951014 (Sept. 22, 1999); P.L.R. 9752011 (Dec. 29, 1997).
- a) It should be noted, however, that the factors generally cited as reasons why a spin-off will enhance the success of an IPO of Controlled will likely not be applicable to a spin-off prior to an IPO of Distributing.
 - b) It may thus be more difficult to obtain a letter from an investment banker, or other necessary documentation, evidencing the business purpose for the spin-off.
 - c) It may be possible to show that a spin-off will enhance the success of an IPO of Distributing by arguing that the market can better judge the value of each individual component. A similar argument -- that increased stock value would result from "clarity" in the market following a spin-off -- apparently was the purpose behind the spin-off by Coors of its non-beer business, and by Ralston Purina of its baking operations. However, without a corporate business purpose related to such increased stock value (such as a planned IPO, or planned acquisition using stock of Distributing or Controlled), this reason would appear to be an illegitimate shareholder purpose, rather than a legitimate corporate business purpose.
- (4) The spin-off may also enable Distributing or Controlled to raise equity in a private placement.
- a) In P.L.R. 9419018 (Feb. 8, 1994), Distributing completed a spin-off transaction to enable Controlled to raise capital in a private placement. The prior spin-off was motivated, in part, because the dividend cost to the corporation of an offering of stock without the spin-off would have been considerably higher.
 - b) Similarly, in P.L.R. 9244008 (July 10, 1992), the Service approved of a spin-off in order to allow a

“strategic investor” to purchase 10% of Controlled stock following the transaction, where the strategic investor indicated that it would not be willing to make the investment in Distributing or in Controlled as a member of Distributing’s group. See also P.L.R. 200206022 (Nov. 6, 2001); P.L.R. 200138004 (Apr. 13, 2001); P.L.R. 200024036 (Mar. 17, 2000); P.L.R. 8744035 (Aug. 4, 1987); P.L.R. 8950019 (Sept. 15, 1989).

- (5) Distributing or Controlled may wish to raise debt capital instead of equity. The Service has ruled favorably where the business purpose for the spin-off was to increase Distributing or Controlled’s borrowing capacity or facilitate a debt offering. See, e.g., P.L.R. 200410013 (Nov. 26, 2003); P.L.R. 200327018 (Mar. 21, 2003); P.L.R. 200126012 (Mar. 27, 2001); P.L.R. 200048030 (Dec. 1, 2000); P.L.R. 200025036 (June 23, 2000); P.L.R. 9611016 (Mar. 15, 1996).
- (6) To establish that the business purpose for the distribution is to facilitate a stock or debt offering, ordinarily the taxpayer must demonstrate to the satisfaction of the Service that:
 - a) The issuing corporation needs to raise a substantial amount of capital in the near future;
 - b) The stock or debt offering will raise significantly more funds per share if Distributing and Controlled are separated. The taxpayer ordinarily must submit substantiation in the form of opinions by professionals, such as investment bankers. However, the Service will generally acknowledge (without extensive substantiation) that an offering of publicly traded stock by a widely held corporation with no significant shareholders will raise more funds per share than an offering by the same corporation in the position of a controlled subsidiary;
 - c) The funds raised in the stock or debt offering will, under all circumstances, be used for the business needs of Distributing or Controlled; and
 - d) The offering must be completed within one year of the distribution.

- (7) Note that an IPO of 50% or more of the stock of Distributing or Controlled would likely indicate the existence of a plan, which would trigger a corporate-level tax to Distributing under section 355(e). See Part III.J., infra.
- i. Cost savings. To establish that a corporate business purpose for the distribution is cost savings, ordinarily the taxpayer was required demonstrate to the satisfaction of the Service that the distribution would produce “significant” cost savings. See Rev. Proc. 96-30, Appendix A, § 2.04.
 - (1) Cost savings generally were “significant” for ruling purposes if savings for the three-year period following the distribution will exceed 1% of the affiliated group’s net income for the three-year period preceding the distribution.
 - (2) Ordinarily, the taxpayer’s submission should include analysis by qualified persons (for example, by the taxpayer’s insurer for insurance savings, an investment banker for lower borrowing costs, or even the taxpayer’s employees). The analysis must explain the savings and why the savings cannot be achieved through another nontaxable transaction.
 - a) Insurance cost savings: It may be possible for the two businesses to obtain insurance for a lower aggregate cost if they are not conducted in the same corporation or in the same affiliated group. See, e.g., P.L.R. 9234006 (May 18, 1992); P.L.R. 9220044 (Feb. 14, 1992); P.L.R. 9121034 (Feb. 22, 1991); P.L.R. 9049005 (Sept. 5, 1990); P.L.R. 9030020 (Apr. 26, 1990); P.L.R. 8904018 (Oct. 27, 1988).
 - b) Finance cost savings and/or enhanced credit rating: By separating a business that is subject to substantial risks, or that has poor cash flow, from a safer, or more profitable, business, it may be possible to borrow money at a lower interest rate, or otherwise on more favorable terms. Spin-offs to enhance the credit ratings of Distributing and Controlled in order to retire expensive debt and to borrow more cheaply have been accepted by the Service as valid business purposes.

- i) In Rev. Rul. 77-22, 1977-1 C.B. 91, a distribution that enhanced access to credit for both the parent and the subsidiary qualified for section 355 treatment. See also P.L.R. 200011017 (Dec. 14, 1999); P.L.R. 199951033 (Sept. 28, 1999); P.L.R. 9351022 (Sept. 27, 1993); P.L.R. 9342007 (July 9, 1993); P.L.R. 9212005 (Dec. 19, 1991); P.L.R. 9030050 (May 2, 1990); P.L.R. 8913050 (Jan. 4, 1989); P.L.R. 8823111 (Mar. 17, 1988).
 - ii) The Service has also approved a spin-off of Controlled, which was structured so that Controlled could avoid state regulatory burdens and pay dividends directly to a higher tier entity, because payment of direct dividends by Controlled enabled the parent of the affiliated group to pay down its debt more quickly (under state law, dividends from Controlled could not be paid immediately to the higher tier entity). P.L.R. 9105033 (Nov. 6, 1990).
 - c) Administrative/personnel cost savings: By separating two dissimilar businesses, it may be possible to reduce administrative costs by decreasing the overall personnel of the two businesses or by reducing administrative expenses (due to regulatory requirements or otherwise). In Rev. Rul. 88-33, 1988-1 C.B. 115, the Service ruled that the business purpose requirement was satisfied by a distribution of the stock of a controlled gaming subsidiary to remove the parent's nongaming business from the licensing review process and to free the parent from the administrative expense of licensing the gaming business. See also P.L.R. 200111026 (Dec. 14, 2000); P.L.R. 9345013 (Aug. 11, 1993); P.L.R. 9334010 (May 27, 1993); P.L.R. 9024014 (Mar. 13, 1990); P.L.R. 8936044 (June 13, 1989); P.L.R. 8932029 (May 15, 1989).
7. As discussed above, the preceding list of business purposes was intended to be non-exclusive. Accordingly, business purposes that have been acceptable in the past should continue to be acceptable. The following is a list of additional business purposes on which the Service has previously ruled favorably.

a. Shareholder Disputes/Going Separate Ways

- (1) A common acceptable business purpose is that the shareholders wish to go their separate ways and operate independently from one another.
 - a) This may be the result of serious disputes or disagreements. See, e.g., Rev. Rul. 77-133, 1977-1 C.B. 96; Rev. Rul. 56-117, 1956-1 C.B. 180; P.L.R. 200419020 (Jan. 23, 2004); P.L.R. 200411031 (Dec. 5, 2003); P.L.R. 200239022 (Jun. 25, 2002); P.L.R. 200229025 (Apr. 12, 2002); P.L.R. 200108019 (Nov. 21, 2000); P.L.R. 199906024 (Nov. 17, 1998); P.L.R. 9750065 (Sept. 18, 1997); P.L.R. 9307020 (Nov. 24, 1992); P.L.R. 8945028 (Aug. 15, 1989).
 - b) It is not necessary that the shareholders be feuding. The shareholders may simply be interested in devoting their time to only one of the corporate businesses or have differing business philosophies. See, e.g., Rev. Rul. 72-320, 1972-1 C.B. 270; Rev. Rul. 56-655, 1956-2 C.B. 214; P.L.R. 200318047 (Jan. 23, 2003); P.L.R. 200247023 (Aug. 15, 2002); P.L.R. 200215034 (Jan. 11, 2002); P.L.R. 200201006 (Sept. 28, 2001); P.L.R. 200140042 (June 7, 2001); P.L.R. 199909020 (Nov. 13, 1998); P.L.R. 9821054 (Feb. 24, 1998); P.L.R. 9231004 (Apr. 28, 1992); P.L.R. 8733027 (May 19, 1987).
 - c) In Rev. Rul. 2003-52 the Service ruled the business purpose requirement was satisfied where the distribution was intended to eliminate disagreement between a son and daughter and to allow each child to focus exclusively on a particular business.
- (2) If the shareholders want to go their separate ways, a pro rata spin-off is not likely to achieve the business purpose; rather, a split-off or a split-up will likely be required. See Gada v. United States, 460 F. Supp. 859 (D. Conn. 1978).
 - a) Nonetheless, the Service has ruled that limited post-distribution dealings between Distributing and Controlled will not affect the tax-free nature of the distribution. See, e.g., P.L.R. 199906024 (Nov. 17, 1998) (one employee provided joint computer support for six months and another provided joint

financial and administrative services for three months); P.L.R. 9843016 (July 21, 1998) (Distributing and Controlled continued to jointly own and use intellectual property without a fee); P.L.R. 9109045 (Dec. 4, 1990) (Distributing continued to provide bookkeeping services for a fee; in short term, certain employees and computer equipment would remain on Controlled's premises); P.L.R. 7842035 (July 18, 1978) (shareholder receiving one controlled corporation continued to provided managerial services to other controlled corporations).

- b) In addition, neutral shareholders may retain an interest in both Distributing and Controlled. See, e.g., P.L.R. 200202060 (Oct. 11, 2001).
- (3) If serious disputes are motivating the distribution, it may be possible to segregate the management of the businesses pending the closing of the transaction or receipt of a ruling. See, e.g., Athanasios v. Commissioner, 69 T.C.M. (CCH) 1902 (1995); P.L.R. 8942048 (July 20, 1989); P.L.R. 8741028 (July 10, 1987); P.L.R. 7842082 (July 21, 1978); see also P.L.R. 9037051 (June 20, 1990) (Distributing leased the business assets to the shareholder); P.L.R. 8226145 (Apr. 2, 1982) (stock of Controlled and the dissident shareholders' Distributing stock placed in escrow).

b. Tax savings

- (1) In Rev. Rul. 76-187, 1976-1 C.B. 97, the Service ruled that a distribution made to substantially reduce the parent's state and local taxes was supported by a valid business purpose. See also Reg. § 1.355-2(b)(2); Rev. Rul. 79-289, 1979-2 C.B. 145; P.L.R. 200211019 (Dec. 13, 2001); P.L.R. 199909038 (Dec. 8, 1998); P.L.R. 9823052 (Mar. 11, 1998); P.L.R. 9720033 (Feb. 19, 1997); P.L.R. 9301007 (Oct. 2, 1992); P.L.R. 9230028 (Apr. 29, 1992).
- (2) In Rev. Rul. 89-101, 1989-2 C.B. 67, a first-tier foreign subsidiary corporation distributed the stock of a second-tier foreign corporation to the domestic parent to reduce the foreign withholding tax imposed on distributions by the second-tier corporation. The parent would be able to take advantage of a reduced treaty rate. The reduction of federal taxes was substantially less than the reduction of non-

federal taxes. The Service ruled that the distribution was supported by a valid business purpose.

- (3) The Service has also privately ruled that a business purpose is present where a spin-off of a foreign corporation results in the elimination or reduction of foreign taxes. P.L.R. 199952029 (Sept. 29, 1999); P.L.R. 8908084 (Dec. 5, 1988); P.L.R. 8705081 (Nov. 6, 1986); P.L.R. 8511086 (Dec. 20, 1984).
- (4) However, the purpose of reducing non-federal taxes is not a valid business purpose for purposes of section 355 if:
 - a) The transaction will effect a reduction in both federal and non-federal taxes because of the similarities between the federal tax law and the tax law of the other jurisdiction; and
 - b) The reduction of federal taxes is greater than or substantially coextensive with the reduction of the non-federal taxes.

Reg. § 1.355-2(b)(2).

- (5) Moreover, the potential for the avoidance of federal taxes is relevant in determining the extent to which a corporate business purpose motivated the transaction. Reg. § 1.355-2(b)(1).

c. Election of S status

- (1) Following the 1986 Act, an issue arose as to whether the desire of either Distributing or Controlled to make an S election constituted a valid business purpose for purposes of section 355.
- (2) Tax practitioners argued that, where the S election is respected at the state level, a valid business purpose should be found in a distribution designed to make a corporation eligible for an S election. Cf. Rev. Rul. 76-187, 1976-1 C.B. 97 (distribution to reduce state and local taxes was supported by a valid business purpose).
- (3) The Service put this discussion to rest by explicitly providing in the regulations that the election of S status is not a valid corporate business purpose because of the reduction in federal taxes occurring as a result of such an election. Reg. § 1.355-2(b)(5), Exs. 6 and 7.

- (4) Interestingly, in P.L.R. 8825085 (Mar. 28, 1988), the Service approved of a distribution where the taxpayer represented that merely qualifying as an S corporation would produce substantial state tax savings even if no actual election were made at the federal level. The taxpayer represented that a federal S election would not be made for three years. Also, a secondary business motive was proffered by the taxpayer.
- (5) Not permitting the election of S status to be a valid business purpose may create an anomalous result. A parent can liquidate its subsidiary under section 332 and make an S election. This does not require a separate business purpose. Under the regulations, a spin-off designed to render either Distributing or Controlled eligible for S status cannot qualify for section 355. Such a result elevates form over substance. The inordinate tax burden that would be imposed under section 311(b), in effect, discriminates against taxpayers who cannot liquidate their subsidiaries.
- (6) The Service had ruled, however, that the preservation of S status may be a valid corporate business purpose for the distribution of Controlled's stock in a divisive "D" reorganization. In P.L.R. 9241021 (July 9, 1992), Distributing, an S corporation, could realize significant savings on the cost of its insurance by separating a high-risk business from its other, low-risk businesses. Although these insurance savings could have been realized simply by forming a new subsidiary and not distributing its stock, such a transaction would have caused Distributing to lose its S status, which would have resulted in increased taxes that would have more than offset any insurance savings. See also P.L.R. 9250027 (Sept. 11, 1992) (separation of businesses was a prerequisite to obtaining HUD financing, distribution was required to preserve S status).
- (7) Appendix C of Rev. Proc. 96-30 now contains representations that must be made by the taxpayer when Distributing or Controlled will become eligible to elect S status as a result of the distribution. The taxpayer must represent that either:
 - a) Distributing is not eligible to elect S status and Controlled does not intend to elect S status; or
 - b) Distributing is not currently eligible but will become eligible to elect S status immediately after

the distribution and both corporations will elect S status; or

- c) Distributing is currently an S corporation and Controlled will elect S status.

(8) The Small Business Job Protection Act of 1996 amended Section 1361 to permit S corporations to own 80% or more of the stock of a C corporation and to elect to treat wholly owned subsidiaries as qualified subchapter S subsidiaries (“QSub”). Pub. L. No. 104-188, 110 Stat. 1755 (1996). Accordingly, this business purpose has become moot.

- a) A QSub is not treated as a separate corporation. Instead, all of its assets, liabilities, and items of income, deduction, and credit are treated as those of the S corporation. Section 1361(b)(3)(A).

- b) An S corporation can spin-off a QSub. Nonetheless, the spin-off will terminate the QSub election, and Controlled will be treated as a new corporation acquiring all of the assets and liabilities of the old corporation immediately before the spin-off. See section 1361(b)(3)(C); Reg. § 1.1361-5(b)(1)(i); P.L.R. 200111026 (Dec. 14, 2000).

d. Separation to enhance profitability

The regulations provide that a separation of two businesses to enhance the profitability of each is a valid business purpose. Reg. § 1.355-2(b)(5), Ex. 2.

- (1) In Rev. Rul. 75-337, 1975-2 C.B. 124, the Service approved of a distribution designed to ensure retention of an existing franchise agreement. See also P.L.R. 8453020 (Sept. 27, 1984) (escape burdensome aspects of a distributorship contract); P.L.R. 8427074 (Apr. 3, 1984) (enhance access to government contracts award process).
- (2) In Rev. Rul. 56-266, 1956-1 C.B. 184, the Service approved of a distribution where it was alleged that Distributing’s businesses could be operated more profitably on a separate company basis.

e. Contain labor problems

- (1) In Olson v. Commissioner, 48 T.C. 855 (1967), supplemented, 49 T.C. 84 (1967); acq. 1968-2 C.B. 2,

Distributing's employees were seeking an election to have a union represent them as their collective bargaining agent. Labor counsel recommended the distribution of the corporation's only subsidiary in order to prevent the possible argument by the employees that the subsidiary would be subject to the outcome of the election at the parent level (the subsidiary's employees were non-unionized).

- (2) The Tax Court was satisfied that the primary purpose of the distribution was to contain labor difficulties being experienced at the parent level and to avoid any spread of the union activity to the subsidiary.
- (3) If Distributing cannot demonstrate that a distribution of the subsidiary would prevent the two corporations from being treated as a single employer unit under the labor laws, the Service might not consider such a purpose to be valid.
- (4) The Service originally acquiesced in the Tax Court's decision in Olson. However, on January 22, 2004, the Service withdrew its acquiescence with respect to the business purpose holding in Olson. See AOD CC-2004-1 (Jan. 22, 2004). The Service stated that upon reconsideration, the facts of Olson did not demonstrate that the distribution could have achieved the taxpayer's stated business objective or that that objective could not have been achieved through means other than a distribution. The Service stated that the analysis required by current regulations may not lead to a court to concluded that the distribution had a valid business purpose.

f. Removal of regulatory burdens

- (1) In Rev. Rul. 82-131, 1982-2 C.B. 83, the Service approved of a distribution that improved the utility's chances of obtaining regulatory approval of a rate increase. See also Rev. Rul. 77-191, 1977-1 C.B. 94; P.L.R. 9026042 (Mar. 30, 1990); P.L.R. 8503052 (Oct. 23, 1984).
- (2) Spin-offs to enable Distributing, engaged in one business, to avoid the regulatory burdens placed upon it because of its ownership of Controlled, engaged in another business, have been accepted. See, e.g., P.L.R. 200237022 (June 11, 2002); P.L.R. 200109023 (Nov. 29, 2000); P.L.R. 200011010 (Dec. 2, 1999); P.L.R. 199915026 (Jan. 11, 1999); P.L.R. 199914007 (Dec. 23, 1998); P.L.R. 9718024

(Jan. 31, 1997); P.L.R. 9322034 (Mar. 10, 1993); P.L.R. 9026042 (Mar. 30, 1990); P.L.R. 9209032 (Aug. 29, 1991).

- (3) Distributing was permitted to distribute stock of Controlled to the parent of the affiliated group so that the parent could receive dividends directly from Controlled, thus alleviating the parent's need to seek state regulatory approval for indirect cash distributions from Controlled. P.L.R. 9105040 (Mar. 20, 1990); see also P.L.R. 200129023 (Apr. 20, 2001) (same); P.L.R. 200212026 (Dec. 26, 2001) (regulation of Distributing restricted Controlled's ability to align with other corporations).
- (4) A spin-off of a foreign Controlled in order to allow it to undertake an IPO and to circumvent certain restrictions imposed in its country of incorporation (as a result of its ownership by a U.S. corporation) has also been upheld. P.L.R. 9045031 (Aug. 14, 1990).
- (5) Distributing was permitted to distribute the stock of Controlled in order to improve its liquidity and improve its rating with Rating Agency. An improved rating would allow Distributing to compete more effectively with other companies in its industry. P.L.R. 200422037 (Feb. 12, 2004).
- (6) Sometimes a business purpose to separate a regulated business from an unregulated business is stated in terms of fit and focus. See, e.g., P.L.R. 200102045 (Oct. 17, 2000); P.L.R. 200029032 (Apr. 19, 2000).

g. Divestiture orders

The regulations provide that a distribution undertaken to comply with a divestiture order is supported by a valid business purpose. Reg. § 1.355-2(b)(5), Ex. 1; see Rev. Rul. 62-138, 1962-2 C.B. 95; Rev. Rul. 70-18, 1970-1 C.B. 74; Rev. Rul. 83-23, 1983-1 C.B. 82; see also P.L.R. 200209047 (Dec. 3, 2001) (spin-off to comply with divestiture requirement that would be imposed by regulator as a condition to approval of Distributing's plans to expand its business); P.L.R. 200113019 (Dec. 27, 2000) (spin-off to comply with new Government Agency rules ordering that competitive and noncompetitive businesses be separated); P.L.R. 9114028 (Jan. 8, 1991) (spin-off of a subsidiary by a federal savings bank in order to avoid sanctions from the Office of Thrift Supervision); P.L.R. 9101029 (Oct. 10, 1990) (spin-off to comply with divestiture order of Federal Reserve Board).

h. Ward off hostile takeovers

Under certain circumstances, a section 355 distribution to ward off corporate raiders may constitute a valid business purpose.

- (1) In P.L.R. 8819075 (Feb. 17, 1988), the corporation's investment banker had advised the corporation (1) that it was currently vulnerable to a takeover attempt, (2) that the takeover price may be inadequate, and (3) that several subsidiaries might be sold, thereby causing harm to the corporation and its shareholders. A Schedule 13D filing recently had been made by a person or entity with a history of takeover participation, suggesting that a takeover was imminent. The Service approved of a distribution that allegedly would make Distributing less vulnerable to such a takeover attempt.
- (2) However, in P.L.R. 9005070 (Nov. 9, 1989) the Service revoked P.L.R. 8930055 (May 3, 1989) (a ruling with facts similar to P.L.R. 8819075). The Service did not provide a reason for the revocation, and stated only that "the described transaction has not been consummated." P.L.R. 9005070 did not revoke P.L.R. 8819075.
- (3) In P.L.R. 9020048 (Feb. 23, 1990), the Service approved a spin-off in order to allow the formation of an ESOP, which was intended, in part, to serve as an anti-takeover device.

- (4) As discussed below in Part III.J., regulations under section 355(e) may limit the ability of Distributing to use this business purpose without triggering a corporate-level tax.

- i. Retain business franchise

- (1) In Rev. Rul. 75-337, 1975-2 C.B. 124, the Service ruled that the business purpose requirement was satisfied where the purpose for the spin-off was to preserve Distributing's ability to renew its automobile franchise upon the death or retirement of the majority shareholder. The franchisor's policy was to require ownership by shareholders who were active in the business.
- (2) The Service has privately ruled that satisfaction of similar franchisor requirements satisfies the business purpose requirement. See, e.g., P.L.R. 200112052 (Dec. 21, 2000) (franchisor required key employees to obtain an ownership interest); P.L.R. 9338037 (June 28, 1993) (satisfy stand-alone and stock ownership requirements to obtain a franchise); P.L.R. 9104025 (Oct. 29, 1990) (Controlled's operations impinged on another franchisee and threatened cancellation of Distributing's franchise); P.L.R. 8934061 (May 31, 1989) (separation of State P and O operations to avoid jeopardizing franchise agreement); P.L.R. 8835014 (June 3, 1988) (separation to avoid inclusion of Distributing's revenues in the calculation of franchise fees); P.L.R. 8712043 (Dec. 23, 1986) (separation in exchange for franchisor's agreement not to establish a new franchise in Distributing's operating area); P.L.R. 8608041 (Nov. 25, 1985) (franchisor required separation from competitive business); P.L.R. 8.12064 (Dec. 21, 1982) (separation to cure violation of franchise agreement).

H. The Continuity of Interest Requirement

The section 355 continuity of interest regulations clarify many aspects of the continuity of interest requirement as it applies in a section 355 context. In general, the regulations codify the principles contained in previously published rulings (i.e., Rev. Rul. 69-293, 1969-1 C.B. 102 and Rev. Rul. 79-293, 1979-2 C.B. 125). However, section 355(d) and (e) also must be considered.

1. In general

- a. Historically, the continuity of interest requirement was viewed as being subsumed within the device requirement. Following the 1986 Act, however, significant attention was devoted to whether

section 355 could be used as a tool for the break-up of target corporations with minimal tax (i.e., as a substitute for the classic “mirror” transaction). Such “bust-up” transactions typically involve a distribution to a corporate shareholder, and the device test does not appear to be applicable -- no earnings pass out of corporate solution.

