CHAPTER 10

CORPORATE DIVISIONS

A. INTRODUCTION

1. TYPES OF CORPORATE DIVISIONS

Code: Skim §§ 355; 368(a)(1)(D), (c).

The preceding chapter examined acquisitive reorganizations. We now turn to a variety of transactions in which a single corporate enterprise is divided into two or more separate corporations. Section 355 allows a corporation to make a tax-free distribution to its shareholders of stock and securities in one or more controlled subsidiaries. If an intricate set of statutory and judicial requirements are met, neither the distributing corporation nor its shareholders recognize gain or loss on the distribution. Section 355 also unlocks the gate to other provisions which govern the treatment and characterization of boot, and collateral matters such as basis, holding period and carryover of tax attributes.[1] The rationale for nonrecognition is that the division of a business conducted under one corporate umbrella into separate corporations is not an appropriate taxable event when no significant assets leave corporate solution and the historic shareholders continue to control all the resulting corporations.

The three types of corporate divisions are commonly known as spin-offs, split-offs and split-ups. To illustrate the elements of these transactions, assume that Alex and Bertha each own 50 percent of the stock of Diverse Corporation ("D"), which for many years has operated a winery and a chicken ranch as separate divisions. For reasons to be elaborated below, the shareholders wish to divide the businesses into two separate corporations on a tax-free basis. The division method they choose will be influenced by their nontax goals. The possibilities are:

(1) *Spin-off.* Assume that to comply with a new state regulation, D is required to operate the chicken ranch and winery as separate corporations. To accomplish the division, D forms a new corporation, Poultry, Inc., contributing the assets of the chicken ranch. It then distributes the stock of Poultry pro rata to Alex and Bertha, who emerge as equal shareholders in each corporation. Because a spin-off involves a distribution of property to shareholders without the surrender of any stock, it resembles a dividend.

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[1] See, e.g., I.R.C. §§ 356; 357; 358; 361; 362; 381; 1223(1) and Section D of this chapter, infra.

(2) *Split-off*. Alex and Bertha desire to part company, with Alex operating the winery and Bertha the chicken ranch. To help them go their separate ways, D again forms a new corporation, Poultry, Inc., contributing the assets of the chicken ranch. D then distributes the stock of Poultry to Bertha in complete redemption of her D stock. Alex becomes the sole shareholder of D, which now owns only the winery, and Bertha is the sole owner of the chicken ranch. If Alex and Bertha did not want to part company, D could have made a pro rata distribution of Poultry stock in redemption of an appropriate amount of D stock. In either situation, a split-off resembles a redemption because the shareholders have surrendered stock of D.

(3) *Split-up*. To comply with a new state regulation, D is required to terminate its corporate existence and divide up its two businesses. The fission is accomplished by D forming Vineyard, Inc. and Poultry, Inc., contributing the winery assets to Vineyard and the chicken ranch assets to Poultry. D then distributes the stock of the two new corporations pro rata to Alex and Bertha in exchange for all their D stock. Because D has distributed all of its assets and dissolved, this transaction resembles a complete liquidation. If the objectives of the parties had been different (e.g., Alex and Bertha wanted to sever their relationship), the transaction could have been effected by distributing the Vineyard stock to Alex and the Poultry stock to Bertha.

As these examples demonstrate, spin-offs, split-offs and split-ups can be classified for tax purposes in two different ways: as a tax-free corporate division or as the taxable transaction that each method resembles. In order to qualify as tax free to the shareholders, the division must satisfy the requirements of Section 355 and its accompanying judicial doctrines. In general, Section 355 allows a corporation with one or more businesses that have been actively conducted for five years or more to make a tax-free distribution of the stock of a controlled subsidiary (or subsidiaries) provided that the transaction is being carried out for a legitimate business purpose and is not being used principally as a device to bail out earnings and profits. In the absence of Section 355, a spin-off likely would be treated as a dividend under Section 301; a split-off would be tested for dividend equivalency under the redemption rules in Section 302; and a split-up would be treated as a complete liquidation under Section 331.

There is one more piece to this introduction to the puzzle. In each of the examples above, Diverse Corporation was required to engage in a preliminary step in order to accomplish its division. Because its two businesses were operated as divisions under one corporate roof rather than as separately incorporated subsidiaries, D had to drop one or more of those businesses into a separate corporate shell before proceeding with the distribution to its shareholders. If that distribution satisfies the tests in Section 355, the initial transfer of assets by D to its new subsidiary (or subsidiaries) will constitute a divisive Type D reorganization.[2] As such, the transfer of assets will be tax free to D under Section 361(a), the assumption of liabilities will be governed by Section 357 and the basis of the transferred assets will carry over to the new subsidiary under Section 362(b).[3] Creation of a new subsidiary, however, is not a condition to qualifying for nonrecognition of gain under Section 355. If its requirements are met, Section 355 applies to distributions of stock of preexisting corporations as well as to new subsidiaries created solely to carry out the division.[4]

2. NONTAX MOTIVES FOR CORPORATE DIVISIONS

Many different strategic and economic considerations can lead a company to the decision that its business should be divided. Some of the more routine motives include resolution of shareholder disputes, insulation of one business from the risks and creditors of another, and compliance with a regulatory decree.

In the world of publicly traded companies, one of the most common motives for a division is the desire to separate the distributing and controlled corporations so they each can devote their attention to a single line of business. In the parlance of Wall Street, focusing the old and new corporations on a single business allows investors to have a "pure play" on a particular industry. For example, a corporation engaged in the transportation, energy and real estate businesses might transfer the latter two businesses to newly formed corporations and then distribute all shares of the new entities to the distributing corporation's shareholders to create three companies, each with a single focus. The theory underlying this maneuver is that a more narrowly focused company will have greater success than a conglomerate by virtue of its ability to devote more energy and attention to the single enterprise. This renewed vigor, so the theory goes, will be derived in part from an increased incentive for corporate managers to perform. Because their performance (or at least the perception of their performance) will be reflected more directly in the stock value of a narrowly focused company than in the stock value of a conglomerate, the managers will be more accountable to shareholders. In addition, proponents of corporate divisions expect the resulting streamlined companies to benefit from the

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2 The initial transaction also would qualify for nonrecognition under Section 351, but Section 368(a)(1)(D) and its accompanying operative provisions generally should take precedence with respect to various collateral tax consequences (e.g., carryover of tax attributes under Section 381) if the transfer of assets is followed by a Section 355 distribution. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 3.19.

3 See Section D of this chapter, infra.

4 I.R.C. § 355(a)(2)(C).

freedom of corporate managers to pursue growth opportunities that they otherwise would feel constrained to pursue.

Another common motive for a corporate division is the desire to increase market recognition of the value of a particular business. Executives of public companies engaged in several lines of business often believe that stock market analysts fail to appreciate the collective value of the corporation's businesses. To overcome this problem, corporate managers often decide to place a particular business in an independent company in the hope that "the market" will recognize the value of that business (and perhaps also the value of the distributing corporation's remaining businesses) more clearly. Increased recognition of value, it is hoped, will attract more capital for both the old and new corporations and increase returns to shareholders. There is evidence to support the view that a corporate division will lead to increased recognition of shareholder value. Certain studies of corporate divisions have concluded that, following an initial period of investor uncertainty, the stocks of both distributing and controlled corporations that have engaged in a spin-off generally outperform the market.[5] This increase in stock value may be attributable in part to the fact that, following a spin-off, distributing and controlled corporations frequently are seen as attractive candidates for a corporate acquisition.

Yet another agenda driving corporate divisions may be an acquiring corporation's need to raise cash to pay down debt incurred in making an acquisition by selling off some of the target's businesses or, conversely, for a potential target to better position itself for an acquisition by shedding businesses that depress its value. Congress's desire to curb deferral of corporate-level tax in connection with these break-up acquisition strategies has contributed to much of the complexity of Section 355.

Alternatives exist to achieve many of the goals of a corporate division. For example, a corporation simply could sell the assets of an unwanted business. Similarly, if the business is conducted through a subsidiary, the parent could sell the subsidiary's stock. Because the selling corporation generally is taxed on the sale and its shareholders are taxed a second time when the sale proceeds are distributed, however, a sale often is not tax efficient. In contrast, the parties to a properly structured spin-off incur no current tax and the distributing corporation might even recoup its investment in a preexisting subsidiary at far less of a tax cost than in a sale. Before the controlled corporation's shares are distributed, the controlled corporation can declare and pay a large

[5] See, e.g., P. Cusatis, J. Miles & R. Woolridge, Restructuring Through Spinoffs: The Stock Market Evidence, 33 J. Financial Economics 293 (1993).

dividend that likely will be eligible for the dividends received deduction provided by Section 243.[6]

Another alternative is for a corporation to issue tracking stock (sometimes referred to as alphabet or letter stock). The issuer pays dividends on tracking stock based on the performance of a particular division or subsidiary. The stock is listed and traded separately from the issuer's other shares, giving the illusion that there are shares outstanding in two distinct corporations. In theory, tracking stock allows for market recognition of the value of a business and provides incentives for corporate managers in the same way as a spin-off, but it allows the issuing corporation to retain control of the business in question. Issuing tracking stock also does not involve the tax cost of a sale of the business. Tracking stock does not offer all the advantages of a spin-off, however, such as the ability to insulate one business from potential liabilities associated with another. It also may give rise to undesirable administrative and political issues, such as the necessity of satisfying two distinct groups of shareholders.

3. HISTORICAL BACKGROUND OF SECTION 355

To better understand the technical requirements for a tax-free corporate division, it is helpful to look back at the historical background of Section 355. The early income tax provisions governing spin-offs were elegantly simple but dangerously naive. Interpreted literally, they permitted a corporation to transfer all or part of its assets to a newly formed subsidiary and then to make a tax-free distribution of the stock of that subsidiary to its shareholders as part of a plan of reorganization.[7] The tax avoidance potential of this blanket exemption from the dividend rules was enormous, and the judiciary swiftly responded by curtailing the use of a spin-off as a bailout device. In Gregory v. Helvering, which follows, the Supreme Court made one of its earliest contributions to the common law of taxation[8] and paved the way toward the enactment of a comprehensive statutory solution to the problem of corporate divisions.

Gregory v. Helvering

Supreme Court of the United States, 1935.
293 U.S. 465, 55 S.Ct. 266.

■ MR. JUSTICE SUTHERLAND delivered the opinion of the Court.