- b. The regulations under section 355 provide, however, that the continuity of interest requirement is independent of the other requirements of section 355. Reg. § 1.355-2(c)(1).
- c. These regulations further provide that “section 355 requires that one or more persons who, directly or indirectly, were owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation.” Reg. § 1.355-2(c)(1).
 - (1) Recently, the Service issued final continuity of interest regulations under section 368. See Reg. 1.368-1(e)(1). However, such regulations do not apply to section 355 transactions.
 - (2) The new regulations, however, provide a useful analogy to the continuity of interest test under section 355. The regulations state that continuity of interest requires that “in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.” Reg. 1.368-1(e)(1).
 - (3) The new regulations further state that the purpose of the continuity of interest requirement is “to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations.” Reg. § 1.368-1(e)(1).
- d. The continuity of interest requirement under section 355 can be broken down into several key aspects:
 - (1) Degree of continuity;
 - (2) Post-distribution continuity;
 - (3) Pre-distribution continuity (i.e. historic continuity); and
 - (4) Continuity in both Distributing and Controlled.

These are discussed below.

2. Degree of continuity

One aspect of the continuity of interest requirement is the degree of continuity required.

- a. The regulations provide that the continuity of interest test is satisfied if shareholders of Distributing maintain some minimum level of continuity in both Distributing and Controlled following the section 355 transaction. Reg. § 1.355-2(c)(1).
- b. By way of example, the Service sets forth in the regulations that 20% continuity of interest is insufficient, whereas 50% continuity is sufficient. Reg. § 1.355-2(c)(2), Exs. 1-4.
- c. However, where the spin-off involves a “D” reorganization, there is an additional requirement that either Distributing or its shareholders control the spun-off corporation immediately after the transaction. See Part III.B.3., supra. Moreover, the Service had suggested that it may use the step-transaction doctrine to impose an 80% “control” requirement even for non-”D” section 355 transactions, which would tend to subsume the continuity requirement. See Rev. Proc. 96-39, 1996-2 C.B. 300. More recently, however, amendments to section 368(a)(2)(H)(ii) have limited the effect of the step-transaction doctrine. See also Rev. Rul. 98-44, 1998-2 C.B. 315.

3. Post-distribution continuity

a. In general

A second aspect of the continuity of interest requirement is whether the recipient shareholders must retain the stock of Distributing and Controlled for a period of time after the transaction.

- (1) The continuity of interest requirement, as set forth in the regulations, requires a continuing level of equity participation in both Distributing and Controlled.
- (2) Where subsequent dispositions of stock cause the shareholder’s ownership to drop below this minimum level, the Service can be expected to argue that continuity of interest is lacking.
- (3) Nevertheless, at some point in time, the shareholder should be able to dispose of his entire stock interest without risking a loss of continuity (i.e., the shareholder’s stock becomes “old and cold”).

- a) In the context of a reorganization, the Service has stated that it will treat a five-year period of unrestricted ownership as a sufficient period of time for purposes of satisfying the continuity of interest requirement; i.e. the stock is “old and cold”. See Rev. Rul. 66-23, 1966-1 C.B. 67; Rev. Rul. 78-142, 1978-1 C.B. 111. A disposition of the stock after that point in time will not violate continuity of interest.
 - b) Nonetheless, the courts have held, in the context of a reorganization, that post-reorganization sales of stock less than five years after the reorganization did not violate the continuity of interest requirement. See Penrod v. Commissioner, 88 T.C. 1415 (1987) (sale within nine months of reorganization did not violate continuity). But see McDonald’s Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982) (sale within seven months of reorganization violated continuity); section 355(e) and (f), which effectively eliminated tax-free Morris Trust transactions and intragroup spins related to such transactions.
 - c) Whether a shareholder sells his stock before it becomes “old and cold” often turns on step-transaction principles. Determining factors include, for example, whether the disposition occurred in close proximity to the distribution, whether the disposition was a sale or a reorganization, and whether the disposition was pursuant to a binding contract at the time of the distribution.
- (4) As a condition of obtaining a ruling, the Service generally requests shareholders with a 5% or greater interest in the corporation to state that they have no intention to dispose of the subsidiary stock received. This has created difficulty where corporate raiders have refused to provide such a statement.
- (5) Query: To what extent should the actions of some shareholders affect the tax consequences of unrelated shareholders? For example, if an 80% shareholder immediately sells all of the stock received in a spin-off, should this necessarily render the transaction taxable to the remaining shareholders who did not “cash out” their 20%

interest in Controlled? Cf. Kass v. Commissioner, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3rd Cir. 1974).

- (6) The sections below discuss transactions in which a shareholder disposes of all of his stock in either Distributing or Controlled following the section 355 transaction.

b. Subsequent distributions

Where the controlled subsidiary is a lower-tier subsidiary in a chain of corporations, its stock will have to be distributed through several tiers of corporations before that stock reaches the hands of the ultimate shareholders. In such a case, it appears that each distribution must satisfy the section 355 requirements independently. However, a question arises as to whether subsequent distributions adversely affect prior distributions.

- (1) In Rev. Rul. 62-138, 1962-2 C.B. 95, a corporation transferred a business to a newly formed subsidiary and distributed the stock to its immediate parent corporation. The parent then distributed the stock to its shareholders.
- (2) The Service concluded that the second distribution of the subsidiary's stock (from the parent to its shareholders) did not violate the continuity of interest requirement in old Reg. § 1.355-2(c) because the ultimate shareholders (i.e., the parent's shareholders) held "the same enterprises in modified corporate form as before the transaction and the corporate enterprises were continued as such." See also Rev. Rul. 84-30, 1984-1 C.B. 114; P.L.R. 9020031 (Feb. 20, 1990).
 - a) In Rev. Rul. 62-138, the Service treated the drop-down of assets and subsequent distributions as a section 351 transaction (not a "D" reorganization) followed by a section 355 transaction (presumably to avoid the "D" reorganization control issue). However, in P.L.R. 200001027 (Oct. 8, 1999); P.L.R. 9236007 (Feb. 14, 1992), and P.L.R. 9141029 (July 11, 1991), "D" reorganizations followed by multiple spin-offs were approved.
 - b) Therefore it would appear that a "D" reorganization is permitted even if followed by multiple spin-offs of Controlled.

- (3) Implicit in this conclusion is the view that either the direct or the ultimate shareholders of Distributing can maintain a continuing proprietary interest in Controlled after the distribution.
- (4) It is not clear, however, how the Service would rule if the ownership of the parent's stock changed or minority shareholders were present in the corporate chain. In P.L.R. 9020031 (Feb. 20, 1990), for example, the Service permitted such a change in ownership of the parent's stock. In that ruling, the stock of Holding Company was owned by four shareholders. Holding's major asset was the stock of Distributing. Because of complications associated with acquiring new technology for one of its businesses, Distributing transferred that business to a newly formed corporation, Controlled, and distributed the Controlled stock to Holding, which distributed it pro rata to its shareholders. The company that provided the technology to the spun-off company acquired a 20% interest in Holding. Notwithstanding the change in ownership of Holding, the Service ruled that no gain or loss will be recognized by Holding or its shareholders.

c. Subsequent transactions involving Distributing

Continuity of interest issues also arise where, following a section 355 transaction, the shareholders of Distributing exchange all of their stock in such corporation for stock of another corporation in a tax-free reorganization. In the past, the Service has not viewed such transactions as violating the continuity of interest requirement.

- (1) For example, in Rev. Rul. 70-434, 1970-2 C.B. 83, an acquiring corporation was interested only in one of the two businesses conducted by the target. The target transferred the unwanted assets to a newly formed subsidiary and distributed the stock of the subsidiary to its shareholders. The acquiring corporation then acquired all of the target stock in exchange for its voting stock.
 - a) The Service stated that the first transaction qualified as a "D" reorganization because the requirements of section 355 were met. The second transaction was held to be a "B" reorganization.
 - b) Implicit in this ruling is the fact that the subsequent reorganization involving Distributing did not break

continuity of interest with respect to Distributing's shareholders. These shareholders retained a continuing equity interest in Distributing through their acquiring corporation stock.

- c) Note that section 355(e) would impose a corporate-level tax on the transaction in Rev. Rul. 70-434 if the target's shareholders do not receive more than 50% of the acquiring corporation's stock.
- (2) Similarly, in Rev. Rul. 78-251, 1978-1 C.B. 89, a parent corporation spun off its subsidiary, and the parent was acquired in a "B" reorganization immediately thereafter. Cf. Rev. Rul. 55-103, 1955-1 C.B. 31 (a subsequent sale of Distributing's stock will cause the distribution to be treated as a device).
 - (3) It is unclear, however, whether the Service continues to take this position. Rev. Proc. 96-30, § 4.06 states that, in general, the Service will view the continuity of interest requirement as satisfied if one or more persons who, directly or indirectly, were the owners of the enterprise before the distribution own, in the aggregate, 50% or more of the stock of each of the modified corporate forms in which the enterprise is conducted after the distribution. This may reflect a more restrictive approach to the continuity requirement by the Service. Significantly, the shareholders in the Morris Trust case received over 50% of the stock of the corporation that acquired Distributing in the merger. See Commissioner v. Mary Archer W. Morris Trust, 42 T.C. 779 (1964), aff'd, 367 F.2d 794 (4th Cir. 1966), acq. Rev. Rul. 68-603, 1968-2 C.B. 148. But see section 355(e), which effectively eliminated tax-free Morris Trust transactions.
- d. Subsequent transactions involving the spun-off corporation
- (1) Historically, subsequent transactions involving Controlled have raised issues under the control requirements of sections 355(a)(1)(D) and 368(a)(1)(D). See, e.g., Rev. Rul. 70-255, 1970-1 C.B. 80; Rev. Rul. 96-30, 1996-1 C.B. 36. However, as discussed above in Part III.B., the issuance of Rev. Rul. 98-27 and the enactment of the 1998 IRS Restructuring Act significantly curtailed the potentially disastrous consequences that resulted if, following a section 355 transaction, the shareholders of Controlled exchanged their newly received stock in such corporation for stock in

another corporation in a purported reorganization. But see Part III.J., infra, for a discussion of section 355(e), which effectively eliminates tax-free Morris Trust transactions.

- (2) In Rev. Rul. 75-406, 1975-2 C.B. 125, obsoleted, Rev. Rul. 98-27, 1998-1 C.B. 1159, in order to comply with a government order, a publicly held corporation spun off a subsidiary to its shareholders. The shareholders then voted to merge the subsidiary with a third corporation. The Service specifically ruled that the continuity of interest requirement in section 355 was satisfied, because the shareholders maintained an interest in the subsidiary through their stock in the acquiring corporation. See also Example 5, supra.
- (3) In P.L.R. 199948032 (Sept. 2, 1999), Distributing distributed the stock of two controlled corporations to its parent corporation. The parent corporation then merged the controlled corporations into a single-member LLC owned by the parent. The facts indicated that the distribution was conducted without regard to the merger of the controlled corporations into the LLC. The Service, citing Rev. Rul. 62-138 and Morris Trust, ruled that the continuity of interest requirement was satisfied.
- (4) In P.L.R. 9016025 (Jan. 18, 1990), the Service ruled that a sale by Controlled of certain assets, including subsidiary stock, had no effect on a prior ruling approving a spin-off.
- (5) In P.L.R. 9030037 (Apr. 30, 1990) the Service ruled that a stock repurchase plan (which excluded prohibited sellers) for up to 5% of outstanding stock of Controlled, due to a decline in the stock's value, did not adversely affect the prior favorable rulings.

4. Pre-distribution continuity (i.e., historic continuity)

A third aspect of the continuity of interest requirement is whether the “historic” shareholders must be the ones who receive (or maintain) the requisite stock interest in Distributing and Controlled.

- a. The regulations require continuity of interest on the part of the “owners of the enterprise prior to the distribution or exchange” and specifically provide that the continuity of interest must be with respect to historic shareholders. Reg. § 1.355-2(c)(1), (2), Ex. 3. (The reference to owners presumably refers to shareholders, but

query whether the phrase would include creditors of a financially troubled corporation.)

- (1) Accordingly, as continuity of interest is measured with respect to historic shareholders, prior sales of stock by such shareholders may prevent a subsequent distribution from qualifying as a section 355 transaction.
- (2) Although no explicit guidance on this issue is provided by the regulations, a shareholder of a corporation is usually considered as being an “historic” shareholder if his stock interest has become “old and cold.” A common benchmark for stock becoming “old and cold” is a two-year holding period.
- (3) However, the two-year period does not appear to be mandated. A period of less than two years may be sufficient to render a stock investment “old and cold.”
- (4) On the other hand, the step-transaction doctrine may apply to treat a shareholder who has held stock for a sufficient period of time as a non-historic shareholder. See F.S.A. 199929013 (Apr. 19, 1999).
 - a) In F.S.A.199929013, P entered into an agreement with XS1, which granted XS2, a wholly owned subsidiary of XS1, a right to purchase P stock from its shareholders. Pursuant to the agreement, P also granted XS2 a one-year put option to require P to acquire its stock from XS2. The option commenced a specified number of years after the closing date. Upon exercise of the option, P had the right to settle the option in cash or with stock of its subsidiary, PS. XS2 exercised the option, and P transferred to XS2 shares of PS in exchange for its P stock, which the parties treated as a split-off.
 - b) The Service applied the step-transaction doctrine to treat the acquisition of P stock by XS2 and the exchange of the P stock for PS stock as part of one plan. As a result, XS2 would be treated as acquiring the P stock immediately before the stock exchange. The Service thus concluded that the transaction did not qualify under section 355, because it failed the continuity of interest requirement.

- b. Section 355(b)(2)(D), in effect, also imposes a historic shareholder requirement in certain cases. Under section 355(b)(2)(D), a distribution will not be tax free if a distributee corporation or Distributing acquired control of Distributing or Controlled within five years of the date of the distribution.
- c. Similarly, if section 355(d) applies, then five years must elapse in respect of “disqualified stock” if the distribution is to be free of tax at the corporate level.
- d. Where a distribution falls outside of section 355(b)(2)(D) or 355(d), a question arises as to whether historic shareholder continuity should apply.
 - (1) One can argue that historic continuity is needed only to prevent so-called “bust-up” transactions, which are used to distribute wanted or unwanted target assets and are specifically targeted by section 355(b)(2)(D) and 355(d).
 - (2) Historic shareholder continuity tends to discriminate against closely held corporations since, as a practical matter, historic continuity is not enforced with respect to publicly held corporations. Indeed, in the context of acquisitive reorganizations, one court decision suggests that trading by public shareholders should be ignored for continuity purposes if it is not in concert with the corporation or controlling shareholders. See Seagram Corp. v. Commissioner, 104 T.C. 75 (1995).

5. Continuity in both Distributing and Controlled

Another key aspect of the continuity of interest requirement is whether continuity must be maintained in both Distributing and Controlled.

- a. The regulations explicitly provide that continuity must be maintained in both corporations. Reg. § 1.355-2(c)(2), Exs. 3 and 4.
- b. To satisfy this requirement, it is not necessary for each shareholder to continue to own an equity interest in each corporation following the transaction. Rather, the continuing shareholders in one corporation do not necessarily have to be the same as the continuing shareholders in the other corporation (e.g., a split-off). See Reg. § 1.355-2(c)(2), Exs. 1 and 2.

6. Continuity issues arising from the division of a subsidiary as part of a “D” reorganization

a. Where Distributing in a divisive “D” reorganization conducts parts of both of its business through the same subsidiary, it may be necessary for the subsidiary to undergo a “D” reorganization of its own as part of the transaction.

b. Example: Distributing is involved in Business A and Business B in the United States. In addition, Sub, a wholly owned subsidiary of Distributing and a Country X corporation, is involved in Business A and Business B in Country X. For valid business purposes, Distributing intends to form Controlled to conduct its Business A and to distribute the stock of Controlled to the Distributing shareholders.

(1) The contribution of Business A to Controlled and the distribution of the Controlled stock will be a “D” reorganization.

(2) As part of the transaction it will be necessary to separate Sub’s Business A from Business B.

a) This transaction should also take the form of a “D” reorganization.

b) The most straightforward method of separating Sub’s businesses would be for Sub to contribute its Business A to NewSub and to distribute the stock of NewSub to Distributing, which would, in turn, contribute the stock of NewSub to Controlled.

i) However, when viewed as a whole, this transaction may not satisfy the requirements of section 368(a)(1)(D). Controlled, and not Distributing or the shareholders of Distributing will be “in control” of NewSub immediately after the transaction.

ii) Thus, it may be preferable for Sub to contribute its Business B to NewSub and distribute the stock of NewSub to Distributing and for Distributing to contribute the stock of Sub to Controlled.

iii) Even this transaction, however, could be viewed as failing to qualify as a “D” reorganization. Immediately after the

transaction, there is no direct shareholder continuity of interest with respect to NewSub.

- iv) However, if the “remote continuity” approach of Rev. Rul. 62-138 is applied, the transaction should be treated as a valid “D” reorganization.
- c) It is also possible that, instead of a spin-off, the division of Sub could be structured as a split-off.
 - i) Prior to the division of Sub, Distributing could contribute a portion of the stock of Sub to Controlled.
 - ii) Sub would then form NewSub with a contribution of its Business B, and would distribute the NewSub stock to Controlled in exchange for its Sub stock.
 - iii) In this manner, the control requirement of section 368(a)(1)(D) and “post-transaction” continuity of interest are preserved.
 - iv) Some issue still remains as to “pre-transaction” continuity of interest. However, section 355(b)(2) provides an indication that pre-distribution intra-group transfers of stock should be disregarded.

I. Continuity of Business Enterprise Requirement

1. The regulations also appear to impose a continuity of business enterprise requirement on section 355 transactions, stating that “section 355 contemplates the continued operation of the business or businesses existing prior to the separation.” Reg. § 1.355-1(b).
2. The preamble to the continuity of business enterprise (“COBE”) regulations under section 368, which were issued in January 1998, provides that the regulations are not limited to transactions enumerated in section 368(a)(2)(C) (i.e., “A,” “B,” “C,” or “G” reorganizations), but rather they apply to all reorganizations for which continuity of business enterprise is relevant. Preamble to Reg. § 1.368-1(d). Accordingly, the new COBE regulations, which generally expand the assets and business of the issuing corporation to include those of members of a qualified group of corporations, should apply to section 355 transactions.

3. It is not clear how the continuity of business enterprise requirement is applied to a section 355 transaction and how it interacts with the other requirements of section 355.
 - a. For example, assume that a corporation operates an historic five-year business which represents 5% of its assets. The corporation also holds cash or cash equivalents, which it received from the sale of its other historic business assets. The corporation apparently would still be considered as engaging in an active business under section 355(b)(2)(A) since it holds the five-year business. See G.C.M. 34,238 (Dec. 15, 1969); P.L.R. 8712019 (Dec. 18, 1986). Nevertheless, it is not clear whether the continuity of business enterprise requirement would prevent a distribution by the corporation from qualifying under section 355.
 - b. Note that in a section 368 context, if the stock or assets of Distributing were acquired by another corporation, such transaction would not be treated as a reorganization, because Distributing would have violated the continuity of business enterprise requirement. See Reg. § 1.368-1(d); Rev. Rul. 87-76, 1987-2 C.B. 84.
 - c. The Service apparently has not applied the continuity of business enterprise requirement to prevent a distribution from qualifying under section 355.
 - d. In any event, a corporation holding a significant amount of liquid assets may not qualify under section 355 because of the device restriction.

J. Section 355(d) Issues

1. In general

- a. Section 355(d) requires that Distributing recognize gain (but does not require that the distributee shareholders recognize income) on a “disqualified distribution” of subsidiary stock or securities. A disqualified distribution means any distribution to which section 355 applies if, immediately after the distribution, a shareholder holds stock representing a 50% or greater interest (by vote or value) in either Distributing or a controlled subsidiary that is attributable to stock or securities that were acquired by “purchase” after October 9, 1990, and during the 5-year period ending on the distribution date (“disqualified stock”).
- b. Section 355(d) was enacted as part of the Omnibus Budget Reconciliation Act of 1990 in order to restrict the availability of section 355 in certain cases discussed below.

- (1) These restrictions were enacted in response to a growing Congressional perception that section 355(b)(2)(D) was capable of being circumvented (by the use of unaffiliated parties), and that section 355 was being used to promote transactions that were, in fact, disguised sales or devices to achieve tax-free stepped-up bases prior to sale.
 - (2) It was felt that this occurred most commonly where corporations used section 355 to achieve a fair market value basis in the stock of a controlled subsidiary and then subsequently sold that stock at little or no gain (i.e., mirror substitute transactions).
- c. Under the section 355(d) rules, gain will be recognized by Distributing on a disqualified distribution. If a disqualified distribution is made, then all gain in respect of the distributed shares will be realized -- not just that relating to disqualified stock.
 - d. Section 355(d) applies whether the distribution is part of a spin-off, split-off, or split-up.
 - e. Section 355(d) does not just foreclose avoidance of section 355(b)(2)(D) but also, in the words of the House Report, will disallow favorable tax treatment for any transaction under section 355 that is “combined with a stock purchase resulting in a change of ownership, [which] in effect results in the disposition of a significant part of the historic shareholders’ interests in one or more of the divided corporations.” H.R. Rep. No. 101-881, at 341 (1990).
 - f. As drafted, section 355(d) is extremely broad. Recognizing the far, and in many instances unintended, reach of section 355(d), Congress specifically authorized the Treasury to issue such regulations “as may be necessary to carry out the purposes of this subsection, including . . . regulations modifying the definition of the term ‘purchase.’” Section 355(d)(9).
 - g. On May 3, 1999, Service issued proposed regulations providing extensive guidance under section 355(d). The proposed regulations adopted a reasonable approach that limits the reach of section 355(d) to transactions that violate the purposes of section 355. Prop. Reg. § 1.355-6(b)(3)(i). These regulations were finalized, with some modifications, on December 20, 2000.
 - (1) The regulations contain an anti-avoidance rule, which permits the Service to treat any distribution as disqualified if the distribution or another transaction is engaged in or

structured with a principal purpose to avoid the purposes of section 355(d). Reg. § 1.355-6(b)(4).

- (2) The regulations also provide that Distributing may rely upon filings with the Securities and Exchange Commission in determining whether there is a disqualified shareholder and, absent actual knowledge, may presume that no less-than-5% shareholder acquired stock by purchase. Reg. § 1.355-6(f).
 - a) The final regulations clarify that the application of statistical sampling procedures to estimate the basis of shares acquired in certain reorganizations does not have the effect of giving actual knowledge of a stock purchase beyond the sample group. Reg. § 1.355-6(f)(5), Ex. 3.

2. Disqualified distributions

- a. Under section 355(d)(2), a “disqualified distribution” refers to any distribution if immediately after the distribution any person holds “disqualified stock” in Distributing or Controlled (or, if stock of more than one controlled corporation is distributed, in any controlled corporation), and such disqualified stock constitutes a 50% or greater interest in such corporation.
 - (1) For example, assume that A holds 50% of the stock of Distributing and such stock is “disqualified stock” (as defined below). The remaining stock of Distributing is owned by unrelated individuals. Distributing distributes the stock of its controlled subsidiary, pro rata, to its shareholders in a transaction that otherwise qualifies for section 355 treatment.
 - (2) After the distribution, A will own disqualified stock representing 50% in both Distributing and the former subsidiary. As a result, the distribution is a disqualified distribution.
- b. A disqualified distribution can result even though a shareholder holds disqualified stock representing less than 50% of Distributing before the distribution.
 - (1) To illustrate, assume that A and B both hold 50% of Distributing (which in turn owns 100% of Controlled). One-half of B’s stock (25%) is disqualified stock. All of A’s stock has been held for more than five years. A and B

decide to divide up the business by way of a split-off, and 100% of Controlled is distributed to B.

- (2) As B owns 50% of Controlled by virtue of disqualified stock in Distributing (formerly the 25% interest), the entire distribution is taxable to Distributing.

c. The 50% requirement can also be met by aggregating purchased stock of the subsidiary (acquired within five years) with distributed stock.

- (1) P purchased a 20% stock interest in Distributing and 10% stock interest in Controlled (Distributing's controlled subsidiary). Such stock is disqualified stock. Within five years after that purchase, 40% of the stock of Controlled is distributed to P in exchange for his Distributing stock in a split-off under section 355. The remaining 60% of the Controlled stock is split-off to an historic 25% shareholder of Distributing in the same transaction.
- (2) Distributing will have to recognize gain on the distributed stock of Controlled, because P's 50% interest in Controlled immediately after the distribution is disqualified stock.

3. Disqualified stock

a. Disqualified stock means any stock in Distributing "purchased" after October 9, 1990 and within the five-year period ending on the distribution date. The term also includes any stock in Controlled purchased or acquired in a section 355 distribution (in respect of disqualified stock or securities in Distributing) after October 9, 1990. Section 355(d)(3).

- (1) The regulations provide that stock of Distributing or Controlled acquired by purchase (or deemed purchased) ceases to be acquired by that purchase if the basis resulting from the purchase is eliminated. Reg. § 1.355-6(b)(2)(iii)(A), (B).
 - a) A stock's basis is eliminated if it would no longer be taken into account in determining gain or loss on a sale or exchange of any stock of such corporation. Basis is not eliminated, however, if it is allocated between the stock of two corporations under Reg. § 1.358-2(a). Reg. § 1.355-6(b)(2)(iii)(C)(1).
 - b) Basis of stock is eliminated if such stock is subsequently transferred in a carryover basis or

substituted basis transaction. However, the purchased basis that carries over to the acquiror in a carryover basis transaction or that attaches to the stock received by the transferor in a substituted basis transaction is not eliminated. Reg. § 1.355-6(b)(2)(iii)(C)(2); see also Reg. § 1.355-6(e)(2), (e)(3). This rule does not apply to eliminate basis resulting from a purchase of Distributing stock that is exchanged for Controlled stock in a split-off or split-up. Reg. § 1.355-6(b)(2)(iii)(C)(3).

- (2) The proposed regulations contained a similar rule, which provided that a person ceases to be treated as purchasing stock if such person no longer owns such purchased stock. See Prop. Reg. § 1.355-6(b)(3)(iv).
 - (3) Under the proposed regulations, a direct purchase by Distributing of all the stock of Controlled, followed by a distribution of Controlled stock was a disqualified distribution. However, under the final regulations, the distribution of Controlled results in an elimination of basis and, therefore, is not treated as purchased. Accordingly, the Controlled stock is not disqualified stock.
- b. Section 355(d)(6) provides that the five-year time period will be suspended whenever the stock or securities are subject to a substantial diminution of risk by the use of an option, a short sale, any special class of stock, or “any other device or transaction.”
- (1) Under the regulations, whether a holder’s risk of loss is substantially diminished will be determined “based on all facts and circumstances relating to the stock, the corporate activities, and arrangements for holding the stock.” Reg. § 1.355-6(e)(5)(iii).
 - (2) However, Congress has stated that a holder’s risk of loss will ordinarily not be considered to be substantially diminished “solely by virtue of customary indemnities given by the seller of stock.” H.R. Rep. No. 101-964, at 1089 (1990) (Conf. Rep.). Thus, it does not seem that warranties and indemnities of a seller will invoke a suspension. Nonetheless, it is possible that mandatory redemption features, or simple put and call options may invoke suspension.
 - (3) The term “special class of stock” includes a class of stock that grants particular rights to, or bears particular risks for,

the holder or the issuer with respect to earnings, assets, or attributes of less than all the assets or activities of a corporation or any of its subsidiaries. Reg. § 1.355-6(e)(5)(iv).

- a) For example, the term includes tracking stock and stock (or related instruments or arrangements) the terms of which provide for the distribution of any controlled corporation or other assets to the holder or to persons other than the holder. Reg. § 1.355-6(e)(5)(iv); see also H.R. Rep. No. 101-964, at 1089-90 (1990) (Conf. Rep.).

4. Stock acquired by purchase

- a. According to section 355(d)(5), the term “purchase” means any acquisition, but only if the basis of the property acquired is not determined in whole or in part by reference to the seller’s basis in the property or under section 1014. Also, property acquired in an exchange to which section 351, 354, 355 or 356 applies generally is not purchased.

- (1) The regulations also treat acquisitions of stock in a section 305 distribution as not purchased, to the extent section 307(a) applies to determine the recipient’s basis. Reg. § 1.355-6(d)(2)(ii).

- a) However, such stock will be treated as purchased on the date the distributee acquired by purchase the stock with respect to which the distribution is made. Reg. § 1.355-6(e)(4)(ii). This rule was added in the final regulations.

- (2) In addition, the regulations treat exchanges of stock qualifying under section 1036(a) as not purchased, to the extent the basis of the property acquired equals the basis of the property exchanged under section 1031(d). Reg. § 1.355-6(d)(2)(iii).

- (3) Moreover, the regulations treat acquisitions of stock in a qualified stock purchase with respect to which a section 338 election is made as not purchased. Reg. § 1.355-6(d)(2)(iv)(A).

- a) However, any stock held by Old Target is treated as purchased unless a section 338 election is also made for that stock. Id.

- b) This reverses a conclusion reached in one of the examples in the proposed regulations. See Prop. Reg. § 1.355-6(d)(1)(iii), Ex. 2.
- (4) Certain partnership distributions are treated as purchases under the regulations.
- a) The regulations provide that stock acquired in a liquidation of a partnership interest is considered purchased at the time of the liquidation if the partner's basis is determined under section 732(b). Reg. § 1.355-6(d)(2)(v)(A).
 - b) Under section 734(b), a distribution of property to a partner may result in an increase in the adjusted basis of the partnership's remaining property. The regulations provide that if the adjusted basis of stock held by a partnership is adjusted under section 734(b), a proportionate amount of the stock will be treated as purchased at the time of the basis adjustment. The proportionate amount is determined by reference to the excess of the basis adjustment over the fair market value of the stock at the time of the adjustment. Reg. § 1.355-6(d)(2)(v)(B).
- (5) The final regulations added a special rule treating certain section 355 distributions as purchases. If Distributing distributes any Controlled stock with respect to recently purchased Distributing stock (i.e., stock purchased during the five-year period preceding the distribution), then the Controlled stock is treated as purchased on the date the Distributing stock was purchased. Reg. § 1.355-6(e)(4)(i).
- (6) In addition, the Service has ruled that distributions to which section 311(b) applies constitute purchases for purposes of section 355(d). See P.L.R. 199931003 (Apr. 21, 1999).
- b. However, property acquired in a section 351 exchange for any cash or cash item, any marketable stock or security, or any debt of the transferor is treated as acquired by purchase. Section 355(d)(5)(B).
- (1) As suggested in the legislative history, the regulations provide exceptions to this rule.
 - (2) Transfers to holding companies

- a) If the transferor transfers marketable stock of a corporation in an amount that meets the requirements of section 1504(a)(2), the transferor will not be treated as purchasing the stock of the transferee. Reg. § 1.355-6(d)(3)(iii).
- b) For example, if the public shareholders of P Corporation, acting pursuant to a plan or arrangement, transfer all the stock of P to D Corporation in exchange for all of the stock of D, the public shareholders of P will not be treated as purchasing the D stock, because they have transferred at least 80% (by vote and value) of the D stock. See Reg. § 1.355-6(d)(3)(iii)(B), (c)(4).

(3) Transfers that are part of an active trade or business

- a) The section 351 transfer is not treated as a purchase, if:
 - i) The transferor is engaged in the active conduct of a trade or business, and the transferred items (i.e., the cash, marketable stock, or debt) are used in such trade or business;
 - ii) The transferred items do not exceed the reasonable needs of the trade or business;
 - iii) The transferor transfers the items as part of the trade or business; and
 - iv) The transferee continues the active conduct of the trade or business.

Reg. § 1.355-6(d)(3)(iv)(A); see also H.R. Rep. No. 101-964, at 1093 (1990) (Conf. Rep.).

- b) The final regulations clarify that a transfer of assets does not fail to meet the active business exception solely because the transferee corporation transfers the business assets to another member of the transferee's affiliated group, provided the requirements for the active business exception would have been met if the transferor had transferred the assets directly to the final transferee. Reg. § 1.355-6(d)(3)(iv)(E).

(4) Transfers between members of an affiliated group

- a) Finally, the rule does not apply if the transferor(s), transferee, and Controlled are all members of the same affiliated group before the section 351 transaction (if the transferee is in existence prior to the transaction) and do not cease to be members of such affiliated group in any transaction pursuant to a plan that includes the section 351 transaction (including any distribution of Controlled). Reg. § 1.355-6(d)(3)(v); see also H.R. Rep. No. 101-964, at 1092-93 (1990) (Conf. Rep.).
- b) The final regulations added an additional requirement for the affiliated group exception. The cash or cash item, marketable securities, or debt of the transferor must not have been acquired by the transferor (or another member of the group) from a nonmember in a related transaction to which section 362(a) or (b) applies to determine the basis of the assets. Reg. § 1.355-6(d)(3)(v)(A)(2).
- c) For example, assume that P Corporation owns all the stock of Distributing and contributes cash to Distributing which is equal to 60% of the value of Distributing in a section 351 transaction. Assume further that within five years after the cash contribution, Distributing contributes assets to a newly formed controlled corporation, Controlled, and distributes its Controlled stock to its sole shareholder, P in a section 355(a) transaction. P's cash contribution to Distributing is not treated as a purchase of Distributing stock, because P, Distributing, and Controlled do not cease to be members of the affiliated group at any time. See Reg. § 1.355-6(d)(3)(v)(B), Ex. 1.

c. Triangular reorganizations

The regulations provide special purchase rules for triangular asset reorganizations. Reg. § 1.355-6(d)(4).

- (1) The regulations generally treat a triangular asset reorganization as if the parent corporation:
 - a) Acquired the assets and assumed the liabilities of the target corporation in a transaction in which the

parent corporation's basis in the assets of the target corporation is determined under section 362(b); and

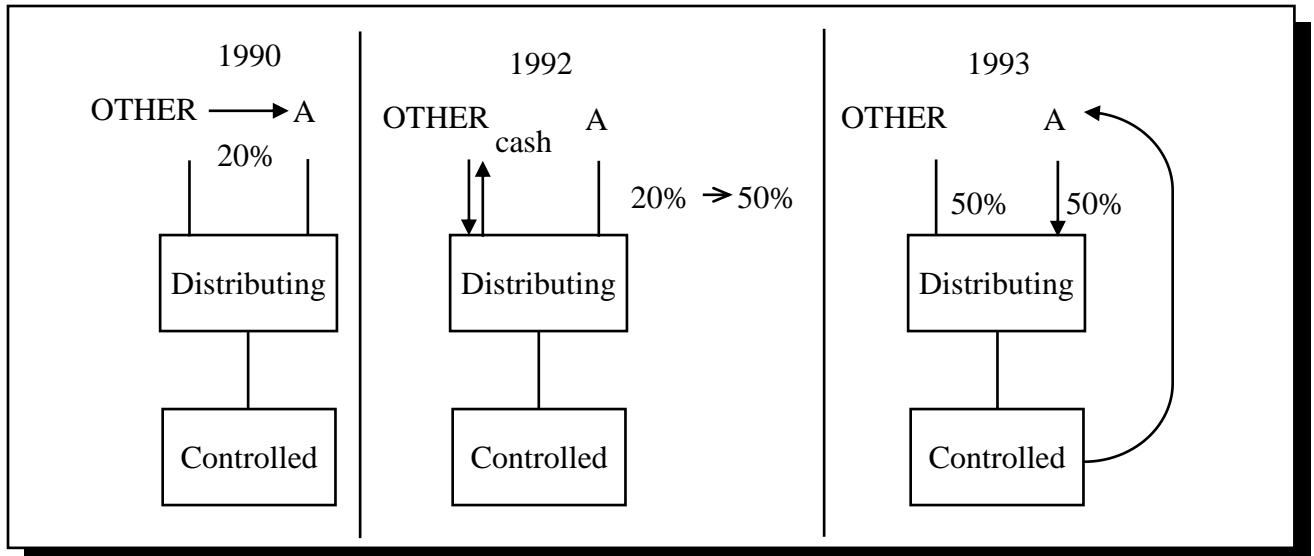
- b) Transferred the acquired assets and liabilities to the subsidiary in a section 351 transfer.
- (2) In the case of a reverse subsidiary merger under section 368(a)(2)(E) that also qualifies as a "B" reorganization or section 351 transaction, the regulations provide that the total amount of stock treated as purchased by the parent corporation will be the higher of:
- a) The amount of stock that would be treated as purchased under the general rule for triangular asset reorganizations; or
 - b) The amount of stock that would be treated as purchased under the transferred basis rule (described below).
 - c) Exception – There is an exception to this rule that effectively allows the taxpayer to choose which rule it uses, as long as it agrees to conform its basis with such choice.
 - i) If the parent corporation obtains a letter ruling from the Service and enters into a closing agreement under section 7121 in which the parent corporation agrees to determine its basis using the over-the-top method in Reg. § 1.358-6(c)(2)(ii)(A) (i.e., an asset acquisition followed by a drop of such assets to a subsidiary), then the parent corporation will be treated as purchasing the amount of stock that would be treated as purchased under the triangular asset reorganization rule. Reg. § 1.355-6(d)(5)(ii); P.L.R. 200741002 (Jul. 11, 2007); P.L.R. 200215047 (Jan. 16, 2002); see also P.L.R. 9620014 (Feb. 14, 1996) (pre-Reg. § 1.355-6 ruling requiring the taxpayer to enter into a closing agreement with the Service, agreeing to determine its basis using the over-the-top method, in order to receive ruling that section 355(d) did not apply).

- ii) Alternatively, if the parent corporation obtains a letter ruling from the Service and enters into a closing agreement under section 7121 in which the parent corporation agrees to determine its basis using the method in Reg. § 1.358-6(c)(2)(ii)(B) (i.e., a deemed stock acquisition), then the parent corporation will be treated as purchasing the amount of stock that would be treated as purchased under the transferred basis rule. Reg. § 1.355-6(d)(5)(ii).
- d. There are also special rules that apply to stock acquired in certain transferred basis and exchanged basis transactions.
- (1) Under section 355(d)(5)(C), if a person acquires property in a carryover basis transaction from a person who purchased the property, then the transferee will be considered to have acquired the property by purchase on the date the transferor purchased the property (the “transferred basis rule”). See also Reg. § 1.355-6(e)(2).
 - (2) In addition, if a person acquires an interest in an entity by purchase, and such interest is exchanged for an interest in a second entity where the adjusted basis of the second interest is determined in whole or in part by reference to the adjusted basis of the first interest, then the second interest is treated under the regulations as having been purchased on the date the first interest was purchased (the “exchanged basis rule”). Reg. § 1.355-6(e)(3).
- e. Deemed purchase rule
- Section 355(d)(8)(B) contains special purchase rules whereby stock purchases by a corporation will be attributed to the corporation’s shareholders, and purchases of a parent corporation will be treated as purchases of lower tier corporation stock.
- (1) Assume that A has owned 40% of Distributing, and Distributing has owned 60% of Controlled for more than five years. A is deemed to have owned 24% (i.e., 40% x 60%) of Controlled for more than five years. In 1993, Distributing purchases an additional 20% of Controlled. A is deemed to have purchased 8% (i.e., 40% x 20%) of Controlled at that time. In 1994, A purchases an additional 10% of Distributing stock and is deemed to have purchased

an additional 8% (i.e., 10% x 80%) of Controlled's stock at that time also.

- (2) A will be treated as owning all 80% of the Controlled stock owned by Distributing (section 355(d)(7)(A)) and as having purchased in 1993 and 1994 a total of 16% of Controlled's stock as a result of the purchases of Controlled stock by Distributing and purchases of Distributing stock by A (section 355(d)(8)).
- f. In certain cases redemptions of stock or distributions of boot will be classified as purchases. See H.R. Rep. No. 101-964, at 1092 (1990) (Conf. Rep.).
- (1) Under the regulations, the fact that a shareholder receives boot will generally not affect whether the acquisition is a purchase under section 355(d), as long as section 358(a)(1) applies to determine the transferor's basis in the stock received. Reg. § 1.355-6(d)(2)(i).
 - a) However, if the transferor receives nonqualified preferred stock or stock in a third corporation as boot, the transferor is treated as purchasing such stock on the date of the section 351 exchange or reorganization (because the transferor receives a fair market value basis in such stock). Reg. § 1.355-6(d)(2)(i)(A)(2); -6(d)(2)(i)(C), Ex. 1; see sections 351(g) and 356(e).
 - b) Similarly, transferee corporations are generally not treated as purchasing stock received to the extent section 362(a) or (b) (or section 334(b)) applies to determine the transferee's basis in the stock received. Reg. § 1.355-6(d)(2)(i)(B)(1). However, to the extent the transferee's basis in the stock received is increased through the recognition of gain by the transferor, the stock is treated as purchased on the date of the stock acquisition. Reg. § 1.355-6(d)(2)(i)(B)(2).

(2) Example 11 -- "Purchase" by redemption



- a) Facts: A purchases 20% of Distributing in November 1990. In 1992, Distributing redeems a portion of its own stock, which raises A's interest to 50%. In 1993, A receives 50% of the stock of Distributing's subsidiary, Controlled, in a pro rata spin-off.
- b) Arguably, the entire distribution is attributable to A's disqualified stock (the 20% acquired and 30% increase due to the previous redemption) and, therefore, should be a disqualified distribution. However, A receives no additional basis in the 30% increase due to the redemption, so the purpose of section 355(d) does not appear to be implicated.
- c) The regulations do not address the issue raised by this example.
- i) They do, however, contain an anti-avoidance example wherein the following steps are undertaken with a principal purpose to avoid section 355(d): B owns all of D's stock; A purchases 45 of D's 100 outstanding shares from B; D distributes its C stock pro rata to A and B; D redeems 20 shares of B's D stock, and C redeems 20 shares of B's C stock, so that A is left with

45 of the 80 outstanding shares in both D and C. The regulations conclude that this violates the anti-avoidance provision and, thus, section 355(d) applies.

- ii) This example is distinguishable from Example 11, above.

5. Fifty-percent test

Under section 355(d)(4), the 50% or greater stock requirement is met if stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote -- or at least 50% of the total value of shares of all classes of stock -- is held.

a. Aggregation of interests

- (1) Section 355(d)(7)(A) contains aggregation rules, which ensure that certain groups of related persons (as defined in sections 267(b) and 707(b)(1)) are treated as one person for purposes of ascertaining stock ownership. These groups include: husband and wife; parent and child; siblings; a corporation and its more-than-50% individual owner; two corporations that are members of the same controlled group; and a partnership and corporation owned more than 50% by the same person.
- (2) Thus, if a person owns more than 50% of a corporation, then under section 267(b), he is deemed to own all the stock owned by the corporation. For example, if A owns 60% of I Corp, which in turn owns 40% of D Corp; and if A owns 10% of D directly, then he will be deemed in the aggregate to own 50% of D Corp (40% through ownership of I Corp and 10% individually).
- (3) Section 355(d)(7)(B) provides that if two or more unrelated persons act pursuant to a plan or arrangement in relation to the acquisition of stock of Distributing, then their interests will be treated as those of one person.
 - a) There is no requirement that the plan be in writing. The intent is clearly to prevent the perceived method of circumventing section 355(b)(2)(D) by use of unrelated entities acting in concert.
 - b) Under the regulations, two or more persons will be treated as acting pursuant to a plan or arrangement only if they have a formal or informal

understanding among themselves to make a coordinated acquisition of stock. Reg. § 1.355-6(c)(4)(ii).

- i) In determining whether an understanding exists, a principal element is whether the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders.
- ii) Thus, a public offering is generally not treated as a plan or arrangement if each investor makes its own investment decision.
- iii) The final regulations clarified this rule in the context of an exchanged basis transaction. If two or more persons do not act pursuant to a plan or arrangement with respect to an acquisition of stock in a corporation (the first corporation), a subsequent exchanged basis transaction will not result in such persons being treated as one person, even if the acquisition of the second corporation's stock is pursuant to a plan or arrangement. Reg. § 1.355-6(c)(4)(iv)(A).

b. Entity attribution rules

- (1) Section 355(d)(8) amends the attribution rules of section 318(a)(2) regarding the constructive stock ownership rules.
 - a) Under 355(d)(8), the threshold test for section 318(a)(2) is reduced from 50% to 10%.
 - b) Any stock owned by a partnership, trust or estate is considered to be owned proportionately by partners or beneficiaries without regard to whether the size of their interest exceeds 10%.
- (2) It should be noted that the aggregation rule controls over any otherwise applicable entity attribution rule. Therefore, if A owns 40% of D Corp, which owns 40% disqualified stock in C Corp, A will be deemed to own 16% of C Corp. If A increases his interest in D to 51%, he will be deemed to own D's entire 40% interest in C.

c. Treatment of options

- (1) The regulations generally do not count options for purposes of section 355(d). Reg. § 1.355-6(c)(3)(i).
- (2) However, Reg. § 1.355-6(c)(3)(ii) provides that an option that has not been exercised on the date of a distribution will be treated as exercised for purposes of section 355(d) if:
 - a) Its exercise would cause a person to become a disqualified person (alone or in conjunction with the deemed exercise of other options), and
 - b) Immediately after the distribution, it is “reasonably certain” that the option will be exercised. If either requirement is not satisfied, an unexercised option will not be treated as exercised.

See also H.R. Rep. No. 101-964, at 1092 (1990) (Conf. Rep.).

- (3) For purposes of these rules, the term “option” is broadly defined to include a call option, warrant, convertible obligation, the conversion feature of convertible stock, put option, redemption agreement, notional principal contract that provides for the payment of amounts in stock, stock purchase agreement or similar arrangement, or any other instrument that provides for the right to purchase, issue, redeem, or transfer stock (including an option on an option). Reg. § 1.355-6(c)(3)(v)(A).
 - a) The proposed regulations also included cash settlement options, phantom stock, stock appreciation rights, notional principal contracts that provide for payment based on the price of stock, or any other similar interest (except for stock). Prop. Reg. § 1.355-6(c)(3)(v)(B).
 - b) However, to the extent that such instruments were exercisable into stock, they would be treated as an “other instrument that provides for the right to purchase, issue, redeem, or transfer stock” and thus would be treated as an option.
- (4) An “option” does not include certain instruments that are not normally abusive, including compensatory options and options that are part of a security arrangement in a typical lending transaction. Reg. § 1.355-6(c)(3)(vi).

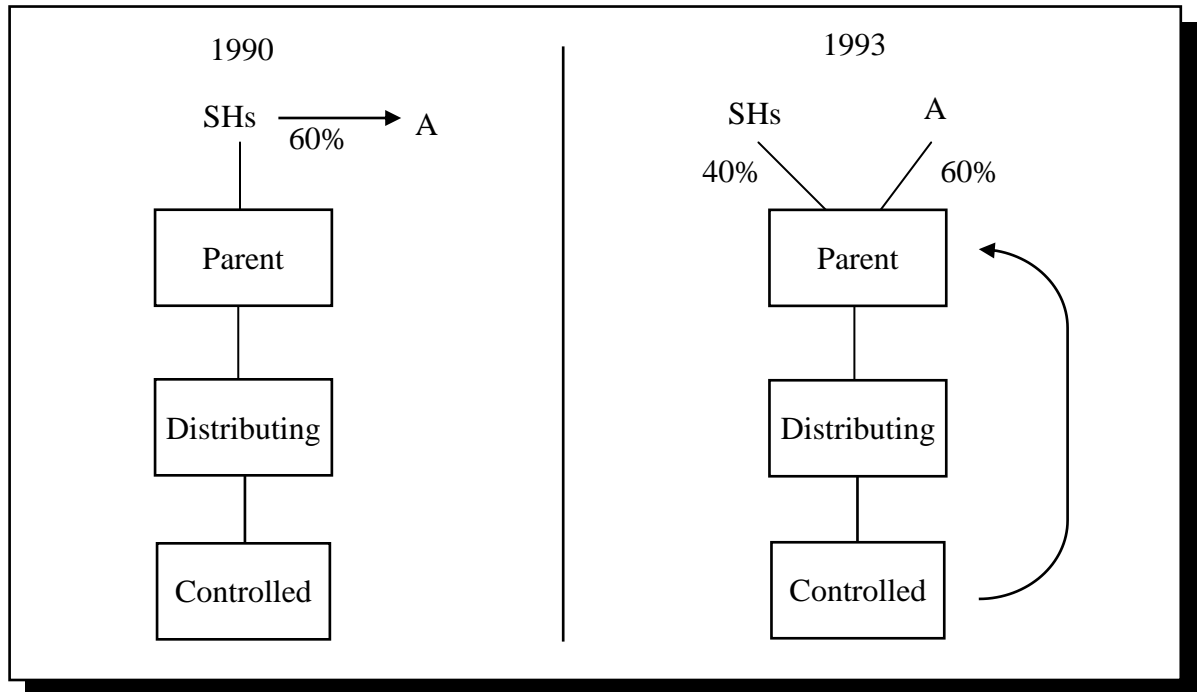
- (5) If an option is treated as exercised under the regulations, it is treated as exercised on the date it was issued or most recently transferred. Reg. § 1.355-6(c)(3)(ii).
- (6) The final regulations added a rule for substituted options. If an existing option is exchanged for another option, and such exchange is not treated as a new issuance or a transfer, then the substituted option will be treated as issued on the date the existing option was issued or most recently transferred. Reg. § 1.355-6(c)(3)(iii)(C).

6. Purpose exception

- a. Congress granted Treasury regulatory authority to exclude from section 355(d) transactions that do not violate the purposes thereof. For example, Treasury may modify the meaning of “purchase” so that certain acquisition cases will not be treated as purchases. See section 355(d)(9); H.R. Rep. No. 101-964, at 1091 (1990) (Conf. Rep.).
- b. As discussed above, the Service has issued regulations that limit the reach of section 355(d) to transactions that violate its purposes. Under the regulations, if section 355(d) would otherwise apply to a distribution, the distribution will not be subject to section 355(d) if it meets a two-prong test: a “disqualified person” neither (1) increases its direct or indirect ownership in Distributing or Controlled nor (2) obtains a “purchased basis” in Controlled stock (the “purpose exception”). Reg. § 1.355-6(b)(3)(i)(A), (B).
 - (1) A “disqualified person” is any person that, immediately after a distribution, holds the requisite 50% or greater disqualified stock interest in Distributing or Controlled. Reg. § 1.355-6(b)(3)(ii).
 - a) The final regulations clarify that the term “disqualified person” includes only a person that meets the definition because of its own purchase of disqualified stock or who receives stock of Controlled with respect to stock that the person purchased.
 - (2) Purchased basis is defined as basis in Controlled’s stock that is disqualified stock, unless Controlled’s stock and Distributing’s stock on which Controlled stock is distributed are treated as acquired by purchase solely by reason of the deemed purchase rule of section 355(d)(8). Reg. § 1.355-6(b)(3)(iii).