Petitioner in 1928 was the owner of all the stock of United Mortgage Corporation. That corporation held among its assets 1,000 shares of the

[6] See Chapter 4A, supra. The distributing corporation's dividends received deduction will be disallowed if the distributing corporation does not hold the controlled corporation's stock for a sufficient period of time. See I.R.C. § 246(c); Chapter 4F2, supra.

[7] See, e.g., Revenue Act of 1924, P.L. No. 176, § 203(c), 43 Stat. 253, 256.

[8] See Blum, "Motive, Intent, and Purpose in Federal Income Taxation," 34 U. Chi. L. Rev. 485 (1967); Chirelstein, "Learned Hand's Contribution to the Law of Tax Avoidance," 77 Yale L.J. 440 (1968).

Monitor Securities Corporation. For the sole purpose of procuring a transfer of these shares to herself in order to sell them for her individual profit, and, at the same time, diminish the amount of income tax which would result from a direct transfer by way of dividend, she sought to bring about a "reorganization" under § 112(g) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 818, set forth later in this opinion. To that end, she caused the Averill Corporation to be organized under the laws of Delaware on September 18, 1928. Three days later, the United Mortgage Corporation transferred to the Averill Corporation the 1,000 shares of Monitor stock, for which all the shares of the Averill Corporation were issued to the petitioner. On September 24, the Averill Corporation was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to the petitioner. No other business was ever transacted, or intended to be transacted, by that company. Petitioner immediately sold the Monitor shares for $133,333.33. She returned for taxation as capital net gain the sum of $76,007.88, based upon an apportioned cost of $57,325.45. Further details are unnecessary. It is not disputed that if the interposition of the so-called reorganization was ineffective, petitioner became liable for a much larger tax as a result of the transaction.

The Commissioner of Internal Revenue, being of opinion that the reorganization attempted was without substance and must be disregarded, held that petitioner was liable for a tax as though the United corporation had paid her a dividend consisting of the amount realized from the sale of the Monitor shares. In a proceeding before the Board of Tax Appeals, that body rejected the commissioner's view and upheld that of petitioner. 27 B.T.A. 223. Upon a review of the latter decision, the circuit court of appeals sustained the commissioner and reversed the board, holding that there had been no "reorganization" within the meaning of the statute. 69 F. (2d) 809. Petitioner applied to this court for a writ of certiorari, which the government, considering the question one of importance, did not oppose. We granted the writ.

Section 112 of the Revenue Act of 1928 deals with the subject of gain or loss resulting from the sale or exchange of property. Such gain or loss is to be recognized in computing the tax, except as provided in that section. The provisions of the section, so far as they are pertinent to the question here presented, follow:

> "Sec. 112. (g) Distribution of stock on reorganization.—If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized * * * .

> "(i) Definition of reorganization.—As used in this section * * * .
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> "(1) The term 'reorganization' means * * * (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, * * * ."

It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. * * * But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" [§ 112(g)] of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Judgment affirmed.

NOTE

The Board of Tax Appeals was more tolerant in its evaluation of Mrs. Gregory's maneuver. Adopting a strict constructionist approach, the Board reasoned that "[a] statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration."[9] On appeal to the Second Circuit, Judge Learned Hand—in one of his most famous pronouncements on tax avoidance—agreed that "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[10] But he quickly eschewed literalism in favor of the big picture, reasoning that "the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create."[11] The Supreme Court's opinion was a less stylish but equally forceful reaffirmation that the language of the Code must be interpreted in light of its purpose.

Gregory v. Helvering has ramifications that go far beyond corporate divisions. It is one of the earliest articulations of the substance over form and step transaction doctrines and paved the way to the related economic substance doctrine that is now "codified" and accompanied by a steep penalty.[12] However amorphous they may be, those doctrines serve as a brooding omnipresence in the responsible tax advisor's conscience. When the system works properly (not always the reality), they also thwart the schemes of aggressive tax avoiders who rely on a literal interpretation of the Code to wreak havoc with its intended purpose. As we will see later in the chapter, the narrower business purpose doctrine emanating from *Gregory* also survives as one of the major requirements for qualification as a tax-free corporate division.[13]

While *Gregory* was pending, Congress saw the light and repealed the tax-free spin-off provision involved in that case. Curiously, split-ups (and, for a time, split-offs) continued to qualify for nonrecognition if they did not run afoul of the limitations in *Gregory*.[14] Congress ultimately realized, however, that not every spin-off is a bailout device, and in 1951 it enacted the statutory forerunner of Section 355 to remove any impediment to corporate divisions

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9 Gregory v. Commissioner, 27 B.T.A. 223, 225 (1932).

10 Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir.1934).

11 Id.

12 See I.R.C. § 7701(o); 6662(a), (b)(6) & (i); and Chapter 14B, infra.

13 See Section C1 of this chapter, infra.

14 For the history of corporate divisions before the 1954 Code, see Bittker & Eustice, supra note 2, ¶ 11.01.

"undertaken for legitimate business purposes."[15] In general, the new statute granted nonrecognition to spin-offs that were pursuant to a plan of reorganization unless one of the corporate parties to the reorganization did not intend "to continue the active conduct of a trade or business" or "the corporation whose stock is distributed was used principally as a device for the distribution of earnings and profits * * * ."[16] The contours of the present Section 355 thus were being shaped: to qualify as tax free, a spin-off had to be motivated by a genuine business purpose and consist of the separation of one or more active trades or businesses in a transaction that was not being used principally as a bailout device.

With the enactment of Section 355 in the 1954 Code, Congress finally provided a comprehensive statutory scheme governing all three types of corporate divisions.[17] At the same time, the business purpose and continuity of interest doctrines were preserved as independent nonstatutory requirements.

4. OVERVIEW OF SECTION 355

Code: §§ 355(a)–(c); 368(c).

Regulations: § 1.355–1(b).

Before becoming immersed in technical details, it is important to recall the purpose of Section 355. Congress intended to provide tax-free status to corporate divisions serving legitimate business needs. At the same time, it included safeguards to patrol against the bailout of earnings and profits. A more recent Congressional concern has been to prevent taxpayers from using divisions to avoid corporate-level gain on transactions that are more akin to sales than mere changes in form. Most of the statutory and judicial requirements are directed at these broad objectives. But their precise meaning and scope are not always clear, and the waters have been muddied further by piecemeal changes made over the years to address real and perceived abuses.

a. STATUTORY AND JUDICIAL REQUIREMENTS

A corporate division will qualify as tax free to the shareholders and the distributing corporation if it satisfies the requirements discussed below.

Control. One corporation (the "distributing corporation," or "D") must distribute to its shareholders (with respect to their stock) or to security holders (in exchange for their securities) the stock or securities of a corporation that D "controls" immediately before the distribution (the

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15 S. Rep. No. 781, 82d Cong., 1st Sess. (1951), reprinted in 1951–2 C.B. 458, 499.

16 Revenue Act of 1951, ch. 521, § 317(a), 65 Stat. 493, amending Internal Revenue Code of 1939, § 112(b)(11).

17 The statute does not explicitly refer to spin-offs, split-offs and split-ups, but Section 355(a)(2) makes it clear that Section 355 applies to all three forms of corporate divisions. The different forms continue to be significant if the transaction fails the Section 355 tests.

"controlled corporation," or "C").[18] For this purpose, "control" is defined by Section 368(c), which requires ownership of 80 percent of the total combined voting power and 80 percent of the total number of shares of all other classes of stock.

Distribution of All Stock or Securities. D must distribute all the stock or securities of C that it holds or, alternatively, an amount of stock sufficient to constitute "control" within the meaning of Section 368(c).[19] If any stock or securities of C are retained, D also must establish to the satisfaction of the Service that the retention is not pursuant to a plan having tax avoidance as one of its principal purposes.[20]

Active Trade or Business Requirement. Immediately after the distribution, both D and C—or in a split-up, each controlled corporation—must be engaged in, or treated as engaged (through a subsidiary) in, a trade or business that has been actively conducted throughout the five-year period ending on the date of the distribution.[21] That business must not have been acquired within the five-year predistribution period in a transaction in which gain or loss was recognized in whole or in part (e.g., a sale of assets taxable to the seller).[22] Moreover, the distributing corporation must not have purchased a controlling stock interest in a corporation conducting the business in a taxable transaction during the five-year predistribution period.[23] In applying these rules, all members of D's and C's "separated affiliated group" (generally, subsidiaries in which the parent owns 80 percent of the voting power and total value) are treated as one corporation.[24]

Not A "Device." The division must not be used "principally as a device for the distribution" of the earnings and profits of either D or C. The "mere fact" that stock or securities of either corporation are sold after the distribution is not to be considered as evidence of a device unless the sales were pursuant to a prearranged plan.[25]

Judicial Limitations: Business Purpose, Continuity of Interest, and Continuity of Business Enterprise. In addition to the statutory tests, the regulations incorporate three judicially created limitations. Nonrecognition is available only if the distribution is carried out for an independent corporate business purpose[26] and the shareholders prior to

[18] I.R.C. § 355(a)(1)(A).

[19] I.R.C. § 355(a)(1)(D).

[20] I.R.C. § 355(a)(1)(D)(ii). See also Rev. Rul. 75–469, 1975–2 C.B. 126; Rev. Rul. 75–321, 1975–2 C.B. 123.

[21] I.R.C. § 355(a)(1)(C), (b).

[22] I.R.C. § 355(b)(2)(C).

[23] I.R.C. § 355(b)(2)(D). The active trade or business test also will be violated if the distributee shareholder is a corporation that acquired control of the distributing corporation within the five-year predistribution period. Id.

[24] I.R.C. § 355(b)(3). This rule applies to distributions made after May 17, 2006. See Section B of this chapter, infra, for the details and ramifications.

[25] I.R.C. § 355(a)(1)(B).