- a) It may be possible to specifically identify shares of Distributing without a purchased basis on which to distribute the Controlled stock, thereby falling within the purpose exception. For example, in P.L.R. 201001009 (Sept. 30, 2009), the shareholder, an indirect wholly owned subsidiary of Parent, acquired a majority of the stock of Distributing by purchase within five years, but the remaining portion was old and cold. Distributing split-off Controlled to the shareholder in exchange for its old and cold shares. As a result, none of the shareholder's purchased basis in Distributing was allocated to the Controlled stock received in the split-off, so section 355(d) did not apply.
 - b) Note, however, that proposed regulations under section 358 would change the ability to specifically identify shares upon which to recover basis. See Prop. Reg. § 1.358-1(a)(2).
- (3) The proposed regulations provided that a distribution is not a disqualified distribution if the distribution “and any related transactions” do not violate the purposes of section 355(d). Commentators noted that some related acquisitions of stock of Distributing or Controlled should not be taken into account in determining if the purpose rule applies. On the other hand, Treasury and the Service were concerned that taxpayers could argue that related transactions allow them to avoid section 355(d) where a distribution, if viewed independently, would constitute a disqualified distribution. To address both concerns the final regulations remove the reference to related transactions.
- (4) To ensure that de minimis increases in ownership of stock of Distributing or Controlled are disregarded, the issuance of cash in lieu of fractional shares is disregarded in applying the purpose exception.

c. Example 12 -- Purpose exception



- (1) Facts: Parent owns all of the stock of Distributing. Parent's basis in the Distributing stock is \$600, and the fair market value of Distributing (including Controlled) is \$800. Distributing owns all of the stock of Controlled. Distributing's basis in the Controlled stock is \$50, and the fair market value of Controlled is \$400. Parent and Distributing have owned all of the stock of Distributing and Controlled, respectively, for more than five years. In 1990, Individual A purchases 60% of the Parent stock for \$600 cash. In 1993, Distributing distributes the Controlled stock to Parent.
- (2) Under the deemed purchase rule, A is treated as having purchased 60% of the stock of both Distributing and Controlled on the date A purchases 60% of the Parent stock. Thus, both the Distributing and Controlled stock constitute disqualified stock, and section 355(d) applies.
- (3) However, under the purpose exception, section 355(d) will not apply, because the purposes of the section are not violated. Because the distribution was a pro-rata spin-off, A did not increase his interest in Distributing or Controlled. In addition, Parent's basis in the Controlled stock is not a

purchased basis, because both the Distributing and Controlled stock are treated as acquired by purchase solely by reason of the deemed purchase rule of section 355(d)(8). Reg. § 1.355-6(b)(3)(vi), Ex. 1.

- (4) If Parent further distributed the Controlled stock to its shareholders pro rata, the purpose exception would not apply. A did not increase his interest in Parent or Controlled. However, A's basis in the Controlled stock is a purchased basis, because it was not treated as acquired by purchase solely under the deemed purchase rule. Reg. § 1.355-6(b)(3)(vi), Ex. 2.
 - a) It is only Parent's gain with respect to Controlled that is recognized -- none of Distributing's gain with respect to Controlled should be recognized, since the intragroup spin-off was not a disqualified distribution. See P.L.R. 199931003 (Apr. 21, 1999).
- (5) Similarly, if Parent further distributed the Controlled stock to A in exchange for A's purchased stock in Parent in a split-off, the purpose exception would not apply. Under these facts, both prongs of the purpose exception are violated. A has increased his ownership in Controlled from a 60% indirect interest to a 100% direct interest. In addition, A's basis in the Controlled stock is a purchased basis, because the Parent stock is not treated as acquired by purchase solely under the deemed purchase rule. Reg. § 1.355-6(b)(3)(vi), Ex. 3.

K. Section 355(e) and (f)

1. Section 355(e) In General

- a. On August 5, 1997, TRA 1997 was enacted, which added section 355(e) and (f) to the Code, effectively eliminating all Morris Trust transactions where a person acquires stock representing at least 50% of the vote or value of Distributing or Controlled.¹

¹ In Commissioner v. Mary Archer W. Morris Trust, 367 F.2d 794 (4th Cir. 1966), acq. Rev. Rul. 68-603, 1968-2 C.B. 148, a state bank entered into a merger agreement with a national bank. The state bank had an insurance department, which the national bank did not want to acquire. In order to facilitate the merger, the state bank contributed its insurance department to a (cont. on next page)

- b. Under section 355(e), if there is a section 355 distribution that is part of a plan pursuant to which one or more persons acquire stock representing at least a 50% interest in Distributing or any controlled corporation, Distributing must recognize gain. Compare P.L.R. 199908036 (Dec. 1, 1998) (section 355(e) did not apply to a spin-off to facilitate Controlled's acquisition of Target where Target shareholders acquired less than 50% of Controlled's stock in the merger) and P.L.R. 199910026 (Dec. 19, 1998) (same) with P.L.R. 199910025 (Dec. 10, 1998) (section 355(e) applied to a spin-off to facilitate an acquisition of apparently more than 50% of Distributing by Acquiring).²
- (1) There is no gain recognition at the shareholder level.
 - (2) Section 355(e)(2)(B) creates a rebuttable presumption that any acquisition occurring two years before or after a section 355 distribution is part of a plan including such distribution. The Service has issued several sets of regulations providing guidance on what constitutes a plan or series of related transactions and how to rebut this presumption. These regulations are described below.
 - (3) Distributing recognizes gain in the amount that it would have recognized had it sold the Controlled stock for its fair market value on the date of the distribution.
 - (4) Any gain recognized is treated as long-term capital gain.
 - (5) The statute is not clear as to what is meant by the reference to "any controlled corporation." For example, if Distributing owned the stock of two controlled subsidiaries,

newly formed corporation and spun off the corporation to its shareholders. Thus, transactions in which a target company spins off unwanted assets to its shareholders to facilitate an acquisition became known as "Morris Trust" transactions. Such transactions were blessed as tax free under section 355 for more than 30 years until the enactment of section 355(e) in 1997. See, e.g., Rev. Rul. 78-251, 1978-1 C.B. 89; Rev. Rul. 75-406, 1975-2 C.B. 125; Rev. Rul. 72-530, 1972-2 C.B. 212; Rev. Rul. 70-434, 1970-2 C.B. 83. For a detailed discussion of section 355(e), see Mark J. Silverman, Andrew J. Weinstein, & Lisa M. Zarlenga, The New Anti-Morris Trust and Intragroup Spin Provisions, 49 TAX EXEC. 455 (1997).

² Ironically, section 355(e) would not apply to the facts of the Morris Trust case, because Distributing's shareholders in Morris Trust retained a 50% or greater interest in Distributing following the acquisition.

Controlled and Subsidiary, and Distributing spun off Controlled but P acquired Subsidiary, is Distributing taxed on the gain in both its Controlled and Subsidiary stock?

- a) There is no policy reason for taxing the gain in the Controlled stock.
- b) Regulations under section 355(e) address this issue. They provide that Distributing only recognizes gain on the stock of the spun off controlled corporation that is acquired. Treas. Reg. § 1.355-7(f). Thus, in the above example, section 355(e) would not apply to the acquisition of Subsidiary. If Distributing is acquired, however, Distributing must recognize gain on all distributed corporations. See id.; see also Preamble to Prop. Reg. § 1.355-7, 66 Fed. Reg. 66, 69 (2001).

c. Attribution and aggregation rules

- (1) For purposes of determining whether one or more persons has acquired a 50% interest, the section 318(a)(2) attribution rules generally apply (without regard to the 50% threshold of section 318(a)(2)(C)).
- (2) In addition, the aggregation rules of section 355(d)(7)(A) apply so that all related persons within the meaning of section 267(b) or 707(b)(1) are treated as one person. Section 355(e)(4)(C).
- (3) Thus, for example, transfers between related persons within the meaning of section 267(b) should not be treated as acquisitions for purposes of section 355(e). See P.L.R. 200125044 (Mar. 22, 2001) (ruling that the transfer of stock to a shareholder's estate, from the estate to a trust pursuant to the estate plan, and to a beneficiary pursuant to the estate plan did not constitute an acquisition as part of a plan under section 355(e)); P.L.R. 199940013 (July 2, 1999) (excluding from the section 355(e) representation transfers to members of the same family as defined in section 267(c)(4)); see also P.L.R. 200112055 (Dec. 21, 2000) (stating that a trust for the benefit of Shareholder C transferred "substantial amounts" of Distributing stock to trusts for the benefit of C's children but that under the attribution and aggregation rules, C and the trusts are treated as one person for purposes of section 355(d)).

- d. Acquire. The term “acquire” is not defined in section 355(e), and the legislative history does not provide much additional guidance as to its meaning. The Conference Report simply states that whether a corporation is acquired is “determined under rules similar to those of present law section 355(d), except that acquisitions would not be restricted to ‘purchase’ transactions.” H.R. Rep. No. 105-220, at 528 (1997) (Conf. Rep.).
- (1) Section 355(d)(5) defines “purchase” as any acquisition, except carryover basis transactions and transactions under sections 351, 354, 355, or 356. Because the legislative history states that the term “acquire” is not restricted to purchase transactions, however, it seems that any carryover basis transaction, as well as section 351, 354, 355, and 356 transactions, will be included in the term “acquire,” unless specifically excluded by statute or regulation.
 - (2) The Service has ruled that the issuance or exercise of a compensatory stock option is not an acquisition for purposes of section 355(e). See, e.g., P.L.R. 200733025 (Dec. 21, 2006); P.L.R. 200125011 (Mar. 14, 2001); P.L.R. 200122041 (Mar. 1, 2001); P.L.R. 200118045 (Feb. 5, 2001); P.L.R. 200032014 (May 8, 2000); P.L.R. 200009031 (Dec. 3, 1999); P.L.R. 200044019 (Aug. 3, 2000); P.L.R. 200043044 (Aug. 1, 2000); P.L.R. 200046001 (Nov. 17, 1999).
 - (3) Similarly, the Service has not treated the distribution of stock held by a trust to its beneficiary as an acquisition. See P.L.R. 200823022 (Feb. 29, 2008).
 - (4) However, the Service appears to treat an acquisition of stock or an increase in voting power as a result of a recapitalization of Distributing or Controlled as an acquisition for purposes of section 355(e). See, e.g., P.L.R. 200048030 (Aug. 30, 2000); P.L.R. 200046001 (Nov. 17, 1999). But see P.L.R. 201004001 (Oct. 22, 2009) (Ruling 22) (recapitalization resulting in increase in vote but not value of Distributing held not to cause any part of the Controlled stock to be acquired).
 - (5) Similarly the Service appears to treat an increase in voting power as a result of redemption as an acquisition. See P.L.R. 200125044 (Mar. 22, 2001) (apparently treating the increased interest as an acquisition, but not as part of a plan); see also P.L.R. 200046001 (Nov. 17, 1999) (representing that stock repurchases do not constitute 50%);

P.L.R. 199910026 (same) Cf. Rev. Rul. 57-144, 1957-1 C.B. 123 (treating a redemption as an acquisition of control for purposes of section 355(b)(2)(D)).

- a) Nonetheless, the Service appears to exclude stock repurchase programs from section 355(e). See, e.g., P.L.R. 200750009 (Sept. 12, 2007); P.L.R. 200731013 (May 4, 2007).
- (6) The Service also appears to treat a contribution of Controlled's assets to a partnership in which Controlled retains a less-than-50% interest as an acquisition. See P.L.R. 200905018 (Oct. 21, 2008).
- a) However, a contribution of Controlled stock to a partnership in which Distributing's shareholders retain a 50% or greater interest does not violate section 355(e), even if an unrelated partner has the right to approve certain extraordinary business matters. P.L.R. 201003009 (Oct. 19, 2009); see also P.L.R. 200927007 (Feb. 26, 2009).
 - b) Note that as long as Controlled's partnership interest is significant (i.e., 33-1/3% or greater), the active trade or business requirement would be satisfied.
- (7) It appears that the Service may apply section 382 principles in determining whether the requisite 50% interest has been acquired. See P.L.R. 200019024 (Feb. 11, 2000) (applying section 382 principles to conclude that the Distributing shareholder group continued to own more than 50% of the acquiring corporation).
- (8) It also appears that the Service will not double count shifts in ownership. Thus, for example, if a shareholder owns 20% of the Distributing stock and a split-off brings its ownership of Distributing down to 10%, a subsequent conversion or other vote shifting feature that brings the shareholder's ownership back up to 15% will not be counted against the 50% threshold. See P.L.R. 201004001 (Oct. 22, 2009).
- e. Exceptions. Section 355(e)(3)(A) provides exceptions for certain acquisitions. The statute does not apply to:
- (1) The acquisition of stock in Controlled by Distributing (e.g., in a "D" reorganization);

- (2) The acquisition of stock in Controlled by reason of holding stock in Distributing (e.g., in a split-off);
- a) See, e.g., P.L.R. 200129007 (Apr. 16, 2001) (section 355(e) did not apply where a key employee owning a 4.5% interest in Distributing surrendered his Distributing stock in exchange for Controlled stock representing 55% of the voting power and 38% of the value).
 - b) The statute does not explicitly exclude the increase in the interest of the remaining Distributing shareholders in a split-off from section 355(e).
 - i) Certainly, Congress could not have intended to trigger section 355(e) in such a case. The imposition of a tax by reason of the increased ownership by Distributing's remaining shareholders would render the exception in section 355(e)(3)(A)(ii) ineffective. Moreover, such an "acquisition" does not present the disguised sale concerns to which section 355(e) was aimed.
 - ii) In P.L.R. 201017031 (Dec. 10, 2009), the Service did not rule, but the taxpayer represented that any increase in ownership of Distributing stock, by a Distributing shareholder, that "occurs solely as a result of the split-off" will not be treated as an acquisition taken into account for purposes of section 355(e)(2)(A)(ii) (except to the extent that the Distributing stock held before the split-off by such shareholder was acquired pursuant to a plan (or series of related transactions) described in section 355(e)(2)(A)(ii)). The taxpayer also represented that any increase in ownership of Distributing stock, by vote or value, by a Distributing shareholder that "occurs solely as a result of a redemption of a family member who is related under section 267(c)(4) will not be treated as an acquisition" taken into account for purposes of section 355(e)(2)(A)(ii).

- iii) The Service has previously issued favorable section 355 rulings in the context of split-off transactions, which implied that it does not view the increased ownership by Distributing's remaining shareholders as violating section 355(e). See, e.g., P.L.R. 200115001 (Apr. 28, 2000); P.L.R. 199940013 (July 2, 1999); P.L.R. 199913026 (Jan. 4, 1999); P.L.R. 9851040 (Sept. 16, 1998).
- (3) The acquisition of stock in any successor corporation of Distributing or Controlled by reason of holding stock in such corporation (e.g., acquisition of Acquiring corporation stock by Distributing shareholders in a Morris Trust transaction); and
- (4) The acquisition of stock to the extent that the percentage of stock owned by each shareholder owning stock in Distributing or Controlled immediately before the acquisition does not decrease.
- a) This exception was amended by the 1998 IRS Restructuring Act. Prior to the amendment, the exception applied to the acquisition of stock if shareholders owning, directly or indirectly, 50% or more of either Distributing or Controlled before the acquisition own indirectly 50% or more in such corporation after such acquisition.
 - b) Literally read, the exception as initially drafted would preclude application of section 355(e), because in a typical Morris Trust transaction, there will be no change in the ownership of the corporation holding the unwanted assets.
 - c) The exception as modified addresses this problem, but creates additional problems. First, because the exception refers to "each shareholder," the interests before and after the acquisition must be calculated for each shareholder, which adds complexity. In addition, the shareholder-by-shareholder approach results in ownership shifts among historic shareholders triggering section 355(e), which is inconsistent with the purpose of section 355(e) to tax disguised sales to non-historic shareholders.

See H.R. Rep. No. 105-148, at 462 (1997); S. Rep. No. 105-33, at 139-40 (1997).

- d) In P.L.R. 201123030 (Nov. 15, 2010), which involved a split-off and series of acquisitions conducted pursuant to a plan, the IRS appears to have compared ownership before all the transactions were undertaken to the ownership after all the transactions were undertaken to determine whether the percentage of stock owned by Distributing and Controlled shareholders decreased. The transaction including an inversion of the Controlled Subsidiary (a publicly-traded company) in which Controlled (previously a subsidiary of Controlled Subsidiary) became the owner of Controlled Subsidiary. In the inversion, Controlled issued several classes of stock, with the historic public of Controlled Subsidiary received the low vote. The ruling stated that section 355(e) would apply if the acquisition of Controlled by the historic public or Distributing were taken into account and that such fact was considered in issuing the ruling that Distributing would not recognize gain on the distribution of Controlled. The ruling makes similar statements with respect to other acquisitions in the overall transaction, including two trusts' expected distribution of the Controlled stock received in the split-off to their beneficiaries.
- (5) Any distribution to which section 355(d) applies. Section 355(e)(2)(D); see P.L.R. 200905018 (Oct. 21, 2008).
- f. Affiliated Group Exception. Section 355(e) also provides that a plan (or series of related transactions) will not cause gain recognition under the anti-Morris Trust rule if, immediately after the completion of the plan or transaction, Distributing and Controlled are members of the same affiliated group. Section 355(e)(2)(C).
- (1) For this purpose, the term "affiliated group" is defined without regard to whether the corporations are includible corporations as defined in section 1504(b). As a result, tax-exempt organizations, life insurance companies, foreign corporations, real estate investment trusts, and regulated investment companies are considered members of the affiliated group.

- (2) To illustrate this exception, assume P corporation owns all of the stock of Distributing, and Distributing owns all of the stock of Controlled, and all three corporations are members of the same affiliated group. Assume further that P merges into unrelated X corporation, in a transaction where X's former shareholders own 50% or more of the surviving X corporation. If, as part of the merger, Distributing distributes Controlled to X in a transaction that otherwise qualifies under section 355, the transaction is not treated as one that requires gain recognition, if Distributing and Controlled are members of the same affiliated group following the transaction. See H.R. Rep. No. 105-220, at 532 (1997) (Conf. Rep.).
- (3) In P.L.R. 199921027 (Feb. 25, 1999), as simplified, Corporation C, a domestic corporation and member of the Parent consolidated group, owned all of the stock of Distributing, a foreign corporation. Distributing, in turn, owned all of the stock of Controlled 1, another foreign corporation. Distributing formed Controlled 2, a foreign corporation, and contributed stock of certain subsidiaries to Controlled 2. Distributing distributed the stock of Controlled 1 and Controlled 2 to Corporation C. Corporation C transferred the stock of Controlled 1 and Controlled 2 to newly formed Holdco, a domestic corporation. The Service ruled that section 355(e) did not apply to the distributions by reason of the affiliated group exception in section 355(e)(2)(C). See also P.L.R. 200741005 (Jul. 12, 2007).
- g. Asset Acquisitions. Section 355(e) further provides that, except as provided in regulations, if a successor corporation in an "A," "C," or "D" reorganization acquires the assets of Distributing or any controlled corporation, the shareholders (immediately before the acquisition) of the successor corporation are treated as if they acquired stock in the corporation whose assets were acquired.
- h. Predecessors and Successors. Section 355(e)(4)(D) provides that for purposes of section 355(e), any reference to Controlled or Distributing "shall include a reference to any predecessor or successor of such corporation." The statute did not define the terms "predecessor" and "successor." However, the Service recently issued proposed regulations providing guidance on this issue. These proposed regulations are discussed below.
- i. Section 355(e) does not apply to a distribution pursuant to a title 11 or similar case.

- j. In addition, TRA 1997 changed the test for determining control immediately after a distribution in a section 355 transaction from 80% of the vote and 80% of each nonvoting class of stock to at least 50% of the vote and value of Controlled.
 - (1) TRA 1997 did not change the requirement that Distributing distribute 80% of the voting power and 80% of each other class of stock of Controlled in the transaction.
 - (2) However, the 1998 IRS Restructuring Act replaced this modified control test with a provision that states that, if the requirements of section 355 are met, the fact that the shareholders of Distributing dispose of part or all of their Controlled stock will not be taken into account for purposes of determining whether the transaction qualifies under section 368(a)(1)(D). Section 368(a)(2)(H)(ii).

- k. Section 355(e) further authorizes the Service to prescribe regulations necessary to carry out the purposes of the legislation, including regulations:
 - (1) providing rules where there is more than one controlled corporation;
 - (2) treating two or more distributions as one distribution; and
 - (3) providing rules similar to the substantial diminution of risk rules of section 355(d)(6) where appropriate for purposes of the legislation.

- l. The provision applies to distributions after April 16, 1997, unless such distribution is:
 - (1) made pursuant to an agreement which was binding on the effective date and at all times thereafter;
 - (2) described in a ruling request submitted to the Service on or before the effective date; or
 - (3) described on or before the effective date in a public announcement or in a filing with the Securities and Exchange Commission required solely by reason of the distribution.

These exceptions only apply if the agreement, etc. identifies the acquirer of Distributing or Controlled, whichever is applicable. Note that a contract that is binding under State law, but is not

written, still may be eligible for transitional relief. See H.R. Rep. No. 105-220, at 536-37 (1997) (Conf. Rep.).

- m. Although disguised sale transactions, such as the General Motors/Raytheon deal referred to in Example 8 above were thought to be the intended target of any new legislation, the intent of TRA 1997 appears to be to eliminate all Morris Trust transactions, except those where the acquirer acquires less than a 50% interest in Distributing or Controlled.

2. Plan regulations under section 355(e)

- a. Final regulations under section 355(e) provide guidance as to what constitutes a “plan (or series of related transactions)” for purposes of section 355(e). Reg. § 1.355-7. These final regulations were issued after several sets of proposed and temporary regulations, which are discussed in more detail below.

- b. Evolution of Plan Regulations

- (1) On August 19, 1999, Treasury and the Service issued proposed regulations under section 355(e) that provided guidance as to what constitutes a plan (the “1999 proposed regulations”).³
 - a) The 1999 proposed regulations created a complicated set of rebuttals, which were the exclusive means of overcoming the two-year presumption. The particular rebuttal that applied depended upon when the acquisition occurred relative to the distribution.
 - b) The taxpayer also had to establish that it satisfied the rebuttals by a high burden of proof – clear and convincing evidence.
- (2) The 1999 proposed regulations received a great deal of criticism, and on December 29, 2000, Treasury and the Service withdrew the 1999 proposed regulations, and issued new proposed regulations in their place (the “2000

³ For a detailed discussion of the 1999 proposed regulations, see Mark J. Silverman & Lisa M. Zarlenga, The Proposed Section 355(e) Regulations: Broadening the Traditional Notions of What Constitutes a Plan, 52 TAX EXEC. 20 (2000).

proposed regulations”). The 2000 proposed regulations represented a vast improvement over the 1999 proposed regulations.⁴

- a) The 2000 proposed regulations adopted a facts-and-circumstances approach, which is consistent with the statute.⁵
- b) The ultimate factual determination was the intent of Distributing, Controlled, and their respective controlling shareholders (collectively the “relevant parties”). In general, in the case of a post-spin acquisition, a distribution and acquisition were treated as part of a plan if the relevant parties intended, on the date of the distribution, that the acquisition or a similar acquisition occur in connection with the distribution. 2000 Prop. Reg. § 1.355-7(b)(1). In the case of a pre-spin acquisition, the acquisition and distribution were treated as part of a plan if the relevant parties intended, on the date of the acquisition, that a distribution occur in connection with the acquisition. Id.
 - i) The 2000 proposed regulations made it clear that the reference to “similar” did not mean identical – “the actual acquisition and the intended acquisition may be similar even though the identity of the person acquiring stock of Distributing or Controlled (acquirer), the timing of the acquisition or the terms of the actual acquisition are

⁴ For a detailed discussion of the 2000 proposed regulations, see Mark J. Silverman & Lisa M. Zarlenga, Section 355(e) Regulations: A Vast Improvement, 53 TAX EXEC. 55 (2001).

⁵ Section 355(e)(2)(B) provides that acquisitions during the two years before and after a spin-off “shall be treated as pursuant to a plan . . . unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions.” Thus, the statute clearly contemplates that taxpayers will be permitted to establish that the distribution and the acquisition were not part of a plan. Neither the statute nor the legislative history limits the manner in which the taxpayer may make this showing. The statute seems to contemplate a facts-and-circumstances approach.

different from the intended acquisition.”
2000 Prop. Reg. § 1.355-7(b)(2).