[26] Reg. § 1.355–2(b).

the division maintain adequate continuity of interest in D and C, and continuity of business enterprise is maintained after the distribution.[27]

All these requirements are applied without regard to the form the parties choose to accomplish the division. Thus, a distribution may qualify as tax-free under Section 355 irrespective of whether it is pro rata and whether or not the distributee shareholder surrenders stock in the distributing corporation or the distribution is preceded by the formation of a new controlled corporation in a Type D reorganization.[28]

This list of basic Section 355 requirements do not tell the entire story. Several other specialized provisions may cause an attempted corporate division to be disqualified[29] or D to recognize gain on its distribution of C stock even though D's shareholders qualify for tax-free treatment.[30]

b. TAXATION OF THE PARTIES

Section 355 provides total shareholder-level nonrecognition only where the distributing corporation distributes stock or securities of a controlled corporation.[31] Stock rights or warrants are not treated as "stock or securities" for this purpose.[32] In the case of a distribution of securities (e.g., long-term notes, bonds, debentures), if the principal amount of securities of the controlled corporation received by the distributee exceeds the principal amount of the distributing corporation's securities surrendered in connection with the distribution, the value of the excess is treated as boot.[33] If securities of the controlled corporation are received and no securities of the parent are surrendered, the entire value of the securities received is treated as boot.[34] In addition, any stock of a controlled corporation acquired in a taxable transaction within the five years preceding the distribution—which we will come to know as "hot stock"—constitutes boot.[35] The distribution of boot does not necessarily disqualify a transaction under Section 355, but it will cause the distributee shareholder to recognize any realized gain, usually as a qualified dividend taxable at preferential capital gains rates, to the

27 Reg. § 1.355–2(c), –1(b).

28 I.R.C. § 355(a)(2).

29 See, e.g., I.R.C. § 355(h), restricting tax-free spin-offs involving real estate investment trusts.

30 See Section E of this chapter, infra.

31 I.R.C. § 355(a)(1). For this purpose, "nonqualified preferred stock," as defined in section 351(g)(2), received in a distribution with respect to stock other than nonqualified preferred stock is not treated as "stock or securities"—i.e., it will be boot. I.R.C. § 355(a)(3)(D).

32 Redding v. Commissioner, 630 F2d 1169 (7th Cir. 1980). For purposes of "boot" characterization, stock rights are treated as "securities," but they are considered to have no principal amount. Reg. § 1.355–1(c).

33 I.R.C. §§ 355(a)(3)(A)(i); 356(d)(2)(C).

34 I.R.C. §§ 355(a)(3)(A)(ii); 356(d)(2)(C).

35 I.R.C. § 355(a)(3)(B). See Edna Louise Dunn Trust v. Commissioner, 86 T.C. 745 (1986).

extent of the boot received.[36] At the corporate level, the distributing corporation generally does not recognize gain on the distribution of stock or securities of its subsidiary but may recognize gain on the distribution of appreciated boot or in certain situations where a divisive transaction is used to facilitate the sale of a subsidiary.[37]

The principal hurdles to achieving nonrecognition under Section 355 are the active trade or business and business purpose requirements and the "device" limitation. The government's interpretation of these tests has evolved over the years and currently is reflected in extensive regulations, which have largely supplanted the case law and are a principal focus of this chapter.

c. ADVANCE RULINGS

Under an IRS pilot program, a taxpayer may request a ruling addressing whether a transaction, as a whole, qualifies under Section 355.[38] In addition, a taxpayer may request a ruling on one or more "significant issues" presented in a Section 355 transaction.[39] An issue generally is "significant" if it is "a germane and specific issue of law," provided that in a ruling "the conclusion . . . otherwise would not be essentially free from doubt."[40] The IRS also has policies on when it will rule on specific issues related to a Section 355 transaction. For example, generally a ruling may not be obtained on whether the distribution of the controlled corporation is being carried out for one or more business purposes or whether the transaction is used principally as a device, unless the issue is a legal issue and not inherently factual in nature.[41] The IRS continues to study its policies on providing rulings in corporate transactions, including those under Section 355. Thus, the expectation should be that the current guidelines may change in the future.[42]

B. THE ACTIVE TRADE OR BUSINESS REQUIREMENT

Code: § 355(a)(1)(C), (b)(1), (2), (3)(A) & (B).

Regulations: § 1.355–3(a)(1)(i), (b)(1)–(3).

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36 I.R.C. §§ 355(a)(4)(A); 356. See Section D of this chapter, infra, for a more detailed explanation of the treatment of boot and the other operative provisions that accompany Section 355.

37 I.R.C. § 355(c), (d).

38 Rev. Proc. 2017–52, 2017–41 I.R.B. 283. The pilot program was initially to expire on March 21, 2019, but it has been extended indefinitely. See IRS Statement on Private Letter Ruling Program Extension, 2019 A.R.D. 052-1 (March 15, 2019).

39 Id. at § 2.02.

40 Rev. Proc. 2019–3, § 3.01(55), 2019–1 I.R.B.130.

41 Id. at § 3.01(58). The IRS also generally will not rule on whether the distribution and an acquisition are part of a plan under Section 355(e). Id. See also, Rev. Proc. 2019–03, supra note 40, §§ 4.01(29)–(31), for additional areas in a Section 355 transaction where a ruling ordinarily will not be issued.

42 See IRS Statement Regarding Private Letter Rulings on Certain Corporate Transactions, 2017 ARD 201-4 (Oct. 16, 2017).

Lockwood's Estate v. Commissioner

United States Court of Appeals, Eighth Circuit, 1965.
350 F.2d 712.

■ VOGEL, CIRCUIT JUDGE.

The single question involved in this review of an unreported decision of the Tax Court of the United States, entered August 26, 1964, is whether the "spin-off" of part of the business conducted by the Lockwood Grader Corporation of Gering, Nebraska, (hereinafter Lockwood) through the organization of a new corporation, Lockwood Graders of Maine, Inc. (hereinafter Maine, Inc.) was tax-free to petitioners, recipients of the stock of Maine, Inc., under 26 U.S.C.A. § 355 (Int.Rev.Code). The government contended that the spin-off was not tax-free since the requirements of § 355(b)(2)(B) relating to the conducting of an active business for five years prior to the date of distribution had not been met. The government apparently conceded and the Tax Court found that the petitioners had met all other requirements to qualify under § 355 for tax-free treatment. The Tax Court upheld the government's contention and petitioners appeal.

The now deceased Thorval J. Lockwood, * * * and his wife Margaret were the sole stockholders of Lockwood and had been so since its incorporation under Nebraska law in 1946. Lockwood's predecessor, Lockwood Graders, was a partnership formed in 1935 for the purpose of producing and selling a portable potato sorting machine invented by the decedent. Starting in the early spring of each year Thorval and Margaret drove to Alabama and worked their way north through Missouri to North Dakota for the purpose of selling Lockwood products. The equipment was sold in "all of the potato growing areas of the United States" but primarily in the biggest growing areas such as North Dakota, Idaho and Colorado.

From 1946 to 1951, inclusive, Lockwood operated its business of manufacturing and selling wash lines, potato machinery, parts and supplies to potato shippers in the potato growing areas. Though Lockwood continued to have its principal place of business at Gering, Nebraska, branches were opened, as the business expanded, in Grand Forks, North Dakota; Antigo, Wisconsin; Monte Vista, Colorado; and Rupert, Idaho. These branches performed both manufacturing and sales functions. In 1952, under a reorganization plan, these branches were separately incorporated to promote greater efficiency and to properly provide for expansion. Assets of Lockwood were exchanged for all of the stock of each new corporation and the stock so exchanged was passed without consideration to Thorval and Margaret as sole stockholders of Lockwood. The reorganization plan, among other things, was specifically designed to make use of the tax-free provisions of what is now § 355.

In the early 1950's Lockwood and the other controlled corporations changed the nature of their business somewhat by selling to individual farmers as well as to potato suppliers. Lockwood had previously dealt primarily in grading equipment but at this time it began to manufacture and sell field equipment such as harvesting pieces, bin holders and vine beaters as well.

Beginning as early as 1947 Lockwood began to make some sporadic and relatively inconsequential sales in the northeastern part of the United States. From 1949 to 1955 the primary sales of products and parts in that part of the country were made to Gould & Smith, Inc., a retailer of farming and industrial equipment, of Presque Isle, Maine (although there are no records of sales made to them in 1952). Such sales were found to be of a relatively small volume by the Tax Court. On November 15, 1954, Lockwood established a branch office in Presque Isle, Maine, from which to handle Lockwood products. On March 1, 1956, pursuant to the 1951 plan for reorganization, the Maine branch office was incorporated under the laws of Maine with its principal place of business at Presque Isle, Maine. Maine, Inc., was a wholly owned subsidiary of Lockwood. On incorporating, Lockwood transferred to Maine, Inc., $23,500 in assets consisting of petty cash totalling $150.00, accounts receivable totalling $4,686.67, automobiles and trucks worth $1,100, shop equipment worth $295.00, office furniture and fixtures worth $81.60, and inventory worth $17,186.73. In return for these assets Maine, Inc., issued all of its stock, 235 shares at $100.00 par value, to Lockwood. On March 31, 1956, Lockwood distributed 162 of these shares of Maine, Inc., to Thorval and 73 of them to Margaret. This distribution gave rise to the controversy here involved.

The Tax Court held this distribution to be outside of § 355. According to the Tax Court there was:

> "* * * the absence of evidence that the *Maine business* was actively conducted during the months between March 31, 1951, and August 1953—a span of time totaling over 40 per cent of the requisite five-year period [required by § 355(b)(2)(B).]" (Emphasis supplied.)

The Tax Court found that the Maine business was not actively and continuously conducted until August 1953, at which time a Lockwood salesman traveled to Maine and personally solicited orders from farmers and businessmen other than Gould & Smith. We do not disagree with the factual finding of the Tax Court as to the active conduct of Lockwood's business in Maine prior to the incorporation of Maine, Inc. However, the Tax Court, for reasons set out below, erred in looking only at the business performed by Lockwood in Maine to determine if the five-year active business requirement had been met prior to the incorporation of Maine, Inc. Nothing in the language of § 355 suggests that prior business activity is only to be measured by looking at the business performed in a geographical area where the controlled corporation is eventually formed. In this case, when the entire Lockwood market is viewed, it can be seen that Lockwood was engaged in active business as required by § 355 for the five years prior to the incorporation of Maine, Inc. Since its incorporation Maine, Inc., has carried on the same kind of manufacturing and selling business previously and concurrently performed by Lockwood. Thus all § 355 prerequisites are met and the Tax Court erred in determining this was not a tax-free transfer.

At this point it would be helpful to look at the evolvement of what is now § 355. Prior to 1924 a distribution to stockholders pursuant to a spin-off was taxed as a dividend. From 1924 to 1932, however, the revenue acts changed position and provided spin-offs could be tax-free. From 1934 to 1950 tax-free spin-offs were again abolished since this device was being used as a method for distributing earnings and profits, which would otherwise be taxable dividends, through the issuance of stock in the controlled corporation. Such stock could be disposed of at the more favorable capital gain rates. Because of the usefulness of the spin-off device in the achievement of corporate growth and flexibility, Congress again accorded it tax-free status in 1951. At that time certain conditions were imposed to prevent any abuse from using this device. In 1954 the tax-free spin-off was continued as § 355 of the Code with additional tax avoidance safeguards which included the five-year active business requirement involved in this case.

As stated by the Second Circuit in Bonsall v. Commissioner, 2 Cir., 1963, 317 F.2d 61, at page 65:

> "* * * Only long application may completely clarify the difficult terminology of section 355."

With this we agree. However, certain things have become clear since the enactment of § 355 in 1954. After much controversy it has been determined that tax-free treatment will not be denied to a transaction under § 355 merely because it represents an attempt to divide a single trade or business. See United States v. Marett, 5 Cir., 1963, 325 F.2d 28; Coady v. Commissioner, 33 T.C. 771, affirmed per curiam, 6 Cir., 1961, 289 F.2d 490. The Commissioner has acceded to the holdings of Marett and Coady in Rev.Rule 64–147, 1964–1, Cum.Bull. 136, even though the Commissioner had previously insisted, in § 1.355–1(a) of the Income Tax Regulations, that two or more existing businesses had to be actively operated the five years prior to distribution.

* * *

Respondent in the instant case, although claiming to accept the single business interpretation, points to the language of § 355(b)(1) and argues, as did the government in Coady, that the word "*and*" in that section means that, in determining whether or not the active business requirement was met, one has to look at both the business done by the distributing corporation (Lockwood) *and* the business done as such by the controlled corporation (Maine, Inc.) and its predecessors in Maine. Contrary to the government's position, once it has been ascertained that two or more trades or businesses are not required for § 355 to apply, the crucial question becomes whether or not the two corporations existing after distribution are doing the same type of work and using the same type of assets previously done and used by the prior *single* existing business. § 355(b)(1) has no relevance to respondent's point once it has been determined that only a single business is required.

Here the five years of prior activity we are concerned with involve the prior overall activity of Lockwood. Previous to 1956 Lockwood had carried on *in toto* what Maine, Inc., would later carry on in part in the northeast. We are not concerned with the prior activity of Lockwood in the northeast only, for Congress has never intimated that such a geographical test should be applied and we are not about to apply such a test now. A perusal of the House and Senate Reports indicates conclusively that at no time did the House or the Senate contemplate any kind of geographic test in applying the five-year active business requirement. The facts clearly show that Lockwood, in fact, was actively conducting the trade or business involved five years prior to the distribution period.

One case, Patricia W. Burke v. Commissioner, 1964, 42 T.C. 1021, did discuss the past business of a controlled corporation as performed in a limited geographical area in finding the prerequisites of § 355 had been met. That case did not, however, hold that there was in fact a geographical test. Further, at page 1028 that court set out what we believe to be the test:

> "* * * as long as the business which is divided has been actively conducted for 5 years before the distribution and the resulting businesses are actively conducted after the division, the active business requirements of the statute are met. Cf. also H. Grady Lester, 40 T.C. 947 (1963)."

Since there is no Congressional intent evidenced to the contrary, the test, restated, is not whether active business had been carried out in the geographic area later served by the controlled corporation but, simply, whether the distributing corporation, for five years prior to distribution, had been actively conducting the type of business now performed by the controlled corporation without reference to the geographic area. In the instant case the facts are abundantly clear that Lockwood had been actively engaged in the type of business later carried on by Maine, Inc., if one refers to a national rather than just the northeastern market.

It was mentioned earlier in this opinion that beginning in 1950 Lockwood began to sell field equipment as well as grading equipment. The respondent apparently does not contend, nor do we find, that Lockwood so changed its business as to be engaged in a new business that had been active for only two years prior to the incorporation of Maine, Inc. Lockwood meets the requirements of an existing five-year active business as set out by the Conference Committee in Conference Report No. 2543 at page 5298 of 3 U.S.C.Cong. & Adm.News, 1954:

> "It is the understanding of the managers on the part of the House, in agreeing to the active business requirements of section 355 and of section 346 (defining partial liquidations), that a trade or business which has been actively conducted throughout the 5-year period described in such sections will meet the requirements of such sections, even though such trade or business underwent change during such 5-year period, for example, *by the addition of new,* or the dropping of old, *products,* changes in production capacity, and the like, provided the changes are not of such a character as to constitute the acquisition of a new or different business." (Emphasis supplied.)

In § 1.355–4(b)(3) of the Income Tax Regulations the Commissioner specifically adopts the above-quoted portion of the Committee Report.

The respondent contends:

> "If the taxpayers' argument prevails, then any corporation with a five-year history could distribute any of its assets regardless of when they were acquired and regardless of what kind of business they are in after the division, as long as the distributing corporation is in an active business. In other words, taxpayer argues that the five-year history rule requires that only the business of the distributing corporation have a five-year history. For instance, suppose a large manufacturing corporation with a ten-year life acquired some data processing machines in order to better control its inventory and work-in-process flow. If taxpayers' argument is correct, a year later this corporation could transfer all the data processing equipment to a new corporation in exchange for its stock, spin off the stock and claim a tax-free distribution under Section 355 since the manufacturing corporation had more than a five-year life and the data processing business, once an integral part of the original business, was being actively conducted after the spin-off. Moreover, the same logic would allow the spin-off of real estate owned by the manufacturing corporation and used in its business."

The fears of the government are unfounded. The example of the manufacturing company is more closely akin to the Bonsall case, supra, and is factually distinguishable from the instant case. Here Lockwood had not just recently acquired that part or segment of its business that was spun off. Rather, what was spun off was a part of the business Lockwood had always performed in the past and which it has continued to perform since the distribution. If Lockwood had, just before distribution, acquired or opened up a new or entirely different aspect of its business unrelated to prior activities and had spun this off to the controlled corporation, a different result might ensue. In *Bonsall* the distributing company, a dealer in floor covering materials, attempted to assert a tax-free spin-off occurred when a rental business of *de minimis* proportions was transferred to a subsidiary with the stock of the subsidiary being distributed to the distributor's shareholders. * * * [I]t is clear that in respondent's example and in *Bonsall* the business sought to be spun off was not actively engaged in for five years prior to distribution, which is not the situation in the instant case. Here, what was spun off was merely an integral part of what had been Lockwood's primary and only business from its inception.

Further, it should be remembered that even if the five-year active business requirement is met, there is further protection in § 355 against spin-offs being used for mere tax avoidance, which would be contrary to Congressional intent. § 355(a)(1)(B) will only allow a tax-free spin-off transaction where "* * * the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both * * *." Under this section, the government and the courts have great latitude in preventing the abuses which the respondent fears will happen by finding for petitioners in this case. Cf. Gregory v. Helvering, 1935, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596. Herein the respondent does not contend that the purpose of the spin off was designed primarily for tax avoidance. No earnings and profits were in fact distributed to Thorval and Margaret. The Tax Court stated that:

> "* * * we do not view the distribution as running afoul of the congressional purpose behind section 355, * * *."

This being so, and since petitioners otherwise complied with § 355, the decision of the Tax Court will be reversed. The transaction herein involved cannot be treated as a taxable distribution of dividends.

Revenue Ruling 2003–38

2003–1 Cum. Bull. 811.

ISSUE

Whether the creation by a corporation engaged in the retail shoe store business of an Internet web site on which the corporation will sell shoes at retail constitutes an expansion of the corporation's business rather than the acquisition of a new or different business under § 1.355–3(b)(3)(ii) of the Income Tax Regulations.

FACTS

Corporation D has operated a retail shoe store business, under the name "D," since Year 1 in a manner that meets the requirements of § 355(b) of the Internal Revenue Code. D's sales are made exclusively to customers who frequent its retail stores in shopping malls and other locations. D's business enjoys favorable name recognition, customer loyalty, and other elements of goodwill in the retail shoe market. In Year 8, D creates an Internet web site and begins selling shoes at retail on the web site. To a significant extent, the operation of the web site draws upon

D's experience and know-how. The web site is named "D.com" to take advantage of the name recognition, customer loyalty, and other elements of goodwill associated with D and the D name and to enhance the web site's chances for success in its initial stages. In Year 10, D transfers all of the web site's assets and liabilities to corporation C, a newly formed, wholly owned subsidiary of D, and distributes the stock of C pro rata to D's shareholders. Apart from the issue of whether the web site is considered an expansion of D's business and therefore entitled to share the business's five-year history at the time of the distribution in Year 10, the distribution meets all the requirements of § 355.

LAW

Section 355(a) provides that a corporation may distribute stock and securities in a controlled corporation to its shareholders and security holders in a transaction that will not cause the distributees to recognize gain or loss, provided that, among other requirements, (i) each of the distributing corporation and controlled corporation is engaged, immediately after the distribution, in the active conduct of a trade or business, (ii) each trade or business has been actively conducted throughout the five-year period ending on the date of the distribution, and (iii) neither trade or business was acquired in a transaction in which gain or loss was recognized, in whole or in part, within the five-year period. Sections 355(b)(1)(A), 355(b)(2)(B), and 355(b)(2)(C).

In determining whether an active trade or business has been conducted by a corporation throughout the five-year period preceding the distribution, the fact that a trade or business underwent change during the five-year period (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded, provided that the changes are not of such a character as to constitute the acquisition of a new or different business. Section 1.355–3(b)(3)(ii). In particular, if a corporation engaged in the active conduct of one trade or business during that five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such character as to constitute the acquisition of a new or different business. Id.

In Example (7) of § 1.355–3(c), corporation X had owned and operated a department store in the downtown area of the City of G for six years before acquiring a parcel of land in a suburban area of G and constructing a new department store. Three years after the construction, X transferred the suburban store and related business assets to new subsidiary Y and distributed the Y stock to X's shareholders. Citing § 1.355–3(b)(3)(i) and (ii), the example concludes that X and Y both satisfy the requirements of § 355(b).

In Example (8) of § 1.355–3(c), corporation X had owned and operated hardware stores in several states for four years before purchasing the assets of a hardware store in State M where X had not previously conducted business. Two years after the purchase, X transferred the State M store and related business assets to new subsidiary Y and distributed the Y stock to X's shareholders. Citing § 1.355–3(b)(3)(i) and (ii), the example concludes that X and Y both satisfy the requirements of § 355(b).