- ii) Nonetheless, the scope of “similar acquisition” was not entirely clear.
 - c) The 2000 proposed regulations set forth a list of nonexclusive factors to consider in determining whether or not there was a plan. 2000 Prop. Reg. § 1.355-7(d)(2), (3).
 - d) The 2000 proposed regulations also contained six safe harbors that, if applicable, obviated the need to perform the facts-and-circumstances analysis. 2000 Prop. Reg. § 1.355-7(f).
 - e) Finally, the 2000 proposed regulations deleted references to a clear and convincing standard of proof.
- (3) On August 2, 2001, Treasury and the Service issued temporary regulations under section 355(e) (the “2001 temporary regulations”). The 2001 temporary regulations were identical to the 2000 proposed regulations, except that the 2001 temporary regulations reserved section 1.355-7(e)(6) (suspending the running of any time period prescribed in the regulations during which there is a substantial diminution of risk of loss under the principles of section 355(d)(6)(B)) and Example 7 (concluding that multiple acquisitions of target companies using Distributing stock were part of a plan, regardless of whether targets were identified at the time of the spin-off, where purpose for the spin-off was to make such acquisitions).
- a) The temporary regulations were issued in response to numerous comments that immediate guidance was needed. Nonetheless, the preamble to the 2001 temporary regulations stated, “The IRS and Treasury will continue to devote significant resources to analyzing the comments and, in the near future, expect to issue additional guidance regarding the interpretation of the phrase ‘plan (or series of related transactions).’” 66 Fed. Reg. 40,590, 40,590 (2001).
 - b) Even before the 2001 temporary regulations were issued, however, the Service appeared to apply the

principles of the 2000 proposed regulations in issuing private letter rulings.

- i) In P.L.R. 200128038 (Apr. 16, 2001), Distributing had received a favorable ruling with respect to the distributions of two of Distributing's three businesses. As a result of certain developments after the distributions, including the appreciation of Controlled B stock by more than 100%, Controlled B proposed to acquire Target.
 - (a) The Service issued a supplemental ruling that the proposed merger would not be treated as part of the same plan as the distributions. Controlled B and Distributing 2 made a number of representations that conformed to the plan and non-plan factors: (i) Neither Controlled B nor Distributing 2 discussed the merger with Target or a similar acquirer before the distributions or within six months thereafter; (ii) there was an identifiable, unexpected change in market or business conditions after the distributions; (iii) the distributions were motivated in whole or substantial by a non-acquisition business purpose; and (iv) the distributions would have occurred at the same time and in similar form regardless of the merger.
 - (b) In its ruling, the Service noted the merger would not constitute part of the plan, regardless of whether Target is a predecessor to Controlled B under section 355(e)(4)(D).
- ii) In P.L.R. 200133035 (May 17, 2001), after the announcement of the spin-off, Distributing suffered severe economic reversals, which led it to shift from its historic focus of operating as an independent company to enter into negotiations for a

business combination. Prior to the announcement of the spin-off, Distributing's size and position in its industry made the possibility of any acquisition of Distributing very remote. The Service weighed various factors and concluded that the proposed combination would not be taken into account for purposes of section 355(e).

- (a) The factors identified by the Service as indicative of a plan were: (i) proximity in time; (ii) intent to undertake the second transaction at the time the first transaction is consummated; and (iii) the acquisition was pursued after the announcement of the spin-off.
 - (b) The factors identified by the Service as not indicative of a plan were: (i) severe and unexpected changes in Distributing's financial condition; (ii) absence of discussions regarding the acquisition before the public announcement and until after unexpected events; (iii) corporate business purposes for the spin-off unrelated to the acquisition; and (iv) spin-off will occur at the same time and in similar form regardless of the acquisition.
 - (c) See also P.L.R. 200410001 (Dec. 3, 2003); P.L.R. 200218021 (Jan. 30, 2002); P.L.R. 200129006 (Apr. 19, 2001); P.L.R. 200131003 (Apr. 10, 2001); P.L.R. 200118050 (Feb. 6, 2001); P.L.R. 200115001 (Apr. 28, 2000); P.L.R. 200024037 (Mar. 17, 2000).
- iii) Nonetheless, in P.L.R. 200125011 (Mar. 14, 2001), the Service seemed to focus on whether "significant action" had been taken with regard to the proposed distribution, rather than the plan and non-plan factors. Distributing had been issuing its stock as

consideration in various acquisitions in the recent past.

- (a) The Service ruled favorably on the “Less Recent Acquisitions” – those that were consummated before significant action had been taken by Distributing with regard to the proposed distribution. However, the Service would not rule with respect to the “Recent Acquisitions,” even though Distributing represented that they were independently motivated, because they were consummated at a time when Distributing’s management was “seriously contemplating” the proposed distribution.
- (b) However, in P.L.R. 200205035 (Oct. 31, 2001) (supplementing P.L.R. 200125011), which was issued after the 2001 temporary regulations, the Service changed its position as to four of the five Recent Acquisitions. The four acquisitions upon which the Service ruled favorably occurred prior to the announcement of the distribution – the fifth one occurred after the announcement. The ruling was based on the following representations: (i) there were no discussions between Distributing or Controlled (or their respective officers or directors) and the acquirers (or their respective officers, directors, or shareholders) regarding the distribution before the acquisitions; (ii) the distribution was never motivated by a business purpose to facilitate the Recent Acquisitions; and (iii) the distribution would occur at the same time and in a similar form regardless of the Recent Acquisitions; (iv) the four pre-announcement Recent Acquisitions occurred before

Distributing had made a final decision to proceed with the distribution; and (v) the Recent Acquisitions occurred before Distributing received regulatory approval to do the distribution (and thus the distribution was uncertain).

- iv) In P.L.R. 200125044 (Mar. 22, 2001), the Service ruled that a number of acquisitions did not constitute an acquisition that was part of a plan within the meaning of section 355(e), including:
- (a) the issuance, adjustment, or exercise of compensatory stock options by employees and directors;
 - (b) the issuance, adjustment, or exercise of nonqualified stock options by two unrelated service providers, where such options were issued on an arm's-length basis;
 - (c) stock repurchases made by Distributing before announcing both its intention to pursue strategic alternatives and the distribution;
 - (d) the issuance of stock in connection with the acquisition of two companies more than six years before the distribution;
 - (e) the conversion of class B into class A stock where no 5% shareholder participated and no person became a 5% shareholder;
 - (f) the acquisition or disposition of stock by shareholders (i) before the announcement of the distribution, (ii) after the announcement but more than six months before the distribution, and (iii) after the announcement and less than six months before the distribution;

- (g) the transfer of stock to a shareholder's estate, from the estate to a trust pursuant to the estate plan, and to a beneficiary pursuant to the estate plan; and
 - (h) the sale of stock by Controlled to underwriters in connection with its initial public offering (which was the business purpose for the distribution). Presumably, the sale by the underwriters to the public is not excluded from the section 355(e) plan.
- (4) On April 23, 2002, Treasury and the Service issued revised temporary regulations to amend the 2001 temporary regulations (hereinafter the revised temporary regulations are referred to as the "temporary regulations").⁶
 - a) Although the temporary regulations retained the overall facts-and-circumstances approach of the 2000 proposed regulations and 2001 temporary regulations, they shifted the focus from the intent of the relevant parties to the existence of bilateral discussions between the acquirer and the relevant parties. Thus, a mere expectation that Distributing or Controlled may be acquired (e.g., operation in a consolidating market) was no longer sufficient to be regarded as a plan. By changing the focus, the temporary regulations carried out the purposes of section 355(e) to prevent tax-free disguised sales, reflected practical business considerations, and provided a great deal more certainty to taxpayers and the government.
 - b) The temporary regulations are generally effective for distributions occurring after April 26, 2002. Temp. Reg. § 1.355-7T(k).

⁶ For a detailed discussion of the new temporary regulations, see Mark J. Silverman & Lisa M. Zarlenga, The Fourth Time's a Charm – New Temporary Section 355(e) Regulations Provide Helpful Guidance to Taxpayers, 54 TAX EXEC. 238 (2002).

- i) For distributions occurring prior to that date, taxpayers may apply the temporary regulations retroactively. Any retroactive application of the temporary regulations must, however, be in whole and not in part.
 - ii) If the distribution occurs after August 3, 2001 (the effective date of the 2001 temporary regulations) and before April 26, 2002, the 2001 temporary regulations apply if the taxpayer does not apply the temporary regulations. Id.
- (5) On April 18, 2005, Treasury and the Service issued final regulations, adopting the 2002 temporary regulations with certain amendments (hereinafter referred to as the “final regulations”).
 - a) The most significant changes made by the final regulations were to provide additional guidance in the case of pre-distribution acquisitions and public offerings.
 - b) The final regulations are effective for distributions occurring after April 19, 2005. The 2002 temporary regulations continue to apply to distributions after April 26, 2002 and before the effective date of the final regulations; however, taxpayers may apply the final regulations in whole, but not in part, to such distributions.
- c. Super Safe Harbor
 - (1) The final regulations provide that a post-distribution acquisition can be part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the two-year period ending on the date of the distribution. Reg. § 1.355-7(b)(2). This rule (hereinafter referred to as the “super safe harbor”) acts as sort of a super safe harbor. If the requirements for the super safe harbor are satisfied, there is no need to look at the safe harbors or do a facts-and-circumstances analysis.
 - (2) For example, assume that D distributes the C stock in order to reduce its financing costs. X approaches C one month after the distribution and acquires C five months after the

distribution. Because no agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition occurred during the two-year period ending on the date of the distribution, the acquisition is not part of a plan.

- (3) The existence of an agreement, understanding, arrangement, or substantial negotiations during the two-year period tends to show that the distribution and acquisition are part of a plan, but such showing may still be rebutted using the safe harbors or the facts-and-circumstances approach.
- (4) The super safe harbor does not apply in the case of public offerings.

d. Other Safe Harbors

(1) Safe Harbor I – Non-Acquisition Business Purpose

- a) Safe Harbor I provides that a distribution and an acquisition occurring after the distribution are not part of a plan if: (i) the distribution was motivated in whole or substantial part by a business purpose other than a business purpose to facilitate an acquisition of the acquired corporation, and (ii) the acquisition occurred more than six months after the distribution (and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins one year before and ends six months after the distribution). Reg. § 1.355-7(d)(1).
- b) Unlike the language of the 2001 temporary regulations, Safe Harbor I refers to a business purpose other than to facilitate an acquisition “of the acquired corporation.” Thus, under the final regulations, the safe harbor would be available in the following situation: D distributes C to facilitate an acquisition of D by X. Negotiations between D and X subsequently break down. One year after the spin-off, Y acquires C. There was a business purpose to facilitate “an” acquisition (i.e., the

acquisition of D by X), but not an acquisition “of the acquired corporation” (C). Thus, Safe Harbor I applies.

- c) Multiple business purposes – Where there are two business purposes for a distribution – one acquisition and one non-acquisition – Distributing must show that the non-acquisition business purpose was “substantial.” The proposed regulations do not define the term “substantial,” but the preamble to the 2000 proposed regulations states that the analysis is similar to analyzing whether there is a corporate business purpose for a distribution in light of the potential avoidance of federal taxes. Preamble to 2000 Prop. Reg. § 1.355-7, 66 Fed. Reg. 66, 68 (2001). Thus, the non-acquisition business purpose thus must be “real and substantial even in light of the acquisition business purpose.”
- d) The final regulations contain certain operating rules that deem or create an acquisition business purpose.
 - i) Internal discussions and discussions with outside advisors by or on behalf of officers or directors of Distributing or Controlled may be indicative of one or more business purposes for the distribution and the relative importance of each. Reg. § 1.355-7(c)(1).
 - (a) Note that the temporary regulations added a definition of “discussions,” which requires that the discussions involve one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person with the implicit or explicit permission of one of such persons. Temp. Reg. § 1.355-7T(h)(5). This definition was retained in the final regulations. Reg. § 1.355-7(h)(6).
 - ii) If Distributing engages in discussions with a potential acquirer, and the distribution is intended, in whole or substantial part, to decrease the likelihood of the acquisition of

either Distributing or Controlled by separating it from another corporation that is likely to be acquired, then Distributing will be treated as having an acquisition business purpose. Reg. § 1.355-7(c)(2).

- (a) Apparently, the concern is that a distribution to separate the wanted company from the unwanted company actually facilitates the acquisition of the wanted company.
- (b) However, this is not the case where the acquirer wants both Distributing and Controlled, and the distribution makes the acquirer's goal more difficult to achieve. Although the language of the final regulations technically does not apply to the latter situation, it will be difficult, as a practical matter, to distinguish the two situations.

(2) Safe Harbor II – Acquisition Business Purpose

- a) Safe Harbor II provides that a distribution and acquisition occurring after the distribution will not be considered part of a plan if (i) the distribution was not motivated by a business purpose to facilitate the acquisition or a similar acquisition; (ii) the acquisition occurred more than six months after the distribution (and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins one year before and ends six months after the distribution); and (iii) no more than 25% of the stock of the acquired corporation was either acquired or subject to an agreement, understanding, arrangement, or substantial negotiations during the period that begins one year before and ends six months after the distribution. Reg. § 1.355-7(d)(2).
 - i) Note that the business purpose cannot be to facilitate “the” acquisition or a similar acquisition. Thus, Safe Harbor II applies if the distribution is motivated by an

acquisition business purpose, as long as such acquisition is not the one being tested.

- ii) For purposes of the 25% test, acquisitions of stock that are treated as not part of a plan pursuant to Safe Harbors VII, VIII, or IX (discussed below) are disregarded.
- b) This safe harbor was intended to address criticisms under the 1999 proposed regulations that if Distributing had an intent to facilitate any acquisition (even a small one), the general post-spin rebuttal was not available for any subsequent, unintended acquisitions.
- c) For example, if D distributes C to facilitate a 15% public offering by C, and D is subsequently acquired in an unexpected acquisition, section 355(e) would apply under the 1999 proposed regulations. Under the regulations, Safe Harbor II would apply to D's acquisition (note that the safe harbor does not apply with respect to C's public offering).

(3) Safe Harbor III – Acquisitions More Than One Year After

- a) Safe Harbor III provides that a distribution and acquisition occurring after the distribution will not be considered part of a plan if there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition at the time of the distribution or within one year after the distribution. Reg. § 1.355-7(d)(3).
- b) Thus, for example, if D and X entered into substantial negotiations regarding an acquisition of D by X eight months before the distribution, but negotiations were terminated five months before the distribution, Safe Harbor III would be available as long as negotiations did not resume until one year after the distribution.

(4) Safe Harbor IV – Acquisitions Before First Disclosure

- a) Safe Harbor IV provides that a distribution and an acquisition not involving a public offering will not be considered part of a plan if the acquisition occurs

before the first disclosure event regarding the distribution. Reg. § 1.355-7(d)(4).

- i) This safe harbor was one of the significant things changed by the final regulations. The temporary regulations contained a much more restrictive safe harbor for pre-distribution acquisitions--the acquisition had to be more than two years before the distribution and there could be no agreement, understanding, arrangement, or substantial negotiation within six months after the acquisition.
- ii) The final regulations define a disclosure event as any communication by an officer, director, controlling shareholder, or employee of Distributing, Controlled, or a corporation related to Distributing or Controlled, or an outside advisor of any of those persons (where such advisor makes the communication on behalf of such person), regarding the distribution, or the possibility thereof, to the acquirer or any other person (other than an officer, director, controlling shareholder, or employee of Distributing, Controlled, or a corporation related to Distributing or Controlled, or an outside advisor of any of those persons).
- iii) Safe Harbor IV does not apply to a stock acquisition if the acquirer or a coordinating group of which the acquirer is a member is a controlling shareholder or a 10% shareholder of the acquired corporation (Distributing or Controlled) at any time during the period beginning immediately after the acquisition and ending on the date of the distribution.
- iv) Safe Harbor IV also does not apply to an acquisition that occurs in connection with a transaction in which the aggregate acquisitions are of stock possessing 20% or more of the total voting power of the stock of the acquired corporation (Distributing or Controlled) or stock having a value of 20%

or more of the total value of the stock of the acquired corporation (Distributing or Controlled).

- v) Safe Harbor IV is intended to reflect the view that where the acquirer has no knowledge of Distributing's intent to effect a distribution and had not intent or ability to cause a distribution, the acquisition and distribution should not be considered part of a plan. See Preamble to Reg. § 1.355-7, 70 Fed Reg. at 20,280.

(5) Safe Harbor V - Pro Rata Distribution

- a) Safe Harbor V provides that a distribution that is pro rata among the Distributing shareholders and an acquisition (other than involving a public offering) of Distributing stock occurring before the distribution will not be considered part of a plan if--
 - i) The acquisition occurs after the date of a public announcement regarding the distribution; and
 - ii) There were no discussions by Distributing or Controlled with the acquirer regarding a distribution on or before the date of the first public announcement.
- b) This safe harbor was another significant change made by the final regulations--there was no similar safe harbor in the temporary regulations. The fact that the distribution was publicly announced suggests that it would have occurred regardless of the acquisition, and the fact that the shareholder's have the same interest in Distributing and Controlled (direct or indirect) before and after the distribution reduces the likelihood that the acquisition and distribution were part of a plan. See Preamble to Reg. § 1.355-7, 70 Fed Reg. at 20,280.
- c) A public announcement regarding the distribution is defined as "any communication by Distributing or Controlled regarding Distributing's intention to effect the distribution where the communication is

generally available to the public.” Reg. § 1.355(h)(10).

- d) Safe Harbor V does not apply to a stock acquisition if the acquirer or a coordinating group of which the acquirer is a member is a controlling shareholder or a 10% shareholder of the acquired corporation (Distributing or Controlled) at any time during the period beginning immediately after the acquisition and ending on the date of the distribution.
 - e) Safe Harbor V also does not apply to an acquisition that occurs in connection with a transaction in which the aggregate acquisitions are of stock possessing 20% or more of the total voting power of the stock of the acquired corporation (Distributing or Controlled) or stock having a value of 20% or more of the total value of the stock of the acquired corporation (Distributing or Controlled).
- (6) Safe Harbor VI - Certain Public Offerings
- a) Safe Harbor VI provides that a distribution and an acquisition involving a public offering occurring before the distribution will not be considered part of a plan if the acquisition occurs before the date of the first disclosure event regarding the distribution in the case of an acquisition of stock that is not listed on an established market immediately after the acquisition, or before the date of the first public announcement regarding the distribution in the case of an acquisition of stock that is listed on an established market immediately after the acquisition.
 - b) This safe harbor was also added by the final regulations and reflects the view that a pre-distribution public offering is not likely to be part of a plan if the acquirers are unaware that the distribution will occur. See Preamble to Reg. § 1.355-7, 70 Fed Reg. at 20,281.
 - c) The final regulations define an acquisition involving a public offering as a stock acquisition for cash where the terms of the acquisition are established by the acquired corporation (Distributing or Controlled) or the seller with the involvement of

one or more investment bankers, and the potential acquirers have no opportunity to negotiate the terms of the acquisition.

- i) Under this definition, while an initial public offering and a secondary offering will be treated as public offerings, a private placement involving bilateral discussions and a stock issuance for assets or stock in a tax-free reorganization will not be treated as public offerings.

(7) Safe Harbor VII – Public trading

- a) Safe Harbor VII provides a safe harbor for public trading of Distributing or Controlled stock listed on an established market if, immediately before or after the transfer, none of the transferor, transferee, and any coordinating group⁷ of which either the transferor or transferee is a member is--
 - i) the acquired corporation (Distributing or Controlled);
 - ii) a corporation controlled by the acquired corporation;
 - iii) a member of a controlled group of corporations of which the acquired corporation is a member;
 - iv) a controlling shareholder⁸ of the acquired corporation; or

⁷ A “coordinating group” is defined as two or more persons that, pursuant to a formal or informal understanding, join in one or more coordinated acquisitions or dispositions of stock of Distributing or Controlled. Reg. § 1.355-7(h)(4). A principal element in determining whether such an understanding exists is whether the investment decision of each person is based on the investment decision of one or more existing or prospective shareholders. Id.

⁸ A controlling shareholder of a public corporation is defined as a shareholder who owns, actually or constructively under section 318, stock of the corporation and actively participates in the management or operation of the corporation. Reg. § 1.355-7(h)(3)(i), (h)(8). A controlling shareholder of a non-public corporation is defined as any person that owns, actually or (cont. on next page)

- v) a 10% shareholder⁹ of the acquired corporation.
 - b) Safe Harbor VII does not apply to a transfer of stock by or to a person if the corporation knows or has reason to know that the person intends to become a controlling shareholder or a 10% shareholder at any time after the acquisition and before the date that is two years after the distribution. Reg. § 1.355-7(d)(7)(ii)(A).
 - c) Safe Harbor VII also does not apply to vote-shifting transactions. If a transfer of stock results immediately, or upon a subsequent event or the passage of time, in an indirect acquisition of voting power by a person other than the transferee, then Safe Harbor VII does not prevent the acquisition of voting power by such other person from being treated as part of a plan. Reg. § 1.355-7(d)(7)(ii)(B).
- (8) Safe Harbor VIII - Compensatory stock arrangements
- a) Safe Harbor VIII provides that if, in a transaction to which section 83 or section 421(a) or (b) applies, stock of Distributing or Controlled is acquired by a person in connection with such person's performance of services as an employee, director, or independent contractor for Distributing, Controlled, a related person, a corporation the assets of which Distributing, Controlled, or a related person acquires in a reorganization under section 368(a), or a corporation that acquires the assets of Distributing or Controlled in such a reorganization (and the stock acquired is not excessive by reference to the

constructively under section 318, stock possessing voting power representing a meaningful voice in the governance of the corporation. Reg. § 1.355-7(h)(3)(ii).

⁹ This was increased from five percent in the 2001 temporary regulations. See 2001 Temp. Reg. § 1.355-7T(f)(5)(i). In determining whether a person is a 10% shareholder, the constructive ownership rules of section 318 apply. Absent actual knowledge that a person is a 10% shareholder, a corporation may rely on Schedules 13D and 13G (or similar schedules) filed with the Securities and Exchange Commission. Reg. § 1.355-7(h)(14).

services performed), the acquisition and the distribution will not be considered part of a plan. Reg. § 1.355-7(d)(8)(i). See, e.g., P.L.R. 200832001 (Apr. 30, 2008).

- b) Safe Harbor VIII does not apply if the acquirer or a coordinating group of which the acquirer is a member is a controlling shareholder or a 10% shareholder of the acquired corporation immediately after the acquisition. Reg. § 1.355-7(d)(8)(ii). This exception was intended to exclude management leveraged buy-outs and going private transactions from the scope of Safe Harbor VIII. See Preamble to Temp. Reg. § 1.355-7T, 67 Fed. Reg. at 20,635.

(9) Safe Harbor IX – Acquisitions by qualified plans

- a) Safe Harbor IX provides that if stock of Distributing or Controlled is acquired by a retirement plan of Distributing or Controlled (or a retirement plan of any other person that is treated as the same employer as Distributing or Controlled under section 414(b), (c), (m), or (o)) that qualifies under section 401(a) or 403(a), the acquisition and the distribution will not be considered part of a plan. Reg. § 1.355-7(d)(9)(i).
- b) Safe Harbor IX does not apply to the extent the stock acquired by all qualified plans of the employer and any other person treated as the same employer under section 414(b), (c), (m), or (o) during the four year period beginning two years before the distribution, in the aggregate, represents 10% or more of the stock of the acquired corporation (by vote or value). Reg. § 1.355-7(d)(9)(ii).

e. Plan and Non-Plan Factors

- (1) Plan factors – The temporary regulations list five factors that tend to show the existence of a plan. Reg. § 1.355-7(b)(3)(i)-(v).
 - a) Post-distribution acquisitions:
 - i) Non-public offering – At some time during the two-year period ending on the date of the

distribution, there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition.

ii) Public offering – At some time during the two-year period ending on the date of the distribution, there were discussions by Distributing or Controlled with an investment banker regarding the acquisition or a similar acquisition.

b) Pre-distribution acquisitions:

i) Non-public offering – At some time during the two-year period ending on the date of the acquisition, there were discussions by Distributing or Controlled with the acquirer regarding a distribution, or a person other than Distributing or Controlled that intends to cause a distribution can, as a result of the acquisition, meaningfully participate in the decision regarding whether to make a distribution.

ii) Public offering – At some time during the two-year period ending on the date of the acquisition, there were discussions by Distributing or Controlled with an investment banker regarding a distribution.

c) Either pre- or post-distribution acquisition:

i) The distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition.

(2) Non-plan factors – The temporary regulations list six factors that tend to refute the existence of a plan. Reg. § 1.355-7(b)(4)(i)-(vi).

a) Post-distribution acquisitions:

i) Public offering – During the two-year period ending on the date of the distribution, there were no discussions by Distributing or Controlled with an investment banker

regarding the acquisition or a similar acquisition.

- ii) In the case of any post-distribution acquisition, there was an identifiable, unexpected change in market or business conditions occurring after the distribution that resulted in the acquisition that was otherwise unexpected at the time of the distribution.
- b) Pre-distribution acquisitions:
- i) Non-public offering – During the two-year period ending on the date of the acquisition, there were no discussions by Distributing or Controlled with the acquirer regarding a distribution.
 - (a) This factor does not apply if the acquisition occurs after the date of the public announcement of the planned distribution.
 - (b) This factor also does not apply if a person other than Distributing or Controlled that intends to cause a distribution can, as a result of the acquisition, meaningfully participate in the decision regarding whether to make a distribution.
 - ii) In the case of any pre-distribution acquisition, there was an identifiable, unexpected change in market or business conditions occurring after the acquisition that resulted in a distribution that was otherwise unexpected.
- c) Either pre- or post-distribution acquisitions:
- i) The distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate the acquisition or a similar acquisition.

- ii) The distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition.

f. Agreement, Understanding, Arrangement, or Substantial Negotiations

- (1) The final regulations state that whether an agreement, understanding, or arrangement exists depends on the facts and circumstances – the parties do not necessarily have to enter into a binding contract or reach an agreement on all significant economic terms. Reg. § 1.355-7(h)(1)(i).
- (2) The final regulations provide guidance as to what constitutes an “agreement, understanding, or arrangement”:

An agreement, understanding, or arrangement generally requires either--(i) an agreement, understanding, or arrangement by one or more officers or directors acting on behalf of Distributing or Controlled, by controlling shareholders of Distributing or Controlled, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders, with the acquirer or with a person or persons with the implicit or explicit permission of the acquirer; or (ii) an agreement, understanding, or arrangement by an acquirer that is a controlling shareholder of Distributing or Controlled immediately after the acquisition that is the subject of the agreement, understanding, or arrangement, or by a person or persons with the implicit or explicit permission of such acquirer, with the transferor or with a person or persons with the implicit or explicit permission of the transferor.

Reg. § 1.355-7(h)(1)(i)

- (3) The final regulations include guidance as to what constitutes “substantial negotiations”:

Substantial negotiations in the case of an acquisition (other than involving a public offering) generally require discussions of significant economic terms, e.g., the exchange ratio in a reorganization, either-- (A) by one or more officers or directors acting on behalf of Distributing or Controlled, by controlling shareholders of Distributing or Controlled, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders, with the acquirer or with a person or persons with the implicit or explicit permission of the acquirer; or (B) if the acquirer is a controlling shareholder of Distributing or Controlled immediately after the acquisition that is the subject of substantial negotiations, by the acquirer or by a person or persons with the implicit or explicit permission of the transferor.

Reg. § 1.355-7(h)(1)(iv) (emphasis added).

- (4) In the case of an acquisition (other than involving a public offering) by a corporation, substantial negotiations generally require that “[i]n the case of an acquisition (other than involving a public offering) by a corporation, substantial negotiations generally require discussions of significant economic terms with one or more officers or directors acting on behalf of the acquiring corporation, with controlling shareholders of the acquiring corporation, or with another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders.” Reg. § 1.355-7(h)(1)(v).
- (5) In the case of a public offering, an agreement, understanding, arrangement, or substantial negotiations will be based on discussions by one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person or persons with the implicit or explicit permission of such persons, with an investment banker. Reg. § 1.355-7(h)(1)(vi).

(6) Options treated as agreements

- a) The final regulations treat certain options as agreements. If stock is acquired pursuant to an option, the option is treated as an agreement, understanding, or arrangement to acquire stock on the earliest of (i) the date the option is written, (ii) the date the option is transferred, or (iii) the date the option is modified. In all three cases, the option must be more likely than not to be exercised as of the relevant date. Reg. § 1.355-7(e)(1)(i).
 - i) For example, assume that Distributing grants an option to acquire 25% of its stock to Holder. On the date the option is written, it is more likely than not to be exercised. Three years later, Distributing spins off Controlled. One month later, while the option is still more likely than not to be exercised, Holder transfers the option to Holder 2. The option is exercised seven months after the distribution.
 - ii) The option is treated as an agreement, understanding, or arrangement on the date the option was written (three years before the distribution). The subsequent transfer of the option has no effect. Because the agreement existed during the two-year period before the distribution and continued to exist beyond the date of the distribution, the super safe harbor and Safe Harbors I and II are not available.
 - iii) Note that the option is only treated as an agreement, understanding, or arrangement if the option is actually exercised. Thus, whether the super safe harbor and the safe harbors are available will be uncertain until outstanding options are or are not exercised. Thus, in applying these rules, Distributing should assume that all options will be exercised.
- b) If there is an agreement, understanding, or arrangement to write, transfer, or modify an option, the option will be treated as written, transferred, or

modified on the date of such agreement, understanding, or arrangement. Reg. § 1.355-7(e)(1)(ii). Substantial negotiations to acquire an option will be treated as substantial negotiations to acquire the stock subject to such option at the time the option would otherwise be treated as an agreement. Reg. § 1.355-7(e)(1)(iii).

- c) For purposes of this rule, the term “option” is defined broadly to include call options, warrants, convertible obligations, the conversion feature of convertible stock, put options, redemption agreements (including rights to cause the redemption of stock), any other instrument that provides for the right or possibility to issue, redeem, or transfer stock (including an option on an option), or any other similar interests. Reg. § 1.355-7(e)(3).¹⁰
- d) Certain instruments, however, are excluded from the definition of an option, unless such instruments are granted with a principal purpose of avoiding the application of section 355(e). Excluded instruments include (Reg. § 1.355-7(e)(4)):
 - i) Options that are part of a security arrangement in a typical lending transaction;
 - ii) Options that are exercisable only upon death, disability, mental incompetency, or separation from service;
 - iii) Bona fide rights of first refusal; and
 - iv) Any other instrument designated by the Service in revenue procedures, notices, or other published guidance.
 - v) Note that compensatory options were excluded in the temporary regulations. See

¹⁰ Note that the final regulations remove the references to restricted stock and cash settlement options, which were contained in the 1999 proposed regulations. Cf. 1999 Prop. Reg. § 1.355-7(a)(7)(ii).

Temp. Reg. § 1.355-7T(e)(3)(ii). The final regulations removed the exclusion because the Service and Treasury became aware of arrangements using compensatory options that were structured to prevent an acquisition from being treated as part of a plan. See Preamble to Reg. § 1.355-7, 70 Fed Reg. at 20,281.

- g. Similar Acquisition – The temporary regulations narrowed the definition of “similar acquisition.”
- (1) The final regulations provide that, in general, an actual acquisition will be similar to another potential acquisition “if the actual acquisition effects a direct or indirect combination of all or a significant portion of the same business operations as the combination that would have been effected by such other potential acquisition.” Reg. § 1.355-7(h)(12).
 - (2) An acquisition is not similar if the ultimate owners of the business operations of the actual acquirer are substantially different from the ultimate owners of the business operations of the potential acquirer. Id.
 - (3) In the case of a public offering or other stock issuance for cash, an actual acquisition may be similar to another acquisition, even though there are changes in the terms, class, or price of stock being offered, the size or timing of the offering, or the participants in the offering. Reg. § 1.355-7(h)(13).
 - a) The final regulations added that if there is an actual acquisition involving a public offering (the first public offering) that is the same as, or similar to, a potential acquisition involving a public offering, then another actual acquisition involving a public offering (the second public offering) cannot be similar to the potential acquisition unless the purpose of the second public offering is similar to that of the potential acquisition and occurs close in time to the first public offering. Id.
- h. Rev. Rul. 2005-65. This revenue ruling held that an acquisition and distribution were not part of a plan under section 355(e) and the final regulations. Although Distributing discussed the distribution with Acquirer during the two-year period preceding

the date of the acquisition, the ruling found that the distribution was substantially motivated by a corporate business purpose other than to facilitate the acquisition. The business purpose for the distribution was to eliminate competition between for capital between two separate lines of businesses—pharmaceuticals and cosmetics. The ruling also noted that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition.

i. Ruling Requests

- (1) Rev. Proc. 2003-48 establishes a one-year pilot program¹¹ under which the national office will not determine whether a proposed or completed distribution of Controlled's stock is being carried out for one or more corporate business purposes, whether the transaction is used principally as a device, or whether the distribution and an acquisition are part of a plan under section 355(e).
- (2) Rev. Proc. 2003-48 requires taxpayers to submit representations regarding the business purpose and device requirements and whether there is a plan under section 355(e).
 - a) For a request for a ruling to be considered, a taxpayer must submit one of the following representations regarding whether there is a plan (or series of related transactions) under section 355(e)(2)(A)(ii):
 - i) There is no acquisition of stock of Distributing 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 §1.355-7) that includes the distribution of Controlled stock.
 - ii) Each of the following acquisitions of stock of Distributing or any controlled corporation

¹¹ Although Rev. Proc. 2003-48 indicated that this was a pilot program, representatives of the Service have indicated informally that unless it hears otherwise from taxpayers, it plans to continue this practice indefinitely.

(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 §1.355-7) that includes the distribution of controlled corporation stock: [describe acquisitions here]. Taking all of these acquisitions into account, stock representing a 50% or greater interest (within the meaning of §355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation) will not be acquired by any person or persons.

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

- (3) Rev. Proc. 2003-48 states, however, that the Service may rule on significant issues under section 355(e).
- a) Rev. Proc. 2009-25 modified Rev. Proc. 2003-48 to provide that the Service will not grant a ruling on significant non-plan issues under section 355(e) unless an adverse ruling on such non-plan issues would result in there being a direct or indirect acquisition by one or more persons of stock representing a 50% or greater interest that is part of a plan within the meaning of section 355(e).
- (4) A determination of whether the distribution and an acquisition are part of a plan under section 355(e) will not be made in a ruling by the National Office, but may be made upon an examination of the taxpayer's return. This procedure applies to ruling requests received after August 8, 2003.
- (5) P.L.R. 201004001 (Jan. 29, 2010) (Ruling 22) ruled that a reclassification will not cause any part of the Controlled stock acquired in the split-off to fail to qualify under section 355(e)(3)(A)(ii). Implicit in that ruling, however, is

that the Distributing stock was not acquired pursuant to a plan. See section 355(e)(3) (flush language). Thus, it appears that the Service did issue a plan ruling.

3. Proposed Section 355(e)(4)(D) Regulations Defining Predecessor and Successor
 - a. On November 22, 2004, the Service issued proposed regulations providing long-awaited definitions of “predecessor” and “successor” (the “proposed section 355(e)(4)(D) regulations”).¹² The proposed regulations adopt the same basic section 381 approach utilized elsewhere in the Code. However, the approach has been modified somewhat to more closely follow the assets being spun off.
 - b. The terms “predecessor” and “successor” are not defined anywhere in section 355 or the legislative history. The phrase is, however, used elsewhere in the Code and regulations (e.g., section 382 net operating loss limitations, section 338 deemed asset purchases, and the consolidated return regulations), and is typically defined with reference to section 381 or other carryover basis transactions.
 - c. Definition of “Predecessor”
 - (1) Consistent with other definitions of predecessor and successor found elsewhere in the Code and regulations, the measuring stick for the proposed section 355(e)(4)(D) regulations is whether there has been a section 381 transaction. The proposed section 355(e)(4)(D) regulations then add a gloss to the definition of predecessor that limits the definition to transactions that implicate the purposes behind section 355(e).
 - (2) The proposed regulations provide separate definitions of predecessor for Distributing and Controlled, focusing largely on predecessors of Distributing, because predecessors of Controlled do not raise the section 355(e) concerns.

¹² Prop. Reg. § 1.355-8, 69 Fed. Reg. 67,873 (2005). For a more in-depth look at these proposed regulations, see Lisa M. Zarlenga and Kevin Spencer, Who Precedes and Who Succeeds: Proposed Section 355(e)(4)(D) Regulations, 2005 TNT 74-52 (2005).

- (3) To determine if a corporation is a predecessor of Distributing, the proposed section 355(e)(4)(D) regulations provide two tests that focus on what happens to the assets transferred to Distributing.
- a) Under the first test, a corporation is a predecessor of Distributing if, before the distribution, it transfers property to Distributing in a section 381 transaction (referred to by the proposed section 355(e)(4)(D) regulations as the “combining transfer”), but only if (i) Distributing transfers some, but not all, of the property to Controlled (or a predecessor of Controlled) (referred to by the proposed section 355(e)(4)(D) regulations as the “separating transfer”), and (ii) Controlled’s basis in the transferred assets is the same as Distributing’s basis in the assets prior to the transfer. Prop. Reg. § 1.355-8(b)(1)(i).
- i) Example: Predecessor of Distributing Test One: Shareholder X owns 100% of P corporation and shareholder Y owns 100% of D corporation. P merges into D in an “A” reorganization. D then contributes in a “D” reorganization one of the former P assets to its wholly owned subsidiary, C, for additional C stock and then distributes C to its shareholders pro rata. Because P transferred property to D in a section 381 transaction and D transferred some, but not all of the former P property to C, there has been a separation of P’s assets. Therefore, P is considered a predecessor to D. See Prop. Reg. § 1.355-8(g), Ex. 1.
- b) Under the second test, a corporation is a predecessor of Distributing if it transfers property to Distributing, including stock of Controlled, in a section 381 transaction (i.e., the combining transfer), and thereafter, Distributing does not transfer all of that property (other than the Controlled stock) to Controlled (i.e., the separating transfer). Prop. Reg. § 1.355-8(b)(1)(ii).
- i) Example: Predecessor of Distributing Test Two: Shareholder X owns 100% of P corporation and shareholder Y owns 100%

of D corporation. P owns 35% of C corporation, and D owns the remaining 65% of C. P merges into D in an “A” reorganization. As a result of the merger, D owns 100% of C. D then distributes C to its shareholders pro rata. Because P transferred property to D, including stock of C, in a section 381 transaction, and D did not transfer all of that property to C, there has been a separation of P’s assets (i.e., the C stock from P’s other assets). Therefore, P is considered a predecessor to D. See Prop. Reg. § 1.355-8(g), Ex. 2.

- (4) By limiting the definition of predecessor to combining transfers that occur before the distribution, the proposed regulations avoid a technical glitch that could lead to anomalous results. To illustrate, assume P, a small corporation, merges into D after D spins off C, and P’s shareholders receive only 2% of D’s stock. Section 355(e) would apply if P were treated as a predecessor, because D’s shareholders acquired 98% of P, a predecessor of D.

d. Determining Whether There Has Been an Acquisition of Distributing or a Predecessor

- (1) The proposed section 355(e)(4)(D) regulations provide that the determination of whether one or more persons has acquired a 50% or greater interest is made separately for Distributing and any predecessor of Distributing. Prop. Reg. § 1.355-8(d)(4). Accordingly, there may be situations where there is an acquisition of a 50% or greater interest in a predecessor of Distributing where there is no similar acquisition of a 50% or greater interest in Distributing, and vice versa.
- (2) The proposed section 355(e)(4)(D) regulations provide that historic shareholders of Distributing immediately before the combining transfer are treated as acquiring stock of the predecessor of Distributing in such combining transfer. Prop. Reg. § 1.355-8(d)(1)(i). Thus, the combining transfer itself can constitute a 50% or greater acquisition of the predecessor of Distributing. Additionally, if stock of Distributing is acquired after the combining transfer, such stock is treated as stock of the predecessor of Distributing. Thus, an acquisition of Distributing stock after the combining transfer is treated as not only an acquisition of

Distributing stock but also of stock of the predecessor of Distributing. Prop. Reg. § 1.355-8(d)(1)(ii).

e. Special Gain Limitation Rules

- (1) The proposed section 355(e)(4)(D) regulations provide special rules limiting the amount of gain to be recognized by Distributing where there is a 50% or greater acquisition of either Distributing or the predecessor of Distributing, but not both. If there is a 50% or greater acquisition of both Distributing and the predecessor, then the entire gain inherent in the Controlled stock is recognized.
- (2) The gain limitation rules focus on which assets are being separated and, therefore, are consistent with the purpose of section 355(e) -- to deny tax-free treatment where a division of a corporation's assets is coupled with a planned 50% or greater acquisition of Distributing or Controlled.
- (3) Acquisitions of Predecessor of Distributing
 - a) If there is a 50% or greater acquisition of a predecessor of Distributing, Distributing's gain is limited to the gain that the predecessor of Distributing would have otherwise recognized if, immediately before the distribution, the predecessor contributed the property that was transferred to Controlled in the separating transfer and any stock of Controlled transferred to Distributing in the combining transfer to a newly formed, wholly owned corporation in a section 351 transaction, and sold the subsidiary's stock to a third party for cash equal to its fair market value. Prop. Reg. § 1.355-8(e)(2)(i).
 - b) The proposed section 355(e)(4)(D) regulations provide a substituted asset rule, which provides that if Distributing or Controlled transfer property of the predecessor of Distributing in a transaction in which gain or loss is not recognized in whole, the property received in exchange is treated as such property. Prop. Reg. § 1.355-8(e)(2)(ii)(A), (C).
 - c) Example: Gain Limitation on Acquisition of Predecessor: Shareholder X owns 100% of P corporation and shareholder Y owns 100% of D corporation. P merges into D in an "A"

reorganization. Immediately after the merger, X and Y own 10% and 90%, respectively, of the stock of D. D then contributes in a “D” reorganization one of the former P assets to its wholly owned subsidiary, C, for additional C stock and then distributes C to its shareholders pro rata. Immediately before the distribution, the asset contributed to C has a basis of \$50 and a fair market value of \$110, and the stock of C held by D has a basis of \$100 and a fair market value of \$200.

(4) Acquisitions of Distributing

- a) If there is a 50% or greater acquisition of Distributing and the acquisition(s) occur in the combining transfer, the amount of gain recognized by Distributing is limited to the excess, if any, of the amount described in sections 355(c)(2) or 361(c)(1), as applicable (which is essentially Distributing’s built-in gain in its Controlled stock), less the amount of gain that Distributing would have recognized if there had been a 50% or greater acquisition of a predecessor of Distributing but not Distributing (which is the amount calculated upon the deemed section 351 transaction and stock sale under Prop. Reg. § 1.355-8(e)(2)). Prop. Reg. § 1.355-8(e)(3).
- b) Where Controlled is newly formed, this calculation will result in a gain limitation equal to the gain inherent in any assets contributed by Distributing to Controlled. Where Controlled is a pre-existing entity, however, Distributing’s gain will include any gain inherent in the Controlled stock as well as any gain inherent in assets transferred to Controlled.
- c) Example: Gain Limitation on Acquisition of Distributing: Shareholder X owns 100% of the stock of P and shareholder Y owns 100% of D. P merges into D in an “A” reorganization. In the merger, X receives 60% of the D stock and Y receives 40%. In a “D” reorganization, D contributes some of the former P assets and one D asset to a newly formed corporation, C. After the contribution, D distributes the C stock pro rata to its shareholders. Immediately before the distribution, the former P assets had a \$1 basis and a fair market

value of \$30, and the former D asset had a \$3 basis and a \$10 fair market value. Furthermore, D's basis in the C stock was \$4 and had a value of \$40.

- (5) What if Distributing and the predecessor are of equal size, so that the combining transfer results in a 50% acquisition of each company? It would appear that Distributing's entire built-in gain in its Controlled stock is recognized. This places a significant amount of pressure on the valuation of Distributing and the predecessor, because the gain will be limited if more than 50% of either corporation is acquired.
- (6) Measuring the Gain Limitation - Timing
- a) Even though the relevant predecessor assets must be acquired in the combining transfer, the proposed section 355(e)(4)(D) regulations measure gain for purposes of the gain limitation rules "immediately before the distribution" with reference to the basis of the property in the hands of Controlled. Prop. Reg. §§ 1.355-8(e)(2)(i), (e)(2)(ii)(B).
 - b) As a result, any post-merger appreciation (or depreciation) in the predecessor's assets (other than Controlled stock) will increase (or decrease) the gain limitation. Similarly, any basis adjustments to the property will affect the gain limitation.
 - c) The one exception is for stock of Controlled owned by the predecessor, the basis and fair market value of which are determined immediately before the combining transfer. Prop. Reg. § 1.355-8(e)(2)(ii)(D).
- (7) Netting Gains and Losses on Multiple Assets. The mechanism for computing the gain limitation with respect to the predecessor's assets, i.e., the deemed section 351 exchange followed by a stock sale, necessarily aggregates the bases and fair market values of the assets being

transferred in the separating transfer. As a result, built-in losses in contributed assets may offset built-in gains.¹³

f. Multiple and Successive Predecessors

- (1) The proposed section 355(e)(4)(D) regulations provide that more than one corporation may be a predecessor of Distributing or Controlled. Prop. Reg. § 1.355-8(b)(4)(iii).
- (2) However, the proposed regulations do not provide for successive predecessors. In other words, a corporation that transfers property to a predecessor of Distributing is not also a predecessor of Distributing. Prop. Reg. § 1.355-8(b)(3).

g. Definition of Predecessor of Controlled

- (1) The proposed regulations contain a definition of a predecessor of Controlled, but only for certain limited purposes.
- (2) Specifically, the definition of a predecessor of Controlled applies only for purposes of determining whether a corporation is a predecessor of Distributing, calculating the gain limitation where a predecessor of Distributing is acquired, and applying a special affiliated group rule.
- (3) An acquisition of a predecessor of Controlled cannot therefore trigger section 355(e) gain. For example, if P merges into Controlled and Controlled distributes certain P assets to Distributing prior to the spin-off, such distribution is taxable and does not implicate section 355(e).
- (4) The reason for limiting the definition of predecessor of Controlled is because generally Controlled will not be able to transfer property it receives in a section 381 transaction to Distributing tax-free.

¹³ This result makes sense, because contributing built-in loss assets to Controlled would likewise reduce the amount of the section 355(e) gain.

h. Definition of “Successor”

- (1) The proposed 355(e)(4)(D) regulations define a “successor” as a corporation to which Distributing or Controlled transfers property in a section 381 transaction after the distribution of Controlled. Prop. Reg. § 1.355-8(c)(1).
- (2) The proposed 355(e)(4)(D) regulations also provide certain deemed acquisition rules for successors similar to those provided for predecessors.
 - a) Each person that owned stock in a successor of Distributing or Controlled before the successor transaction is deemed to acquire stock in Distributing or Controlled in the successor transaction. Prop. Reg. § 1.355-8(d)(2)(i), (d)(3)(i).
 - b) Likewise, successor stock acquired after the successor transaction is counted as Distributing or Controlled stock. Prop. Reg. § 1.355-8(d)(2)(ii), (d)(3)(ii).
- (3) Multiple and Successive Successors
 - a) Similar to the definition of predecessor, more than one corporation may be a successor of Distributing or Controlled. Prop. Reg. § 1.355-8(c)(2).
 - b) However, unlike the definition of predecessor, the proposed 355(e)(4)(D) regulations trace to successors of successors. For example, if Distributing transfers property to X corporation in a section 381 transaction, and X corporation transfers property to Y corporation in a 381 transaction, then each of X and Y may be successors of Distributing. Id.
- (4) Subsequent Transfers to Partnerships or Corporations. The Service appropriately decided not to treat a partnership or corporation to which Distributing or Controlled transfers assets as a successor. Such a rule would have added substantial complexity as it would have required measuring the ownership changes of Distributing or Controlled as well as each entity to which it transferred assets. By limiting the definition of successor to require a section 381 transaction, the prior entity no longer exists and there is only one entity to monitor.

4. Intragroup Spin-offs – Section 355(f)

- a. TRA 1997 also added section 355(f) to the Code, which eliminates the use of section 355 for intragroup spin-offs that are part of a Morris Trust-type transaction, except as provided in regulations.
- b. Under section 355(f), intragroup spins are generally not taxed (but are subject to the issuance of regulations under section 358). However, section 355(f) provides that section 355 will not apply to distributions of stock from one member of an affiliated group to another member if the distribution is part of a Morris Trust transaction described in section 355(e).
- c. Because section 355 in its entirety does not apply to such intragroup spin-offs, the intragroup spin-off will be taxable to both Distributing and the shareholder.
 - (1) The dividend to the shareholder will, however, be eliminated under the consolidated return regulations. Reg. § 1.1502-13(f).
 - (2) In addition, the shareholder will receive a fair market value basis in Controlled's stock and, thus, will not be taxed again on such built-in gain upon the subsequent distribution.
- d. In addition, the legislative history to section 355(f) clarifies that all of the Morris Trust provisions in section 355(e) apply in determining whether the intragroup spin provisions apply. For example, an intragroup spin-off in connection with a transaction that does not cause gain recognition under section 355(e) as a result of the exceptions contained therein is not subject to the intragroup spin-off rules. See H.R. Rep. No. 105-220, at 534 (1997) (Conf. Rep.).
- e. Further, TRA 1997 added section 358(g) to the Code, which allows Treasury to provide adjustments to the adjusted basis of stock in the case of intragroup distributions to which section 355 applies, in order to appropriately reflect the proper treatment of such distributions.
 - (1) Treasury's authority to provide adjustments under TRA 1997 is limited to adjustments to the adjusted basis of stock in a corporation that is a member of an affiliated group and is held by another member of such group.
 - (2) The Conference Report to TRA 1997 notes two concerns that it hopes regulations will address: (1) the possibility

that corporations can eliminate excess loss accounts in lower tier subsidiaries, and (2) the possibility that corporations can manipulate basis allocation rules and increase stock basis relative to asset basis in one corporation, while correspondingly decreasing stock basis relative to asset basis in another corporation. See H.R. Rep. No. 105-220, at 535-36 (1997) (Conf. Rep.).