Rev. Rul. 2003–18, 2003–7 I.R.B. 467, concludes that the acquisition by a dealer engaged in the sale and service of brand X automobiles of a franchise (and the assets needed) to sell and service brand Y automobiles is an expansion of the brand X business and does not constitute the acquisition of a new or different business under § 1.355–3(b)(3)(ii) because (i) the product of the brand X automobile dealership is similar to the product of the brand Y automobile dealership, (ii) the business activities associated with the operation of the brand X automobile dealership (i.e., sales and service) are the same as the business activities associated with the operation of the brand Y automobile dealership, and (iii) the operation of the brand Y automobile dealership involves the use of the experience and know-how that the dealer developed in the operation of the brand X automobile dealership.

ANALYSIS

The product of the retail shoe store business and the product of the web site are the same (shoes), and the principal business activities of the retail shoe store business are the same as those of the web site (purchasing shoes at wholesale and reselling them at retail). Selling shoes on a web site requires some know-how not associated with operating a retail store, such as familiarity with different marketing approaches, distribution chains, and technical operations issues. Nevertheless, the web site's operation does draw to a significant extent on D's existing experience and know-how, and the web site's success will depend in large measure on the goodwill associated with D and the D name. Accordingly, the creation by D of the Internet web site does not constitute the acquisition of a new or different business under § 1.355–3(b)(3)(ii). Instead, it is an expansion of D's retail shoe store business. Therefore, each of D and C is engaged in the active conduct of a five-year active trade or business immediately after the distribution. See Rev. Rul. 2003–18 and § 1.355–3(c), Examples (7) and (8).

HOLDING

The creation by a corporation engaged in the retail shoe store business of an Internet web site that sells shoes at retail constitutes an expansion of the retail shoe store business rather than the acquisition of a new or different business under § 1.355–3(b)(3)(ii).

Revenue Ruling 2007–42

2007–2 Cum. Bull. 44.

ISSUE(S)

Under the facts described below, is a corporation (D) that owns a membership interest in a limited liability company (LLC) classified as a partnership for Federal tax purposes engaged in the active conduct of a trade or business for purposes of § 355(b) of the Internal Revenue Code?

FACTS

Situation 1

LLC is a domestic limited liability company that has been classified as a partnership for Federal tax purposes since its date of organization. For more than five years, LLC has owned several commercial office buildings that are leased to unrelated third parties. LLC has one class of membership interests outstanding. For more than five years, D has owned a 33 1/3-percent membership interest in LLC, and has owned all the stock of a subsidiary (C), a corporation that has been engaged for more than five years in the active conduct of a trade or business that is unrelated to D's activities.

LLC continuously seeks additional properties to expand its rental business. When a property is located, LLC negotiates its purchase and financing and determines whether renovations or alterations are necessary to make the building suitable for rental. LLC periodically repaints and refurbishes its existing properties.

Pursuant to the terms of its leases, LLC provides day-to-day upkeep and maintenance services for its office buildings. These services include trash collection, ground maintenance, electrical and plumbing repair, and insect control. Additionally, LLC advertises for new tenants, verifies information contained in lease applications, negotiates leases, handles tenant complaints, prepares eviction notices and warnings for delinquent tenants, collects rent, and pays all expenses, including gas, water, sewage, electricity and insurance for the office buildings. LLC also maintains financial and accounting records to reflect income and expenses relating to each of its rental properties as well as LLC's general expenses.

The above described activities of LLC have been conducted for more than five years. The employees of LLC perform all management and operational functions with respect to LLC's rental business. Neither D nor any other member of LLC performs services with respect to LLC's business.

For a valid business purpose, D proposes to distribute all its C stock pro rata to D's shareholders in a transaction intended to satisfy the requirements of § 355.

Except for the issue of whether D is engaged in the active conduct of a trade or business under § 355(b), the transaction will otherwise meet all the requirements of § 355.

Situation 2

The facts are the same as Situation 1 except that D owns a 20-percent membership interest in LLC.

LAW AND ANALYSIS

Section 355(a) provides that, under certain circumstances, a corporation may distribute stock or securities in a corporation it controls to its shareholders or security holders in a transaction that is nontaxable to such shareholders or security holders. Sections 355(a)(1)(C) and 355(b) require that both the distributing and controlled corporations be engaged, immediately after the distribution, in the active conduct of a trade or business that has been actively conducted throughout the five-year period ending on the date of distribution.

Section 1.355–3(b)(2)(ii) of the Income Tax Regulations, in defining trade or business for purposes of § 355, provides that a corporation is treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses.

Section 1.355–3(b)(2)(iii) provides that the determination whether a trade or business is actively conducted will be made from all the facts and circumstances. Generally, for a trade or business to be actively conducted, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. A corporation may, however, satisfy the active trade or business test through the activities that it performs itself, even though some of its activities are performed by others.

Under § 1.355–3(b)(2)(iv), the active conduct of a trade or business does not include the holding of property for investment purposes. It also does not include the ownership and operation (including leasing) of property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property.

The fact that a partnership engages in activities that would constitute the active conduct of a trade or business if conducted by a corporation does not necessarily mean that each partner in the partnership is considered to be engaged in the active conduct of a trade or business for purposes of § 355(b). In such a case, the determination of whether a partner is considered to be engaged in the active conduct of a trade or business must be based on the requirements of § 355 and the regulations thereunder taking into account the activities of the partner (if any), the partner's interest in the partnership, and the activities of the partnership.

Rev. Rul. 92–17, 1992–1 C.B. 142, considers whether D, a corporate general partner in a limited partnership, is engaged in the active conduct of a trade or business within the meaning of § 355(b). For more than five years, D owned a 20-percent interest in LP, a limited partnership that owned several commercial office buildings leased to unrelated third parties. D's officers performed active and substantial management functions with respect to LP, including the significant business decision-making of the partnership, and regularly participated in the overall supervision, direction, and control of LP's employees in operating LP's rental business. concludes that D is engaged in the active conduct of a trade or business within the meaning of § 355(b). Rev. Rul. 2002–49, 2002–2 C.B. 288, reaches a similar conclusion where D and another corporation (X) each own a 20-percent interest in a member-managed LLC that is classified as a partnership for Federal tax purposes and D and X jointly manage the LLC's business.

By comparison, § 1.368–1(d)(4)(iii)(B), regarding the continuity of business enterprise requirement applicable to corporate reorganizations, provides that the issuing corporation will be treated as conducting a business of a partnership if members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business. Those regulations indicate that a one-third interest in the partnership represents a significant interest in the partnership business, and a corporation that owns such interest but does not perform active and substantial management functions for the business of the partnership is nevertheless treated as conducting the business of the partnership.

In Situation 1, D is engaged in the active conduct of LLC's rental business for purposes of § 355(b) because D owns a significant interest in LLC and LLC performs the required activities that constitute an active trade or business under the regulations.

In Situation 2, D is not engaged in the active conduct of LLC's rental business for purposes of § 355(b) because D neither owns a significant interest in LLC nor performs active and substantial management functions for LLC.

HOLDING

In Situation 1, D is engaged in the active conduct of a trade or business for purposes of § 355(b).

In Situation 2, D is not engaged in the active conduct of a trade or business for purposes of § 355(b).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 92–17 is modified to the extent it indicated that a partner must perform management functions in order for the partner to be treated as engaged in the active conduct of the trade or business of the partnership.

NOTE

Although the anti-bailout objective of the active business requirement is clear enough, this multifaceted test has engendered many controversies. The *Lockwood* case is typical of the Commissioner's unsuccessful early efforts to apply the test strictly. The Service has since retreated on many previously contentious issues and most of these changes of heart are reflected in the regulations and in comprehensive proposed regulations that, although not yet final, are already influencing the interpretation of the active trade or business requirement.[43] The proposed regulations were issued in response to the enactment of Section 355(b)(3), which substantially revised the active trade or business requirement for corporations that utilize complex structures such as subsidiaries and partnerships to conduct their activities. They also incorporate and "upgrade" several decades of rulings and cases. This Note surveys the settled and lingering questions, incorporating selectively the proposed regulations.

Trade or Business: In General. Both the distributing and the controlled corporation (or the controlled corporations in the case of a split-up) must be engaged immediately after the distribution in a trade or business with a five-year history. The regulations treat a corporation as being engaged in a trade or business if:[44]

> * * * a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses.

The regulations go on to create a dichotomy between the active conduct of a trade or business and passive investment activities. Although the determination of whether a trade or business is "actively conducted" is a factual question turning on all the facts and circumstances, active business status generally requires the corporation to itself perform active and substantial management and operational functions.[45] For this purpose, the activities performed by persons outside the corporation, such as independent

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[43] See REG–123365–03, 2007–1 C.B. 1357.

[44] Reg. § 1.355–3(b)(2)(ii).

[45] Reg. § 1.355–3(b)(2)(iii). Under the proposed regulations, some of the corporation's activities, however, can be performed by others, such as employees, shareholders, affiliated corporations, and partnerships in which the corporation is a partner. Prop. Reg. § 1.355–3(b)(2)(iii).

contractors, generally are not taken into account.[46] To preclude a tax-free separation of passive investment assets, "active conduct" does not include the holding of property for investment (e.g., raw land or portfolio securities) or the ownership and operation (including leasing) of real or personal property used in the owner's trade or business unless the owner performs significant management services with respect to the property.[47]

Relative Size of Active Trade or Business. In interpreting Section 355(b), the IRS's position has been that "there is no requirement * * * that a specific percentage of the [distributing or controlled] corporation's assets be devoted to the active conduct of a trade or business."[48] But the relative size of the active trade or business may be a factor in determining whether the transaction is being used principally as a device for the distribution of earnings and profits. Some taxpayers have relied on this generous interpretation in structuring transactions where a relatively small trade or business is combined in a subsidiary with substantially more valuable investment assets such as a highly appreciated stock position. The tax-driven planning agenda is to distribute the investment assets to shareholders or sell them without payment of any corporate-level tax. To combat this abuse, the IRS has announced that it will not rule on the application of § 355 to transactions in which the value of the business assets relied upon by either the distributing or controlled corporations to satisfy the active trade or business test is less than five percent of the value of the total gross assets of such corporation.[49] These and other transactions with similar characteristics, and proposed regulations under various Section 355 requirements to address the IRS's concerns, are discussed later in this chapter.[50]

Real Estate. The Service has consistently maintained that the holding of vacant investment land does not constitute an actively conducted business.[51] Real estate qualifies as an active business only if the owner performs "significant services with respect to the operation and management of the property."[52] Thus, the Service will not approve the spin-off of vacant land or mineral rights on ranch land, even if development activities are imminent.[53] But it will sanction the separation of an office building substantially leased (10 of 11 floors) to outsiders and actively managed by the lessor.[54] The Service also has ruled that a real estate investment trust's rental activities can constitute an active trade or business if, for example,

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46 Reg. § 1.355–3(b)(2)(iii). Activities performed by independent contractors, however, are considered if the corporation itself performs a sufficient quantity of active management and operational functions. See Rev. Rul. 73–234, 1973–1 C.B. 180; Prop. Reg. § 1.355–3(b)(2)(iii).