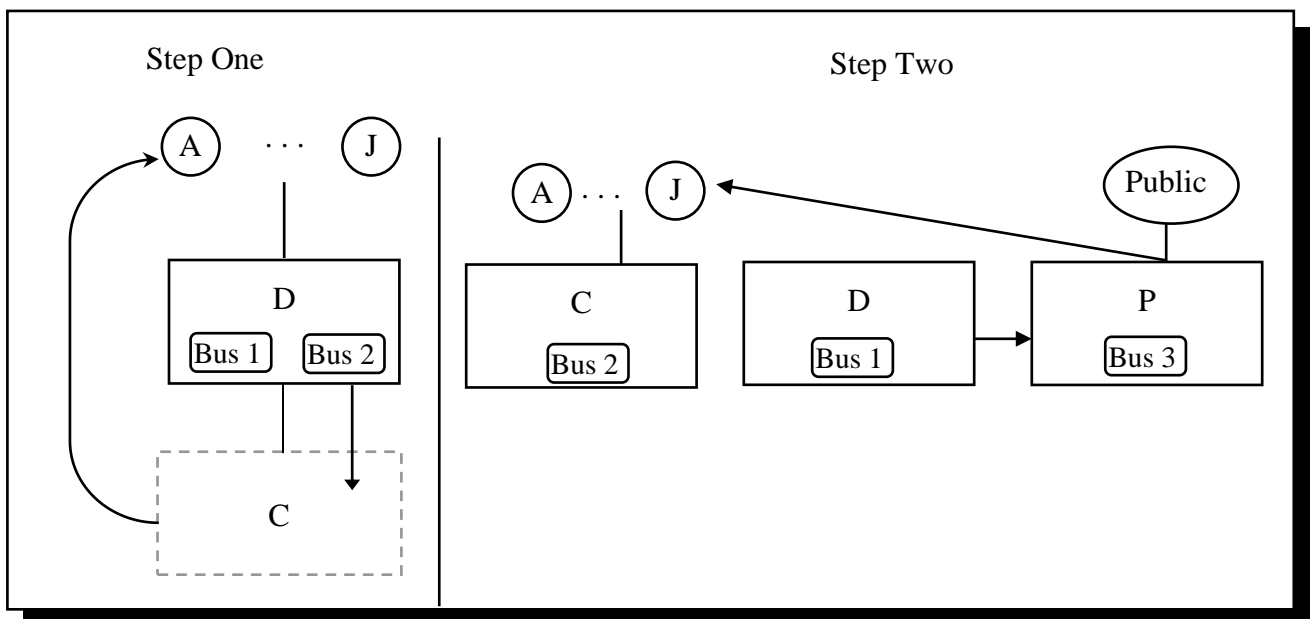
a) Note, however, that the Service has other means available to attack eliminations of ELAs it believes are abusive. For example, in F.S.A. 200022006 (Dec. 9, 1999), the Service applied the anti-avoidance rule of Reg. § 1.1502-19(e) to preserve gain from an ELA in the context of a tax-free intragroup spin-off.

(3) The conferees “expect that any Treasury regulation will be applied prospectively, except in cases to prevent abuse.” H.R. Rep. No. 105-220, at 537 (1997) (Conf. Rep.).

f. Section 355(f) generally applies to distributions made after April 16, 1997, with the same transition rules as for section 355(e) discussed above.

5. Examples

a. Example 13 -- Morris Trust Transaction



- (1) Facts: Ten individuals (A . . . J) own all of the stock of Distributing. Distributing conducts two qualifying five-year businesses, Business 1 and Business 2. P, a public corporation, wants to acquire Business 1, but not Business 2. P is willing to issue 10% of its outstanding stock in exchange for Business 1. Distributing's shareholders are willing to dispose of Business 1 for P stock.

The parties agree on the following transaction, which takes place one month later: (i) Distributing will contribute Business 2 to a newly formed subsidiary, Controlled; (ii) Distributing will distribute the stock of Controlled to its shareholders pro rata; (iii) Distributing will merge into P, and the Distributing shareholders will transfer their Distributing stock to P in exchange for P voting stock.

- (2) Issues:

- a) The distribution of unwanted assets to facilitate the merger of Distributing constitutes a valid business purpose for a spin-off. Commissioner v. Mary Archer W. Morris Trust, 42 T.C. 779 (1964), aff'd, 367 F.2d 794 (4th Cir. 1966), acq. Rev. Rul. 68-603, 1968-2 C.B. 148; see also Rev. Proc. 96-30, Appendix A, § 2.07.
- b) It is not necessary that Distributing merge into P. It may also be acquired by P in a stock for stock exchange qualifying as a "B" reorganization. See Rev. Rul. 70-434, 1970-2 C.B. 83. Rev. Rul. 70-434 declined to recharacterize such a transaction as a distribution of Controlled stock by P as consideration in the merger. In that event, the Controlled stock could have been viewed as "boot" that would have caused the transaction to fail to meet the requirement that the acquisition be "solely" for P voting stock.
- c) Importantly, the fact that the shareholders of Distributing will dispose of "control" of Distributing in a Morris Trust transaction does not prevent the distribution transaction from qualifying under section 355.
- i) There is no requirement that shareholders "control" Distributing before or after a distribution. Thus, even if the merger is

“stepped together” with the distribution under the step-transaction doctrine, the distribution transaction should still qualify under section 355.

- ii) However, as discussed below, the disposition of a 50% or greater interest in Distributing as part of the same plan as the spin-off will trigger section 355(e). Thus, Distributing will recognize gain as if it had sold its Controlled stock.
- d) Continuity of interest should be satisfied even though the Distributing shareholders will own less than a 50% interest in the assets of Distributing. The Morris Trust case involved a merger in which the Distributing shareholders received over 50% of the stock of the combined entity. Thus, it does not provide direct authority for treating continuity as satisfied. Nevertheless, rulings issued by the Service have not imposed a requirement that the Distributing shareholders retain a 50% or greater interest in Distributing in Morris Trust transactions. See, e.g., Rev. Rul. 75-406, 1975-2 C.B. 125; Rev. Rul. 68-603, 1968-2 C.B. 148.
- i) The Service’s current approach to this issue is not entirely clear from the ruling guidelines. See Rev. Proc. 96-30, § 4.06. That provision states that, in general, the Service will view the continuity of interest requirement as satisfied if one or more persons who, directly or indirectly, were the owners of the enterprise before the distribution own, in the aggregate, 50% or more of the stock of each of the modified corporate forms in which the enterprise is conducted after the distribution. This could be interpreted as imposing substantially the same restrictions regarding post-distribution stock ownership as section 355(e).
 - ii) However, the regulations merely require that the business be continued in “modified corporate form.” See Reg. § 1.355-2(c). This should include the indirect conduct of the business through P. See Rev. Rul. 75-

406. It would be anomalous to treat continuity of interest as not met when Distributing shareholders receive solely stock of P and no other consideration in the merger.

- e) For similar reasons, there should be no limitation on the amount of new stock that may be issued by Distributing following a section 355 distribution of Controlled. Rev. Proc. 96-30 specifically recognizes that facilitating a subsequent IPO by Distributing may be a valid reason to spin-off a business. See Rev. Proc. 96-30, Appendix A, § 2.02. There is no requirement that historic shareholders maintain “control” of Distributing, and continuity should not be implicated by a dilutive transaction. Therefore, even if Distributing issues an amount of stock that reduces the interest of the historic shareholders below 50%, this should not implicate the prior spin-off. Nevertheless, prior to Rev. Proc. 96-30, the Service would not rule where Distributing intended to issue an amount of stock that exceeded 50% of its outstanding stock prior to the offering. Although this limitation is not reflected in Rev. Proc. 96-30, the Service’s informal position may be unchanged.
- f) Query whether the continuity of business enterprise requirement will be met if the value of the unwanted assets significantly exceeds the value of the wanted assets (for example, if the unwanted assets constitute 90% or more of Distributing’s value).
- g) Section 355(e) will apply to P’s acquisition of a greater than 50% interest in Distributing, because the acquisition and distribution are part of the same plan.
 - i) Applying the regulations defining plan, the super safe harbor does not apply, because Distributing and P entered into an agreement during the two-year period prior to the distribution. In addition, none of the safe harbors applies. Looking to the plan and non-plan factors, two plan factors are present (agreement within the two-year

period prior to the distribution and business purpose to facilitate the acquisition), but none of the non-plan factors is present. Accordingly, the acquisition and distribution are part of a plan.

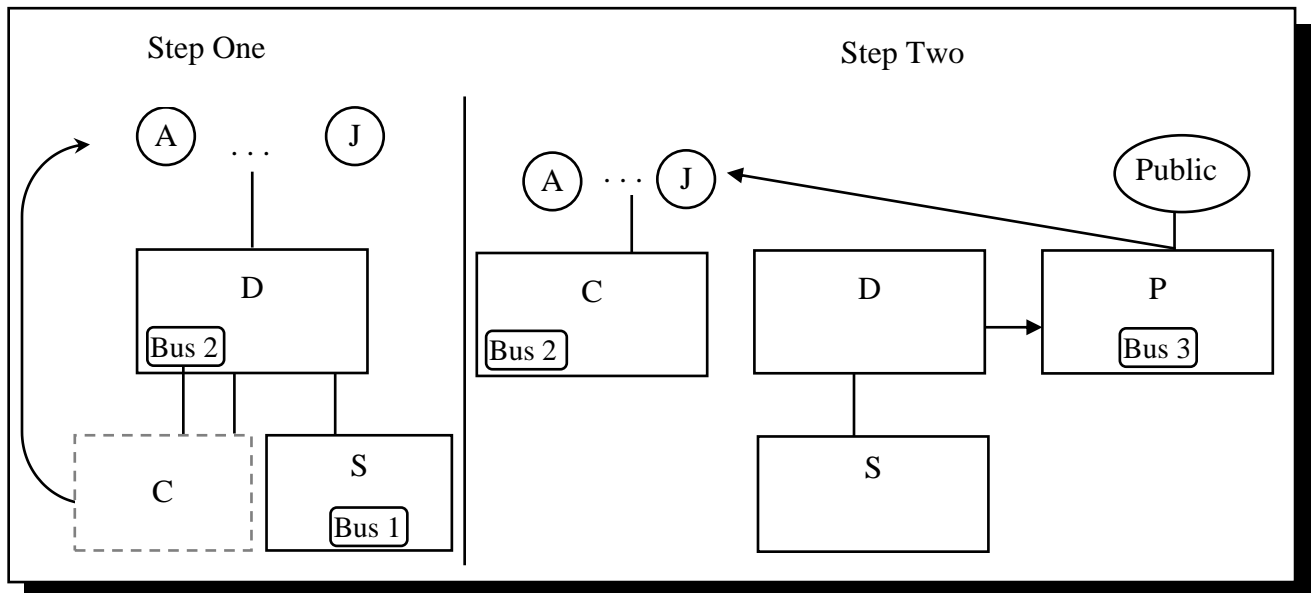
- ii) Note that section 355(e) operates to trigger tax on Distributing's built-in gain in the Controlled stock, but the transaction is still tax free to Distributing's shareholders.

- h) The subsequent acquisition of Distributing must be of a form that does not have a "substantially all" requirement. Accordingly, a "C" reorganization, a triangular merger under section 368(a)(2)(D), or a reverse triangular merger under section 368(a)(2)(E) will not be available. See Helvering v. Elkhorn Coal, 95 F.2d 732 (4th Cir. 1937).

However, Rev. Rul. 2003-79, 2003-2 C.B. 79, held that the "substantially all" requirement will be satisfied in a "C" reorganization where an unrelated corporation acquires all the assets of a newly formed controlled corporation. The ruling stated the determination of whether an acquiring corporation has acquired substantially all of the properties of a newly formed controlled corporation should be made by reference solely to the properties held by Controlled, rather than by reference to the properties held by Distributing immediately before its formation of Controlled.

Also, a reverse triangular merger may instead be structured as a "backwards B" reorganization, provided that (1) only voting stock of P will be issued in the merger, (2) P acquires 80% or more of Distributing, and (3) the acquisition subsidiary is a transitory entity. See Rev. Rul. 67-448, 1967-2 C.B. 144. Because there is no "substantially all" requirement in a "B" reorganization, such a structure should be viable.

b. Example 14 -- Morris Trust Transaction / Business Purpose / Preexisting Subsidiary



- (1) Facts: Ten individuals (A . . . J) own all of the stock of Distributing. Distributing conducts two qualifying five-year businesses, Business 1 and Business 2. Business 1 is conducted by a preexisting subsidiary, S. P, a public corporation, wants to acquire Business 1, but not Business 2. P is willing to issue 10% of its outstanding stock in exchange for Business 1. Distributing's shareholders are willing to dispose of Business 1 for P stock. Thus, the facts are identical to the Morris Trust structure described in Example 13, except that the wanted business is conducted indirectly by a subsidiary of Distributing rather than directly.

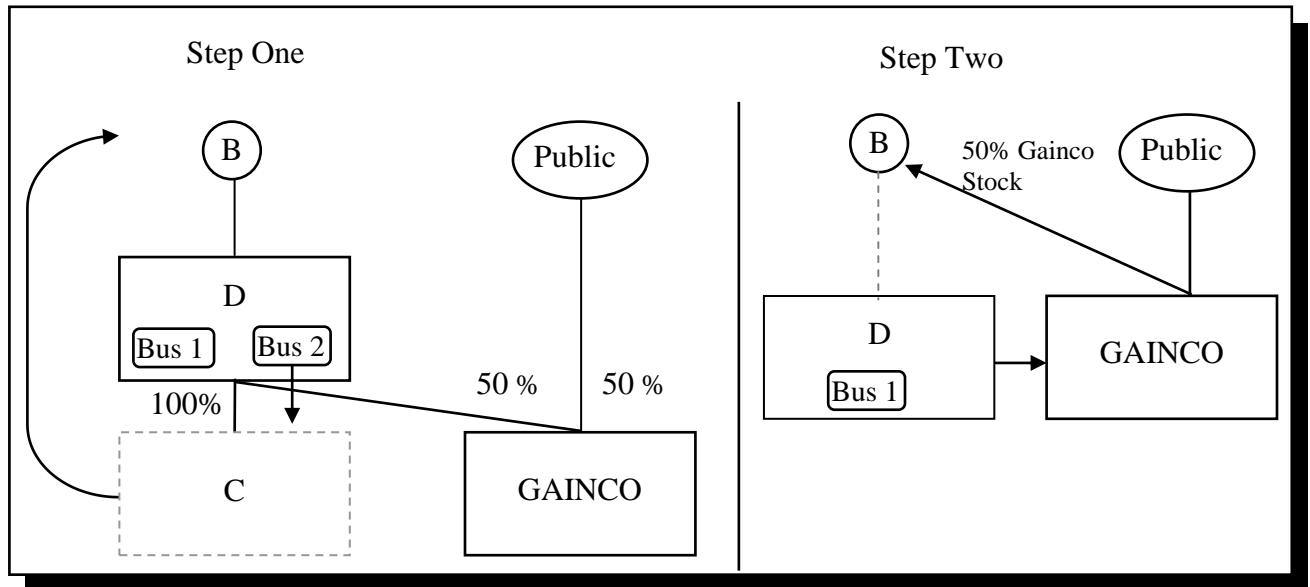
The parties agree on the following transaction, which takes place one month later: (i) Distributing will contribute Business 2 to a newly formed subsidiary, Controlled; (ii) Distributing will distribute the stock of Controlled to its shareholders pro rata; (iii) Distributing will merge into P, and the Distributing shareholders will transfer their Distributing stock to P in exchange for P voting stock.

- (2) It is questionable whether the business purpose requirement would be satisfied in this case. P could have achieved the same result by acquiring the stock of S in exchange for P stock. However, if P is a public corporation, it may argue

that it does not want a significant block of its stock held by Distributing.

- (3) Nonetheless, as in Example 13, section 355(e) would apply to impose a corporate-level tax on Distributing.

c. Example 15 -- McCaw Cellular / Petrie Stores



- (1) Facts: In addition to conducting two qualifying five-year businesses, Distributing owns 50% of GainCo. The stock of GainCo has appreciated substantially in Distributing's hands. Distributing would like to sell the GainCo stock and distribute the proceeds to its shareholder, but with only one level of tax. It is decided that Distributing should merge downstream into GainCo, but that first Business 2 should be distributed to the Distributing shareholders.

This structure was used in the merger of Affiliated Publications into McCaw Cellular, following the spin-off of the Boston Globe. See P.L.R. 8921065 (Feb. 28, 1989) (supplemented by P.L.R. 8933038) (May 23, 1989)). A similar downstream merger was used to dispose of appreciated Toys-R-Us stock held by Petrie Stores. See P.L.R. 9506036 (Nov. 15, 1994).

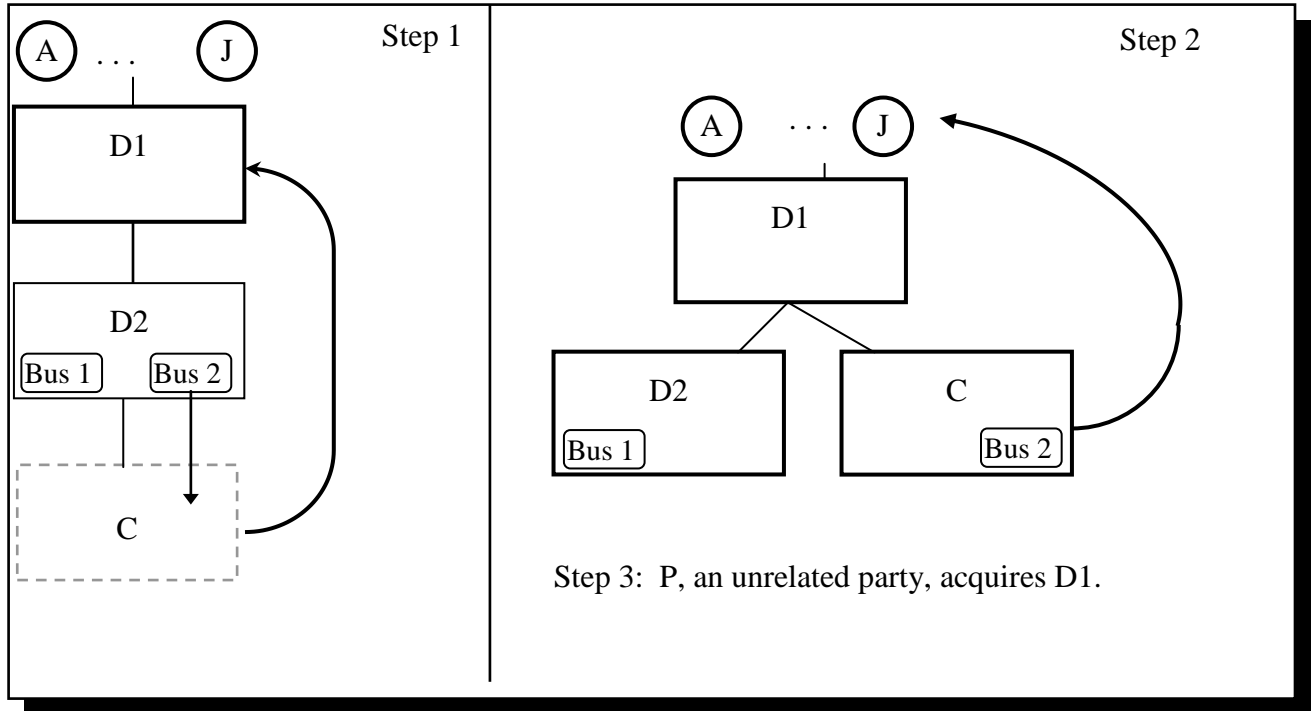
- (2) If the business retained by Distributing (Business 1) is small compared to the business distributed to the shareholders (Business 2) and the value of the GainCo stock received, this transaction has much the same effect as

a distribution of the appreciated GainCo stock to the shareholders of Distributing. However, by structuring the transaction as a merger, GainCo stock may be disposed of without recognizing any corporate-level tax.

- a) A downstream merger is economically similar to a liquidation. Nevertheless, the Service has ruled that taxpayers may choose the form of their transaction, and that the tax consequences will be governed by which form is chosen. Rev. Rul. 70-223, 1970-1 C.B. 79; T.A.M. 8936003 (June 7, 1989).
 - b) In P.L.R. 9104009 (Oct. 24, 1990), the Service reached this same conclusion, but indicated that the issue was being studied in connection with regulations under section 337(d), and that a different result might be reached in the future in order to avoid the circumvention of the General Utilities repeal.
 - c) Subsequently, in Rev. Proc. 94-76, 1994-2 C.B. 825, the Service announced it was studying downstream mergers. However, the Service later announced that this study has been abandoned. See Notice 96-6, 1996-1 C.B. 358.
- (3) Provided a downstream merger is respected as such, the distribution should qualify under section 355. This result is possible, because the taxpayer may choose to structure the transaction as a distribution of Business 2 rather than a distribution of Business 1 -- i.e., a smaller business may spin off a much larger business. Even under the Service's pronouncements discussed in Part III.B.4. above (which suggest that the Service may reorder transactions under the step-transaction doctrine), this distribution should qualify under section 355. There is no requirement that the recipient shareholders have control of Distributing before or after the distribution. There also appears to be no authority to recharacterize the transaction as a spin-off of Business 1 rather than Business 2 based on the relative sizes of the businesses.
- (4) Arguably, however, the continuity of business enterprise requirement may not be satisfied with respect to the merger if the sole asset of Distributing is portfolio stock.

- (5) Nonetheless, the disposition of a 50% interest in Distributing as part of the same plan as the spin-off will trigger section 355(e). Thus, Distributing will recognize gain as if it sold Controlled.

d. Example 16 -- Intragroup Spinoff

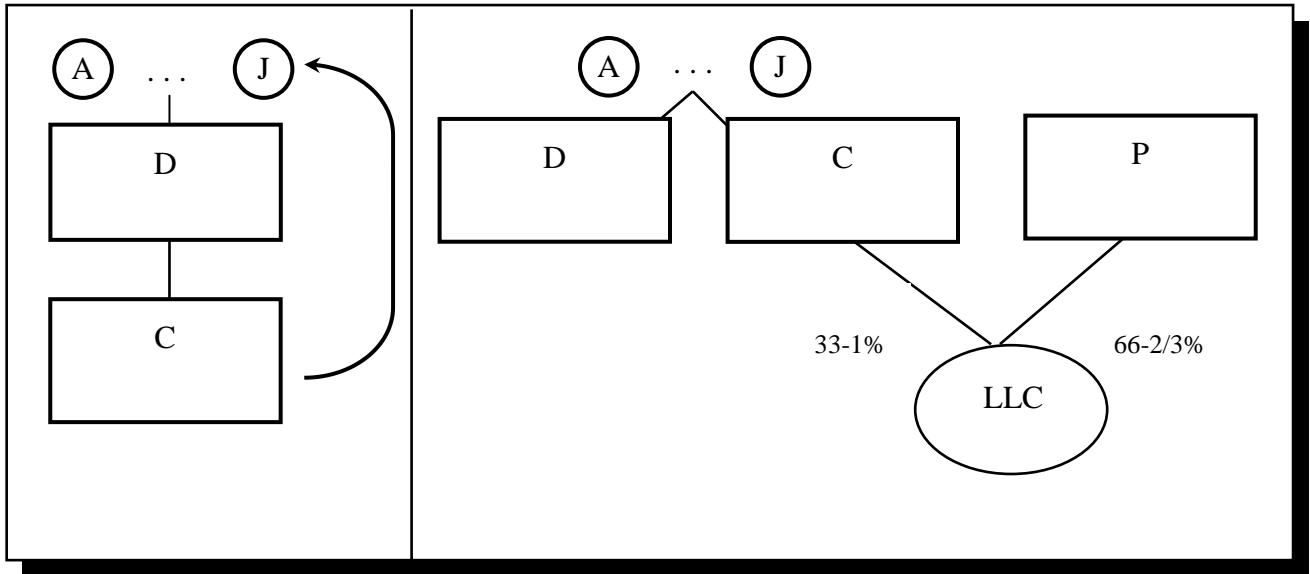


- (1) Facts: Ten individuals (A . . . J) own all of the stock of D1. D1 owns all of the stock of D2. D2 conducts two qualifying five-year businesses, Business 1 and Business 2. The parties want to separate Business 2 from Business 1 for business reasons, and sell D1. The parties agree on the following transaction: (i) D2 will contribute Business 2 to a newly formed subsidiary, C; (ii) D2 will distribute the stock of C to D1, its sole shareholder; (iii) D1 will distribute the stock of C to its shareholders pro rata, (iv) P, an unrelated party, will then acquire D1.
- (2) Issues:
- a) Under pre-TRA 1997 law, this transaction would be tax free to D1, D2, C, and A . . . J.
 - b) However, under section 355(f), section 355 will not apply to intragroup spin-offs if section 355(e)

applies. Because section 355(e) applies to D1's distribution of C, section 355(f) will apply to D2's distribution of C.

- i) Thus, D2 will recognize deferred intercompany gain as if it had sold C stock on the date of the distribution (and such gain will be triggered into income upon the spin of C outside the group).
 - ii) Moreover, D1 will receive a taxable dividend, which will be eliminated under Reg. § 1.1502-13(f).
 - iii) D1 will receive a fair market value basis in the C stock.
 - iv) D1's basis in its D2 stock will increase by the amount of the gain recognized and decrease by the fair market value of the stock of C.
- c) Furthermore, D1 will recognize gain as if D1 had sold its C stock on the date of the distribution, as a result of section 355(e). The amount of gain should only be the amount of gain accrued on D1's C stock while it held C directly.
- d) The total amount of tax would be the same if, instead of acquiring D1, P acquired C.
- e) Variation on Example: Assume that D2 distributed C to D1, D1 distributed D2 to A...J, and P acquired D1. If P's shareholders own 50% or more of the stock of the new merged corporation, D2 will again recognize deferred intercompany gain as if it had sold C stock on the date of the distribution, under recognize gain as if D1 sold its D2 stock on the date of the distribution, under section 355(e). See H.R. Rep. No. 105-220, at 534 (1997) (Conf. Rep.).

e. Example 17 – Using LLCs to Avoid Section 355(e)



(1) Facts: P substantially negotiates with D to acquire C. D C, in a tax-free spin-off pursuant to section 355. Six months later, C agrees instead to a transaction wherein it drops its assets into a newly formed LLC in exchange for 33-1/3% of the LLC membership interests, and P drops some of its assets into the LLC in exchange for 66-2/3% of the membership interests.

(2) Issues:

a) Does this transaction qualify as a tax-free spin-off under section 355?

i) Section 355(b)(1)(A) requires that D and C be engaged immediately after the distribution in the active conduct of a trade or business. Because C has transferred all of its assets (and employees) to LLC in exchange for a 33 1/3% interest, it will not be directly engaged in the conduct of an active trade or business. However, C's ownership of LLC may qualify as the conduct of an active trade or business if C's interest is significant or it can establish that, through its officers, it performs active and substantial management functions for LLC.

Rev. Rul. 2007-42, 2007-2 C.B. 44; Rev. Rul. 92-17, 1992-1 C.B. 142.

- ii) As discussed above in Part III.H., the regulations under section 355 also contain a continuity of business enterprise (“COBE”) requirement. Reg. § 1.355-1(b). The preamble to the final COBE regulations (Reg. § 1.368-1(d)) acknowledge that the proposed regulations did not extend to transactions qualifying under section 355 and note that “[t]he COBE provisions in the final regulations apply to all reorganizations for which COBE is relevant.” If the COBE regulations apply to section 355 transactions, then C will be treated as conducting the business of LLC, and thus, the COBE requirement will be met, because C owns a “significant interest” in LLC. See Reg. § 1.368-1(d)(4)(iii)(B), -1(d)(5), Ex. 9.

- b) Does the transfer of C’s assets to LLC avoid the application of section 355(e)?
 - i) If P had acquired the stock of C in a tax-free reorganization, then D would be required to recognize corporate-level gain under section 355(e).

 - ii) In Example 17, however, P is not acquiring a 50% or greater interest in C. Rather, P acquires a 66-2/3% interest in an LLC that owns the assets previously held by C. It is not clear how the Service will treat these transactions, although representatives have informally indicated that they are looking closely at the issue. See Sheryl Stratton, Corporate Regs Highlighted, 2000 TNT 40-4 (Feb. 28, 2000).
 - (a) Arguably, the regulations that define plan result in the acquisition being treated as part of a plan because it is “similar” to the acquisition negotiated between P and D.

- (b) An acquisition is similar if the actual acquisition combines all or a significant portion of the same business operations as the potential acquisition, and the ultimate owners of the business operations are substantially the same. Reg. § 1.355-7(h)(8).
 - (c) Is P's acquisition of LLC "similar" to the acquisition of C originally negotiated? Does it matter what portion of P's assets were contributed to the LLC? Does it matter whether P originally negotiated an acquisition of C's asset or stock? What if P acquires less than 50% of the LLC interests?
- iii) Even if the acquisition is similar and, therefore, part of a plan pursuant to the temporary regulations, it may not constitute an acquisition within the meaning of section 355(e). Section 355(e)(3)(B) treats certain asset acquisitions (i.e., "A," "C," or "D" reorganizations) as stock acquisitions. Section 721 transactions are not mentioned, but the statute gives the Service the authority to specify other transactions in regulations.

IV. PLANNING TRANSACTIONS/ALTERNATIVES TO SPIN-OFFS

A. "Synthetic" Spin-Offs

A synthetic spin-off derives its name from the fact that while it is, in effect, a spin-off, it is achieved not under section 355 but under section 351.

1. A synthetic spin-off envisages Distributing, in exchange for assets, receiving from Controlled various types of preferred stock (having for example, the right to elect 20% of the board) and "exchange rights" giving the right to exchange Distributing stock for Controlled stock. Distributing retains the preferred stock but distributes the exchange rights to its shareholders who then exchange some of their stock in Distributing for that of Controlled.

2. This structure was used in a transaction involving Tele-Communications, Inc. ("TCI") and its newly formed controlled corporation, Liberty Media Corporation ("LMC"), to which TCI had contributed its programming interests. TCI received several classes of preferred stock, one of which represented a 20% voting interest in LMC (by retaining a 20% voting interest, TCI was entitled to an 80% dividends-received deduction on receipt of dividends from LMC as opposed to the 70% corporate dividends-received deduction for lesser interests) as well as exchange rights, which it distributed to TCI shareholders.

a. The receipt of the exchange rights by Distributing would either be treated as a tax-free stock dividend under section 305(a), or as boot under section 351(b). If the rights are boot, any gain would be minimal because of the negligible value of the exchange rights.

(1) Note: TRA 1997 added section 351(g) to the Code, which states that "nonqualified preferred stock" will be treated as boot for purposes of sections 351, 354, 355, 356, and 368.

(2) Nonqualified preferred stock is generally preferred stock for which (1) the holder has the right to require the issuer to redeem or purchase the stock, (2) the issuer is required to redeem or purchase the stock, (3) the issuer has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part with reference to interest rates, commodity prices, or other similar indices.

(3) If the preferred stock in the above facts constitutes nonqualified preferred stock, the transfer of assets to Controlled in exchange for the preferred stock and exchange rights may not be fully tax free under section 351. See section 351(g)(1).

b. The distribution of the exchange rights to Distributing's shareholders would constitute a distribution under section 301. If the receipt of exchange rights by Distributing were treated as a section 305 distribution, Distributing would have to recognize gain on distribution of the exchange rights under section 311(b) to the extent that the fair market value exceeds the basis. If receipt of the exchange rights were previously treated as boot, there would be no gain, because Distributing would have a fair market value basis in the exchange rights.

- c. Shareholders receiving the exchange rights would have ordinary income equal to the fair market value of the rights (to the extent of Distributing's earnings and profits).
- d. The exchange by the Distributing shareholders of their Distributing stock for Controlled stock should constitute a tax-free section 351 transaction (as it is part of the overall plan in which Distributing transfers assets to Controlled).
- e. If Controlled subsequently redeems the preferred stock held by Distributing, it would presumably be treated as a dividend under section 302.
 - (1) Prior to TRA 1997, Distributing would be entitled to an 80% dividends-received deduction.
 - (2) TRA 1997 amended section 1059, however, to provide that a corporate shareholder must recognize gain with respect to any redemption treated as a dividend when the nontaxed portion of the dividend exceeds the basis of the shares surrendered. Section 1059(e)(1)(A)(iii).

B. Subsidiary Tracking Stock

- 1. Individual A owns all of the stock of T. T owns all of the stock of T-1. T has a value of \$200, \$80 of which is attributable to T-1. Parent is interested in T-1, but not T. Parent buys 40% of the T stock for \$80.
- 2. An immediate distribution of the T-1 stock does not qualify under section 355 because historic continuity of interest is not satisfied.
- 3. Suppose Parent cannot wait until its interest in T becomes "old and cold" before the distribution of T-1 stock is made.
 - a. Parent can benefit from T-1's financial performance if it exchanges its T stock for another class of T stock that pays dividends based on T-1's earnings.
 - b. Once Parent's subsidiary tracking stock becomes "old and cold," Parent can exchange such stock for the actual T-1 stock. In the interim, Parent will have participated solely in T-1's earnings.
 - c. As an alternative to the above structure, Parent could have acquired its subsidiary tracking stock directly from T and then had such stock redeemed when its interest in T became "old and cold."
- 4. USX Corporation has issued tracking stock, which (unlike most tracking stock) also provided that liquidating distributions were tied to the value of

the tracked assets at the time of liquidation. The voting power of the tracking stock was tied to the relative fair market value of the tracked assets and thus changed from time to time.

This raises the issue of whether tying the tracking stock so closely to the tracked assets results in the tracking stock being considered stock of a separate corporation rather than that of the issuer (thus meaning that any transaction must qualify independently under section 355)

5. It should be noted that if more than 50% of the stock of T-1 is acquired as a result of the redemption of tracking stock then section 355(d) will apply regardless of the period of time between the acquisition of the T stock and the exchange for T-1 stock (section 355(d)(6)(B)).
6. If the parent later wants to distribute the tracked subsidiary to the holders of the tracking stock, such distribution may be accomplished as a tax-free split-off under section 355. AT&T obtained a favorable ruling on the split-off of its tracked subsidiary, Liberty Media Corporation. See also P.L.R. 9822037 (Feb. 27, 1998).

C. Dividend Followed by Public Offering

1. Corporation Parent owns all of the stock of S. Parent and S do not file a consolidated return. The value of S is \$500, Parent's basis in its S stock is \$100, and S has earnings and profits in excess of \$400.
2. P wants to sell its S stock, but does not want to recognize any gain.
3. P causes S to declare \$400 dividend payable with a \$400 promissory note.
4. P then causes S to make a public offering of its stock, the proceeds of which would be used to retire the note and possibly to redeem P's stock in S.
5. If the form of the transaction is respected, P may claim a deduction for 100% of the \$400 dividend under section 243(a)(3), and will recognize no gain on the sale or redemption of its stock (the basis of \$100 will be equal to the stock's fair market value). Litton Industries v. Commissioner, 89 T.C. 1086 (1987).
6. If, however, the public offering is arranged prior to the issuance of the dividend (or if the steps may be linked together into an integrated transaction through some other means), the payment of the dividend may be disregarded and the \$400 may be treated as part of the purchase price of the stock. This would result in P's recognizing the full \$400 gain inherent in the S stock. Waterman S.S. Co. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970).

7. The transaction would have to be carefully analyzed to determine whether section 1059 applies to reduce P's basis in S by the amount of the dividend prior to the distribution.

D. Option to Purchase Corporate Assets

1. Corporation P is planning to expand its operations into a new field, and for this purpose is going to form a new, wholly owned subsidiary, S, with a capital contribution of \$100 (S will issue 100 shares of stock).
2. Immediately after the formation of S, P distributes to its shareholders a fully assignable and transferable right to purchase S stock for \$1 per share, exercisable in, for example, 10 years.
3. The distribution will constitute a taxable dividend under section 301.
 - a. P will argue that the value of this right should not be significant, since the strike price is equal to the current value of the S stock.
 - b. However, there is presumably some value to the right, because it allows a holder to share in the appreciation of the S stock without risking any of his own capital. It would be advisable for P to obtain an independent appraisal of the value of the right prior to undertaking this course of action.
 - c. Were the right not to be assignable and transferable independently of the P stock, the Service might argue that no distribution was made at the time the rights were originally issued; rather a distribution would be made at the time the rights became exercisable. Compare Rev. Rul. 80-292, 1980-2 C.B. 104 with Palmer v. Commissioner, 302 U.S. 63 (1937).
4. If, after 10 years, the stock of S has, as desired, significantly appreciated, P's shareholders can exercise their options to purchase S stock at \$1 per share. No tax should result to P, since P's amount realized will equal its basis in the stock of S. Nor should any tax result to P's shareholders, since the exercise of an option simply results in adding the basis of the option to the cost basis of the property purchased under the option. Rev. Rul. 70-521, 1970-2 C.B. 72.

E. Transaction to Thwart Hostile Takeovers

1. Publicly held corporation T has one wholly owned subsidiary, T-1. In an effort to stave off the potential for a hostile takeover, the board of directors of T has adopted a resolution that if a hostile party acquires 20% of its stock, then it will distribute the stock of T-1 to its shareholders. The grant of this right should not be a taxable distribution. See Rev. Rul. 90-11, 1990-1 C.B. (1990).

2. The spin-off of T-1 prior to the acquisition of T may not qualify as a section 355 transaction, because the continuity of interest requirement may not be satisfied. If that is the case, the distribution will be taxable to T under section 311(b) and taxable to T's shareholders as a dividend. This tax cost may effectively thwart the hostile takeover.
3. However, the hostile nature of the takeover may be considered to be an independent event and thus continuity may be considered to be satisfied. See Rev. Rul. 75-406, 1975-2 C.B. 125.
4. Nevertheless, a successful hostile takeover may result in corporate-level tax under section 355(e). See Part III.J., supra.

V. **REQUESTING A PRIVATE LETTER RULING UNDER SECTION 355**

A. In General. General rules governing requests for letter rulings are contained in Rev. Proc. 2014-1, 2014-1 I.R.B. 1. Requests should be directed to CC:PA:LPD:DRU, the Docket, Records, and User Fee Unit of the IRS Office of Chief Counsel. Rev. Proc. 2014-1, § 7.03. The filing fee for a request under section 355 generally is \$19,000. Rev. Proc 2014-1, App. A. The request must be accompanied by a declaration, signed by the taxpayer (or in the case of a corporation, a corporate officer) under penalties of perjury, attesting to the accuracy of the facts contained in the ruling request. Rev. Proc. 2014-1, § 7.01(15).

1. Allowed Letter Rulings. Under Rev. Proc. 2013-32, the Service will not rule generally on whether a transaction qualifies under section 355, or whether the transaction is a reorganization within the meaning of section 368. The Service will only rule on significant issues presented in such transactions. A significant issue is defined as an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction. Taxpayers are encouraged to call the office of Chief Counsel to discuss whether the Service will rule on the issue that the taxpayer is addressing.

B. Checklist. Rev. Proc. 96-30, 1996-1 C.B. 696, provides a list of items that must be included in a request for a letter ruling under section 355.

Under Rev. Proc. 96-30, a taxpayer's request must provide detailed information regarding both Distributing and Controlled, including: the stock ownership of the corporations; five years of financial data for each corporation (on a pro forma basis if Controlled is newly formed); the number of employees used in each trade or business for the preceding five years; the history of any acquisitions or dispositions of trades or businesses; a description of any assets held that are not used in a trade or business; and a detailed description of the business purpose for the transaction (to the extent the spin-off is prompted by a request or advice from a third party, it is advisable to include documentation from such third party). Rev.

Proc. 96-30 and the list of items were modified and amplified in Rev. Proc. 2003-48, 2003-2 C.B. 86. Rev. Proc. 2003-48 establishes a one-year pilot program under which the national office will not determine whether a proposed or completed distribution of Controlled's stock is being carried out for one or more corporate business purposes, whether the transaction is used principally as a device, or whether the distribution and an acquisition are part of a plan under section 355(e). Rev. Proc. 2003-48 requires taxpayers to submit representations regarding the business purpose and device requirements and whether there is a plan under section 355(e). Rev. Proc. 2003-48 also requires the taxpayer to describe in narrative form each corporate business purpose for the distribution of the stock of Controlled. The taxpayer is instructed not to provide any documentation or substantiation in support of the narrative. This pilot program applies to ruling requests postmarked or, if not mailed, received after August 8, 2003. Rev. Proc. 2003-48 stated that the pilot program is intended to operate for at least for at least a year, after which the Service may consider further changes, including ruling only on significant issues. However, representatives of the Service have indicated informally that unless it hears otherwise from taxpayers, it plans to continue this practice indefinitely.

- C. Request for Expedited Ruling. Rev. Proc. 2014-1 provides procedures for taxpayers to request expedited consideration of ruling requests under section 355. Rev. Proc. 2014-1, § 7.02(4).
- D. Change in Facts. Frequently changes occur in the facts described in a ruling request between the date of submission and the time that the ruling is issued or the transaction occurs. A question arises in such circumstances as to whether the taxpayer should update or supplement the ruling request.
 - 1. Although a ruling request is signed by the taxpayer under penalties of perjury, neither the regulations nor Rev. Proc. 2014-1 requires the taxpayer to supplement the request if facts subsequently change.
 - 2. However, under Rev. Proc. 2014-1, § 11.05 a ruling may be revoked retroactively, even if relied upon by the taxpayer, if
 - a. There has been a misstatement or omission of material fact;
 - b. The facts at the time of the transaction are materially different from the facts on which the letter ruling was based; or
 - c. The facts change during the course of the transaction.
 - 3. There is little clear guidance as to what represents a "material" fact for these purposes. Cases tend to reach conclusory opinions as to what is material. See, e.g., Boggs v. Commissioner, 784 F.2d 1166, 1171 (4th Cir. 1986); Wisconsin Nipple & Fabricating Corp. v. Commissioner, 67 T.C. 490, 497 (1976). If one would reasonably conclude that a change in facts would cause a change in the analysis of the transaction, then that change in

facts is likely to be “material,” and it would be prudent to supplement a ruling request.

4. Rev. Proc. 2003-48 also provides that the Service will no longer issue supplemental letter rulings, unless the request presents a significant issue. A change in circumstances arising after the transaction ordinarily does not present a significant issue. See Rev. Rul. 2003-55.

APPENDIX A

Requirements for Business Purpose Listed under Rev. Proc. 96-30¹⁴

1. Key Employees.

- The transfer of Distributing or Controlled stock to the employee will accomplish a “real and substantial purpose germane to the business” of Distributing, Controlled, or the affiliated group to which Distributing belongs. Among other things, the taxpayer must explain why the individual is considered a key employee, and why it is necessary to give the individual an equity interest of the type and amount proposed in the transaction.
- Generally within one year of the distribution, the employee must receive a “significant amount” of stock, unless this would be prohibitively expensive for the employee. In the past, the Service has been willing to issue rulings when the stock to be issued will constitute as little as 2% of the outstanding stock of a publicly traded company. However, the Service will only take into account stock that is to be purchased by the employee for this purpose and not options or other rights to purchase stock in the future.
- The taxpayer must demonstrate that the purpose cannot be accomplished by an alternative nontaxable transaction that does not involve the distribution of Controlled stock and which is neither impractical nor unduly expensive. Where the taxpayer contends that a transaction involving a distribution will provide the employee with voting power representing a meaningful voice in the governance of the employer’s business that is not available through an alternative transaction, the Service will consider such cases on a case-by-case basis, taking into account factors such as the distribution of voting power among the shareholders, family relationships, and competing economic interests.
- The same principles that apply to key employees also apply if the asserted business purpose is to transfer Distributing or Controlled stock to an ESOP. For purposes of this analysis, the ESOP is treated as a group of key employees.

¹⁴ Note that Rev. Proc. 2003-48 establishes a one-year pilot program (which has been extended indefinitely) under which the national office will not determine whether a proposed or completed distribution of Controlled’s stock is being carried out for one or more corporate business purposes.

2. Raising Capital Through Stock Offering.

- The issuing corporation needs to raise a substantial amount of capital in the near future;
- The stock offering will raise significantly more funds per share if Distributing and Controlled are separated. The taxpayer ordinarily must submit substantiation in the form of opinions by professionals such as investment bankers. However, the Service will generally acknowledge (without extensive substantiation) that an offering of publicly traded stock by a widely held corporation with no significant shareholders will raise more funds per share than an offering by the same corporation in the position of a controlled subsidiary;
- The funds raised in the stock offering will, under all circumstances, be used for the business needs of Distributing or Controlled;
- The offering must be completed within one year of the distribution.

3. Raising Capital Through Debt Offering or Borrowing.

- The issuing (or borrowing) corporation needs to raise a substantial amount of capital in the near future;
- The debt offering (or borrowing) will raise significantly more funds if Distributing and Controlled are separated.
- The taxpayer ordinarily must submit substantiation in the form of opinions by professionals such as investment bankers.
- The funds raised will, under all circumstances, be used for the business needs of Distributing or Controlled;
- The offering (or borrowing) must be completed within one year of the distribution.

4. Cost savings.

- The taxpayer must demonstrate to the satisfaction of the Service that the distribution will produce “significant” cost savings.
- Cost savings generally are “significant” if savings for the three-year period following the distribution will exceed 1% of the affiliated group’s net income for the three-year period preceding the distribution.
- Ordinarily, the taxpayer’s submission should include analysis by qualified persons (for example, by the taxpayer’s insurer for insurance savings, an

investment banker for lower borrowing costs, or the taxpayer's employees). The analysis must explain the savings and why the savings cannot be achieved through another nontaxable transaction.

5. Fit and Focus.

- If Distributing is not publicly traded -- or is publicly traded, but has a significant shareholder (i.e., 5% shareholder who actively participates in management or operations) -- in the past, the Service ordinarily has not ruled unless the distribution (a) is non-pro rata or (b) effects an internal restructuring within an affiliated group.
- The taxpayer must submit documentation describing in detail the problems associated with the current corporate structure and demonstrate why the distribution will lessen or eliminate these problems. However, in the case of a non-pro rata distribution made to enable a significant shareholder or shareholder group to concentrate on a particular business, the Service in the past has not ordinarily required third-party documentation or detailed studies.
- The Service will closely scrutinize situations involving (1) any continuing relationship between Distributing and Controlled, (2) except for cases involving an internal restructuring of an affiliated group, any continuing cross ownership of Distributing and Controlled, (3) any internal restructuring where the distributee would not otherwise be entitled to a 100% dividends-received deduction.

6. Competition.

- Ordinarily, the taxpayer must demonstrate to the satisfaction of the Service that:
 - One or more customers or suppliers have significantly reduced (or will significantly reduce) their purchases from, or sales to, Distributing or Controlled because of the competing business;
 - Because of the distribution, these customers or suppliers will significantly increase (or will not implement a planned significant reduction in) their purchases from, or sales to, Distributing or Controlled after the distribution;
 - These customers or suppliers do not object to the Distributing shareholders' ownership of stock of Controlled after the distribution; and

- Sales to these customers, or purchases from these suppliers, will represent a meaningful amount of sales or purchases by Distributing or Controlled after the distribution.
- In most cases, corroboration from customers or suppliers will be necessary.

7. Facilitating an acquisition “of” Distributing.

- To establish that a corporate business purpose for the distribution is to tailor Distributing’s assets to facilitate a subsequent tax-free acquisition of Distributing by another corporation, ordinarily, the taxpayer must demonstrate to the satisfaction of the Service that:
 - The acquisition will not be completed unless Distributing and Controlled are separated;
 - The acquisition cannot be accomplished by an alternative nontaxable transaction that does not involve the distribution of Controlled stock and is neither impractical nor unduly expensive;
 - The acquiring corporation is not related to Distributing or Controlled; and
 - The acquisition will be completed within one year of the distribution.

8. Facilitating an acquisition “by” Distributing or Controlled.

- The taxpayer must demonstrate to the satisfaction of the Service that:
 - The combination of the target corporation with Distributing or Controlled will not be undertaken unless Distributing and Controlled are separated;
 - The acquisition cannot be accomplished by an alternative nontaxable transaction that does not involve the distribution of Controlled stock and is neither impractical nor unduly expensive;
 - The target corporation is not related to Distributing or Controlled; and
 - The acquisition will be completed within one year of the distribution.

9 Risk Reduction.

- The Service will consider the nature and magnitude of the risks faced by the risky business. The taxpayer must submit information regarding the claims history of the risky business, or of the typical risk experience of similar businesses in that industry.
- The Service will consider whether the assets and insurance associated with the risky business are sufficient to meet reasonably expected claims arising from the conduct of the risky business. The taxpayer must submit the book value and approximate fair market value of the net assets, including intangibles, of the risky business and describe any other factors, such as liabilities that are not included on the taxpayer's balance sheet, that affect the value of the net assets of the risky business. Facts regarding the cost and availability of insurance generally require third-party substantiation.
- The Service will consider whether, under applicable law, (1) the distribution will significantly enhance the protection of the other businesses from the risks of the risky business, and (2) an alternative nontaxable transaction that does not involve the distribution of Controlled stock and is neither impractical nor unduly expensive would provide similar protection.
- The taxpayer must include an analysis of the law and the application of the law to the relevant facts of the proposed transaction. It is not necessary for the taxpayer to establish conclusively that, under applicable law, the proposed transaction will afford adequate protection or that an alternative transaction would not afford adequate protection. Nevertheless, the taxpayer must convince the Service that, based on objective analysis of the law and its application to the facts, risk reduction is a real and substantial purpose for the transaction.