47 Reg. § 1.355–3(b)(2)(iv).

48 Rev. Rul. 73–44, 1973–1 C.B. 182.

49 Rev. Proc. 2019–3, supra note 40, § 4.01(30).

50 See Section C4 of this chapter, infra.

51 Reg. § 1.355–3(b)(2)(iv).

52 Id.

53 Reg. § 1.355–3(c) Examples (2) & (3). See also Prop. Reg. § 1.355–3(d) Example 13.

54 Reg. § 1.355–3(c) Example (12). Compare Reg. § 1.355–3(c) Example (13), where the separation of a two-story office building did not qualify where the distributing corporation occupied the ground floor and half of the second floor in the conduct of its banking business and rented the remaining area as storage space. See also Prop. Reg. § 1.355–3(d) Examples 11 & 12.

the REIT provides significant services to its tenants.[55] Even if the active business hurdle is surmounted, however, separations of real estate may be vulnerable under the "device" and business purpose tests.[56]

For many years, the IRS has carefully scrutinized the separation of owner occupied real estate in enforcing the active trade or business requirement.[57] Activist investors then began urging corporations to spin off real estate assets to provide greater shareholder value from those properties. Thus, retailers, restaurant chains, casino operators and telecommunications companies undertook to spin off their real estate assets into separate publicly traded REITs. The operating business then would typically lease back the real estate, and the rental income paid to the REIT would pass through to the shareholders without being subject to an entity-level tax.[58] The economics of this transaction only made sense if the distribution qualified as tax-free under Section 355.

One of several difficulties with this technique is that, after the distribution, the REIT normally just collected rents and thus failed to engage in an active trade or business. A possible solution was to include a qualifying active business with the nonqualifying real estate assets as part of the spin-off.[59] This is similar to the strategy previewed above where a relatively small active business is combined with substantial investment assets in the hope that the active trade or business hurdle can be surmounted.

Congress eventually addressed the concern with REIT spin-offs by enacting Section 355(h) which disqualifies a transaction under Section 355 if either the distributing or controlled corporation is a REIT.[60] If a corporation that is not a REIT is the distributing or controlled corporation in a qualified Section 355 transaction, it may not elect tax treatment under the special REIT regime for any taxable year beginning before the end of the 10-year period beginning on the date of the distribution.[61]

Vertical Divisions of a Single Integrated Business. Suppose a corporation wishes to divide a single trade or business that has been operated for more than five years? Does Section 355 require two separate predistribution trades or businesses, each with its own five-year history, or may one existing business be divided in two? After several defeats,[62] the Service acknowledged that Section 355 can apply to the separation of a single

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55 Rev. Rul. 2001–29, 2001–1 C.B. 1348.

56 See, e.g., Reg. § 1.355–2(d)(2)(iv)(C).

57 Reg. § 1.355–3(b)(2)(ii).

58 Under a special tax regime, REITs generally are not subject to an entity-level tax if they pass through most of their income to their shareholders.

59 See Hoffman, "IRS Raises Red Flag on Real-Estate Spinoffs," Wall St. J., Sept.15, 2015, available at http://www.wsj.com/articles/irs-raises-red-flag-on-real-estate-spinoffs-1442359003.

60 I.R.C. § 355(h)(1). This general disqualification rule does not apply if, immediately after the distribution, both the distributing and controlled corporations are REITs and in a specialized situation involving a spin-off of a taxable REIT subsidiary. I.R.C. § 355(h)(2).

61 I.R.C. § 856(c)(8).

62 See Coady v. Commissioner, 33 T.C. 771 (1960), affirmed per curiam 289 F.2d 490 (6th Cir.1961) (single construction business divided into two businesses to resolve shareholder dispute); United States v. Marett, 325 F.2d 28 (5th Cir.1963) (food manufacturer operating at three factories spun off one factory opened eight months before the distribution).

business. Thus, assuming the other statutory and judicial requirements are met, a corporation engaged in an integrated business at one location may transfer half of its assets to a new subsidiary and distribute the stock of the subsidiary to a 50 percent shareholder in a tax-free split-off.[63] Similarly, as illustrated by the *Lockwood* case, a separation of activities in the same line of business conducted at different locations can be accomplished tax-free if one of the locations does not have a five-year history. The current regulations look to the character of the activity and commonality of functions in determining whether geographically dispersed operations constitute a single integrated business.[64]

Horizontal Divisions. The treatment of horizontal (sometimes called "functional") divisions—i.e., separations of certain distinct functions of a single business enterprise—was once uncertain, but they are now authorized by the active trade or business regulations. To illustrate the issue, assume that a manufacturer of high technology equipment wishes to spin off its research and development function for valid business reasons. The Service once maintained that such support activities did not constitute a separate trade or business because they did not independently produce income.[65] The regulations now sanction some types of horizontal divisions, as illustrated in the following example:[66]

> For the past eight years, corporation X has engaged in the manufacture and sale of household products. Throughout this period, X has maintained a research department for use in connection with its manufacturing activities. The research department has 30 employees actively engaged in the development of new products. X transfers the research department to new subsidiary Y and distributes the stock of Y to X's shareholders. After the distribution, Y continues its research operations on a contractual basis with several corporations, including X. X and Y both satisfy the requirements of section 355(b). * * * The result in this example is the same if, after the distribution, Y continues its research operations but furnishes its services only to X. * * *

Similarly, if a company that has processed and sold meat products for more than five years separates the sale and processing functions, the active business test is satisfied.[67]

The regulations make it clear that the functional separation in the example above satisfies the active business test whether the research department subsequently provides services only to the business from which it was separated or also to other customers. The example reflects the

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63 See, e.g., Reg. § 1.355–3(c) Examples (4) & (5); Prop. Reg. § 1.355–3(d) Examples 14 & 15.

64 See Reg. § 1.355–3(c) Example 7, which permits a nine-year old department store to spin off a suburban branch constructed three years ago where, after the distribution, each store has its own manager and is operated independently.

65 Reg. § 1.355–1(c)(3) (pre-1989).

66 Reg. § 1.355–3(c) Example (9). See also Prop. Reg. § 1.355–3(d) Example 16, which reaches the same conclusion provided the research department has significant assets and goodwill.

67 Reg. § 1.355–3(c) Example (10). See also Prop. Reg. § 1.355–3(d) Example 17.

Service's abandonment of any requirement that an active business must "independently" produce income. But even if the active business test is met, tax-free treatment for a functional division is still not assured. The transaction also must have a corporate business purpose, and it must not run afoul of the "device" limitation. As we will discover shortly, the regulations provide that the same functional separations that pass muster under the active business test may present "evidence" of a prohibited bailout device.[68]

Expansion of a Trade or Business. To satisfy the active business test, both the distributing and controlled corporations—or each controlled corporation in a split-up—must have actively conducted businesses for the five years prior to the distribution.[69] In addition, those businesses must not have been acquired within the five-year predistribution period in a transaction in which gain or loss was recognized by the seller, and must not have been conducted by a corporation the control (i.e., 80 percent) of which was acquired by the distributing or any distributee corporation in a taxable transaction during that five-year period.[70] A purpose of these requirements is to prevent a corporation from using Section 355 to avoid the dividend provisions of Subchapter C by temporarily investing its earnings in a business that it plans to spin off to its shareholders.

The five-year rules have spawned controversies over whether a particular activity is a separate business requiring its own five-year history or simply part of an integrated business which has been active for more than five years. For example, a recently opened suburban branch store may be treated as an integral part of an ongoing department store business with a more than five-year history.[71] On the other hand, businesses with clearly distinct products or services (e.g., a chicken ranch and a winery) are considered to be separate.[72] As *Lockwood* and Revenue Ruling 2003–38 illustrate, similar issues arise in the case of a diversification or expansion of a business within the five-year predistribution period. In rulings and regulations, the Service has offered helpful guidance on this question, suggesting that a new activity in the same line of business will be treated as an expansion of the original business unless the "purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business."[73] This interpretation permits a

[68] See Reg. § 1.355–2(d)(2)(iv)(C).

[69] I.R.C. § 355(b)(2)(B).

[70] I.R.C. § 355(b)(2)(C)–(D); Reg. § 1.355–3(b)(1)–(5). For this purpose, a "taxable transaction" is one in which gain or loss was recognized in whole or in part by the seller. If a business is acquired in a tax-free reorganization, its previous history carries over (along with its tax attributes) for purposes of the five-year rule.

[71] Reg. § 1.355–3(c) Example (7).

[72] See, e.g., Rev. Rul. 56–655, 1956–2 C.B. 214 (retail appliance branch and retail furniture branch considered separate businesses); Rev. Rul. 56–451, 1956–2 C.B. 208 (metal industry magazine separate from magazine to serve electrical industry).

[73] Reg. § 1.355–3(b)(3)(ii). See also Rev. Rul. 2002–49, 2002–2 C.B. 288, where a corporation that actively conducted a commercial real estate business in conjunction with another unrelated corporation through a limited liability company in which each corporation held a 20 percent interest continued to engage in the same trade or business (and did not acquire a new or different business) after it acquired the remaining 80 percent of the LLC in a taxable transaction.

corporation to accumulate funds and use them to create or purchase the assets of a business, or buy the stock of a corporation conducting the business, and promptly spin off that business to its shareholders provided the "new" activity is in the same line of business that the distributing corporation historically conducted.[74]

Limit on Taxable Acquisitions Within Five-Year Predistribution Period. A trade or business does not qualify for purposes of the predistribution business history requirement if it was acquired within the five years preceding the distribution in a transaction in which gain or loss was recognized in whole or in part.[75] Although the statute is not crystal clear, it obviously means gain or loss recognized by seller—e.g., a taxable acquisition in which the buyer takes a cost rather than a carryover basis.[76] Tax-free acquisitions, such as liquidations of a controlled subsidiary, do not disqualify the acquired trade or business. Nor do acquisitive reorganizations if the target shareholders do not recognize any gain as a result of receiving boot.[77] The active trade or business requirement also is not met if within the five-year predistribution period the distributing corporation acquires control, measured by the 80 percent tests in Section 368(c), of a corporation conducting the trade or business in a taxable transaction.[78] As explained below, however, the proposed regulations treat stock acquisitions that result in the distributing corporation obtaining control of the acquired corporation as if they were asset acquisitions because, once the acquisition occurs, the corporations are treated as a single corporation.[79]

Activities Conducted by a Partnership or LLC. With the issuance of Revenue Ruling 2007–42,[80] the Service has clarified when a corporate partner is considered to be engaged in the active conduct of a trade or business by attributing to it the activities performed by a partnership in which it holds an interest. Prior rulings held that a corporate partner could be treated as engaged in the active conduct of a trade or business of the partnership if the corporation itself or through its officers performed active

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[74] The proposed regulations endorse this approach and make it clear that a corporation can expand an existing active trade or business by acquiring not only assets but also enough stock (at least 80 percent of the voting power and value) in another corporation in the same line of business to qualify the new subsidiary as a member of the acquiring corporation's "separate affiliated group." Prop. Reg. § 1.355–3(b)(3)(ii), –3(d)(2) Examples 18 & 20.

[75] I.R.C. § 355(b)(2)(C).

[76] See Bittker & Eustice, supra note 2, ¶ 11.05[2][a]. The proposed regulations elaborate in great detail. See Prop. Reg. § 1.355–3(b)(4).

[77] Bittker & Eustice, supra note 2, ¶ 11.05[2][a].

[78] I.R.C. § 355(b)(2)(D)(ii). In addition, if control of a corporation conducting the trade or business is acquired by a corporate distributee shareholder within the five-year period preceding the distribution in a transaction in which gain or loss is recognized, the active trade or business requirement is not met. I.R.C. § 355(b)(2)(D)(i). For an explanation of this cryptic rule and related roadblocks to using corporate divisions to avoid corporate-level gain on the sale of a business, see Section E1 of this chapter, infra.

[79] Prop. Reg. § 1.355–3(b)(1)(ii), –3(b)(4)(iv)(F). If this regulation becomes final, the applicability of Section 355(b)(2)(D) will be limited to situations where D acquires stock constituting "control" of C as measured by the Section 368(c) tests (voting power and other classes of stock) but not the type of control measured by Section 1504(a) (voting power and value) that would cause C to become part of D's separate affiliated group.

[80] Supra p. 473.

and substantial functions for the partnership's business,[81] even if another partner also performed active and substantial management functions. Revenue Ruling 2007–42 goes further and attributes to a member that owns a "significant interest" (at least one-third) in an LLC's capital and profits the trade or business of the LLC even if the corporate member does not itself directly conduct any activities relating to the LLC's business.[82]

Treatment of Affiliated Groups. A corporation historically was treated as actively conducting a trade or business if it did so directly (e.g., through a division) or if "substantially all" of its assets consisted of the stock or securities of one or more "controlled" corporations each of which was engaged in the active conduct of a trade or business.[83] As a result, a holding company not directly conducting any business activities still could satisfy the active trade or business test if substantially all of its assets consisted of stock or securities of a controlled corporation that itself conducted the business. In some situations, however, a holding company was forced to orchestrate cumbersome predistribution maneuvers by relocating active businesses within the corporate group in order to satisfy the "substantially all" requirement and qualify a distribution under Section 355.[84]

To simplify planning for corporations with more complex capital structures, Congress eliminated the "substantially all" test and added Section 355(b)(3), which provides that, for purposes of determining whether a corporation is engaged in the active conduct of a trade or business, all members of that corporation's separate affiliated group ("SAG") are treated as one corporation.[85] A distributing or controlled corporation's SAG is the group consisting of each such corporation as the "common parent" and all corporations "affiliated" with the common parent through the control tests (i.e., 80 percent or more ownership of voting power and value) in Section 1504(a)(1)(B).[86]

This means that the distributing or controlled corporation will be treated as actively conducting a trade or business during the five-year predistribution period and immediately after a distribution if any lower-tier affiliate in its SAG is so engaged. The SAG rules not only simplify planning for corporations with complex structures but also may have a ripple effect on whether a transaction qualifies under Section 355. For example, because the acquisition of stock of a subsidiary is treated as an acquisition of assets, it may qualify as an expansion of an existing trade or business.[87] But if any

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[81] Rev. Rul. 92–17, 1992–1 C.B. 142; Rev. Rul. 2002–49, 2002–2 C.B. 288. See also Prop. Reg. § 1.355–3(b)(2)(v)(C), which requires the corporate partner to own a "meaningful" interest (at least 20 percent is meaningful based on prior rulings) in the partnership.

[82] See also Prop. Reg. § 1.355–3(b)(2)(v)(B), –3(d)(2) Example 23.

[83] I.R.C. § 355(b)(2)(A) (pre-2008).

[84] See, e.g., Rev. Rul. 74–79, 1974–1 C.B. 81.

[85] I.R.C. § 355(b)(3)(A). The proposed regulations apply this single-entity approach in testing for active trade or business status immediately after a distribution and also throughout the five-year predistribution period. Prop. Reg. § 1.355–3(b)(3).

[86] I.R.C. § 355(b)(3)(B). In applying the Section 1504 control tests, the rule in Section 1504(b) that disregards "nonincludible" corporations (e.g., foreign corporations or insurance companies, among others) does not apply. I.R.C. § 355(b)(3)(A).

[87] See, e.g., Prop. Reg. § 1.355–3(d)(2) Example 20.

corporation becomes a member of a SAG as a result of a transaction in which gain or loss was recognized, such corporation is subject to the limitations regarding taxable acquisitions within the five-year predistribution period.[88]

PROBLEMS

1. Lemon Corporation has been engaged in the manufacture and sale of personal computer hardware equipment for ten years at two plants, one in Boston, Massachusetts and the other in San Jose, California. During this same period, Lemon also has operated at each location a separate research and development division, each of which had significant assets and goodwill. Lemon's common stock, the only class outstanding, is owned equally by Ms. Micro and Mr. Chips. In each of the following alternative transactions, consider whether the active trade or business requirement has been satisfied:

Split off. ?

(a) As a result of a shareholder dispute, Ms. Micro wishes to say goodbye to Mr. Chips. To enable the shareholders to part company but continue in the computer business, Lemon contributes the assets and research division of the Boston facility to a new corporation, Peach, Inc., and distributes all the Peach, Inc. stock to Mr. Chips in redemption of his Lemon stock. Ms. Micro remains as the sole shareholder of Lemon.

(b) Same as (a), above, except that the Boston facility was opened only three years ago. OK - [illegible] ✓.

(c) Same as (b), above, except that three years ago Lemon acquired all the stock of Peach, Inc., which operated the Boston facility, for cash. → taxable trans. if new business, control must × be acquired within last 5 yr in ta[...]

(d) Same as (c), above, except Peach had two classes of stock and Lemon acquired enough stock to constitute control under Section 368(c) but not enough to make Peach a member of Lemon's separated affiliated group under Section 1504(a)(2). (How could this happen?).

[illegible] reg [illegible] acquire another T/B in same line of business treated as expansion of bus[...] proposed reg: expansion doctrine apply in stock pu[...] 80% t[...]

(e) To comply with a divestiture order, Lemon transfers the assets of the research divisions to a new corporation, Research, Inc. and distributes all the Research stock pro rata to the shareholders. After the distribution, Research, Inc. continues to perform services solely for Lemon. → may fail "device" test.

[...]ntal division [...]k if can operate as [...]eparate [...]siness [...]nly provide [...]vice to Lemon Corp. [...] predecessor

utility split. spin-off.

(f) In addition to the operations described above, assume that three years ago Lemon purchased all the stock of Floppy Disk, Inc., a computer software manufacturer, in a taxable transaction. To comply with a regulatory decree, Lemon distributes the stock of Floppy Disk pro rata to its shareholders. → if same line of business, exp[...] of business. [illegible] software [illegible] different know-how & bu[...] experience.

(g) Same as (f), above, except that Floppy Disk merged into Lemon three years ago in a Type A reorganization. Assume that the

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88 I.R.C. § 355(b)(3)(C); see also I.R.C. § 355(b)(2)(C) & (D).

acquisition is not an expansion of Lemon's trade or business. The consideration for that acquisition consisted of Lemon nonvoting preferred stock (80%) and Lemon short-term notes (20%).

2. DC Enterprises ("DC") is a large manufacturing company which owns the 10 story building in which it conducts its business. For the past 15 years, it has used six floors for its own operations and rented the other four floors to unrelated tenants. Six years ago, DC formed a wholly owned subsidiary, Properties, Inc., which leases two other commercial buildings previously owned by DC on a long-term net lease basis, under which the tenants are responsible for property taxes, insurance and maintenance. Consider whether the following alternative transactions satisfy the active trade or business requirement:

(a) On the advice of a management consultant, DC transfers its 10 story office building to a new corporation, Rental, Inc., and distributes the Rental stock pro rata to its shareholders. After the distribution, DC leases from Rental the six floors that it occupies; and Rental continues to rent the other four floors to unrelated tenants. Rental employees actively manage the building and perform repair and maintenance services.

(b) Same as (a), above, except that DC only occupies one floor and the remaining space is leased to unrelated tenants.

(c) Same as (b), above, except the nine floors are rented to outsiders under a long-term net lease.

(d) DC distributes all the stock of Properties, Inc. pro rata to the DC shareholders. After the distribution, Properties continues its rental activities.

C. JUDICIAL AND STATUTORY LIMITATIONS

1. BUSINESS PURPOSE

Regulations: § 1.355–2(b).

Background. The business purpose doctrine originated in Gregory v. Helvering[89] and rapidly assumed its role as one of the first "common law" principles of federal taxation. The doctrine has become an increasingly important limitation under Section 355 even though it is never mentioned in the Code. The business purpose and device limitations are conceptually linked, each focusing on the taxpayer's motivation for the transaction. It is appropriate to consider the business purpose requirement first because the strength or weakness of a corporate business purpose is evidence in determining whether a transaction was used principally as a device for distributing earnings and profits.[90] Moreover, the regulations have long provided that the "business purpose

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89 See p. 457, supra.

90 Reg. § 1.355–2(b)(4), (d)(3)(ii).

requirement is independent of the other requirements under section 355."[91] Thus, a corporate division lacking a business purpose cannot be accomplished tax free even if it is not used principally as a device to bail out earnings and profits.[92]

Business Purpose Regulations. The regulations define a corporate business purpose as "a real and substantial non Federal tax purpose germane to the business of the distributing corporation, the controlled corporation or the affiliated group * * * to which the distributing corporation belongs."[93] Valid business purposes include compliance with antitrust and other regulatory decrees, resolution of shareholder disputes, or even amicable partings to permit shareholders to pursue separate business interests.[94] Among other business purposes approved by the courts and the Service over the years are: facilitating a merger of the distributing or controlled corporation;[95] increasing access to credit or new equity investment (such as by enabling either the controlled or distributing corporations to raise capital on more favorable terms through a public offering);[96] resolving labor problems;[97] providing an equity interest to a newly-hired key employee;[98] and warding off a hostile takeover.[99]

A pure shareholder purpose, such as personal estate planning, does not suffice under the regulations,[100] but the transaction may pass muster if a shareholder purpose is "so nearly coextensive with a corporate business purpose as to preclude any distinction between them."[101] For example, in Revenue Ruling 2003–52,[102] the Service ruled that the division of a family farm business into two separate corporations, one to grow grain and the other to raise livestock, satisfied the business purpose requirement. The division was motivated by a desire to permit the two principal shareholders (a brother and sister who disagreed over the future direction of the family business) to go their separate ways and devote their undivided attention to the businesses in which they were most involved, and also to promote family harmony and further the estate planning goals of their parents, who also were shareholders. The

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91 Reg. § 1.355–2(b)(1).

92 Id.

93 Reg. § 1.355–2(b)(2).

94 Reg. § 1.355–2(b)(5) Examples (1) & (2).

95 Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir.1966); Rev. Rul. 76–527, 1975–2 C.B. 103. But see I.R.C. § 355(e) and Section E2 of this chapter, infra.

96 See, e.g., Rev. Rul. 77–22, 1977–1 C.B. 91; Rev. Rul. 85–122, 1985–2 C.B. 118; Rev. Proc. 96–30, 1996–1 C.B. 696, App. A, §§ 2.02–.03.

97 Olson v. Commissioner, 48 T.C. 855 (1967).

98 Rev. Rul. 88–34, 1988–1 C.B. 115.

99 See Priv. Ltr. Rul. 8819075 (May 13, 1988).

100 Reg. § 1.355–2(b)(2). But see Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir.1962), where the court held that a shareholder business purpose justified a spin-off even in the absence of a corporate business purpose.

101 Reg. § 1.355–2(b)(2).

102 2003–1 C.B. 960.

Service concluded that since the principal motivation for the transaction was to benefit both businesses, the fact that it also facilitated personal estate planning of the shareholders and promoted family harmony was not fatal.

Similarly, the Service found nearly co-extensive corporate and shareholder purposes on a separation of two lines of business of a public company that was motivated by a desire to increase the aggregate trading price of the stock of both businesses after they became separate corporations.[103] In addition to the obvious shareholder benefit, the higher stock prices were found to benefit the distributing corporation in two alternative situations: (1) by enhancing an equity-based employee compensation plan without diluting the interests of existing shareholders by issuing more stock, and (2) by allowing the corporation to use its own (more valuable) stock as partial consideration for future acquisitions with significantly less dilution of existing shareholder interests.[104]

The Service has ruled that the reduction of state and local taxes can be a corporate business purpose.[105] But the regulations make it clear that the reduction of "non Federal" taxes is not an independent corporate business purpose if: (1) the transaction will result in a reduction in both Federal and non Federal taxes because of similarities in the respective laws, and (2) the reduction of Federal taxes is greater than or substantially coextensive with the reduction of non Federal taxes.[106] For example, a spin-off of a subsidiary to enable one or both of the resulting corporations to elect S corporation status is not a business purpose[107] even though the transaction may bear little resemblance to the original bailout evil of Gregory v. Helvering.

A business purpose for a distribution also does not exist if the same corporate objectives can be met through a nontaxable transaction that does not require a distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive.[108] For example, assume that a corporation manufactures both toys and candy through divisions which are not separately incorporated, and the shareholders wish to insulate the candy business from the risks of the toy business. If that goal can be achieved by dropping down the assets of one of the businesses to a new subsidiary, a subsequent distribution of the subsidiary's stock to the parent's shareholders is not carried out for a corporate business purpose.[109]

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[103] Rev. Rul. 2004–23, 2004–1 C.B. 585.

[104] Id.

[105] Rev. Rul. 76–187, 1976–1 C.B. 97.

[106] Reg. § 1.355–2(b)(2).

[107] Reg. § 1.355–2(b)(5) Example (6).

[108] Reg. § 1.355–2(b)(3).

[109] Reg. §§ 1.355–2(b)(3), 1.355–2(b)(5) Example (3). See also Reg. § 1.355–2(b)(5) Examples (4) and (5).

The fact that Section 355 permits a distributing corporation to avoid corporate-level gain on the distribution of stock of a controlled corporation is not considered by the Service to present such a potential for avoidance of federal taxes that it overrides an otherwise valid corporate business purpose.[110] The Service also has ruled that as long as a distribution is motivated in whole or substantial part by a corporate business purpose at the time it is made, the corporation's later failure to succeed in meeting that purpose will not prevent the distribution from satisfying the business purpose requirement.[111] In addition, continuing relationships for a limited period of time between the distributing and spun-off companies do not necessarily jeopardize the distribution from qualifying under Section 355.[112]

A notable addition to the list of acceptable business purposes is known as "fit and focus." The Service has ruled[113] that a software company's spin-off of a paper products business satisfied the business purpose requirement because the distribution was motivated by a desire to allow senior management of the distributing corporation "to concentrate its efforts on the software business, which it believes presents better opportunities for growth and allow the management of the paper products business to secure for that business the management resources needed for its full development." The ruling also states that the existence of common directors of the distributing and spun-off companies does not necessarily preclude reliance on a "fit and focus" business purpose.

2. CONTINUITY OF INTEREST

Regulations: § 1.355–2(c).

The regulations require that those persons who historically owned an interest in the enterprise prior to a corporate division must 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 distribution.[114] This means that one or more of the shareholders of the distributing corporation must emerge from the transaction (in the aggregate) with at least a 50 percent equity interest in each of the

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110 Rev. Rul. 2003–110, 2003–2 C.B. 1083 (corporation used Section 355 to separate its baby food and pesticide businesses to improve a market perception problem arising from the baby food company's affiliation with a pesticide business).

111 Rev. Rul. 2003–55, 2003–1 C.B. 961, where the business purpose for a corporate separation was to facilitate the raising of capital through an initial public offering of the stock of what previously was a wholly owned subsidiary of the distributing corporation. Even though market conditions unexpectedly deteriorated and the public offering was postponed indefinitely, there was a valid business purpose at the time the distribution was made.

112 See Rev. Rul. 2003–75, 2003–2 C.B. 79, where a distribution was made to resolve issues relating to the competition for capital between two businesses (pharmaceuticals and cosmetics) and, after the spin-off, the two companies entered into "transitional" agreements (two years, after which the agreements were to be renegotiated at arm's length for a limited period) relating to information technology, benefits administration, and accounting and tax matters.

113 Rev. Rul. 2003–74, 2003–2 C.B. 77.

114 Reg. § 1.355–2(c)(1).

corporations that conduct the enterprise after the division.[115] The continuity of interest test overlaps considerably with the device limitation, which patrols against prearranged postdistribution sales as part of its anti-bailout mission. The regulations nonetheless emphasize that continuity of interest is an independent test that must be met in addition to the other Section 355 requirements.[116]

A common divisive transaction involves the breakup of a corporate enterprise to allow feuding shareholders to part company, with each taking a share of the business in the form of stock in separate corporations. The regulations acknowledge that this type of transaction, whether structured as a split-off or split-up, satisfies the continuity of interest requirement because the prior owners of the integrated enterprise emerge in the aggregate with all the stock of two corporations that survive the separation. Assume, however, that A and B each own 50 percent of the stock of P, Inc., which is engaged in one business, and P owns all the stock of S, Inc., which is engaged in a different business. If new and unrelated shareholder C purchases all of A's stock in P and P then distributes all the stock of S to B in redemption of B's P stock, the transaction fails the continuity of interest test because the owners of P prior to the distribution (A and B) do not, in the aggregate, own an amount of stock establishing continuity of interest in both P and S after the distribution.[117] Only the historic shareholders of P (i.e., A and B) may be counted for continuity of interest purposes, and the smoking pistol is present if none of those shareholders owns any stock of P after the distribution. As for who qualifies as an historic shareholder, it appears that a shareholder who acquires P stock prior to the time that P decides to engage in a division should qualify even if the acquisition occurred shortly before the distribution.[118] Apparently, even a person who acquired P stock in contemplation of a distribution of S stock will be treated as an historic shareholder if the acquisition was more than two years prior to the distribution.[119]

The shareholders of the distributing corporation also must maintain continuity of interest after the distribution.[120] A postdistribution

[115] Without explicitly saying so, several examples in the regulations indicate that a 50 percent equity interest, the safe harbor benchmark for Type A reorganizations, is what is needed to "maintain" continuity of interest. See, e.g., Reg. § 1.355–2(c)(2) Example (2). Although 50 percent continuity historically was required to obtain an advance ruling from the Service, the case law supports a lower percentage, and the regulations on acquisitive reorganizations now confirm that the Service will accept 40 percent continuity for mergers. Reg. § 1.368–1(e)(2)(iv) Example 1. It follows that 40 percent also should be sufficient for corporate divisions. See Ginsburg & Levin, Mergers, Acquisitions & Buyouts, ¶ 610.2 (April 2018).

[116] Reg. § 1.355–2(c)(1). For a rare published ruling on the application of the continuity of interest doctrine to a spin-off, see Rev. Rul. 79–273, 1979–2 C.B. 125.

[117] Reg. § 1.355–2(c)(2) Example (3).

[118] See Kaden & Wolfe, "Spin-offs, Split-offs, and Split-ups: A Detailed Analysis of Section 355," 44 Tax Notes 565, 588–589 (July 31, 1989).

[119] Id. at 589. Cf. Rev. Rul. 74–5, 1974–1 C.B. 82, declared obsolete on other grounds by Rev. Rul. 89–37, 1989–1 C.B. 107.

[120] This is similar to the recently abandoned postacquisition continuity requirement for acquisitive reorganizations. See Chapter 9B1, supra. It remains to be seen whether the Service

continuity issue might arise, for example, if shareholders sold more than 50 percent of the stock of either the distributing or controlled corporations shortly after the distribution. Shareholders who committed themselves to sell prior to the distribution or who had a fixed intention to do so are not likely to have maintained continuity of interest, but an unanticipated sale should not be a problem.

3. THE "DEVICE" LIMITATION

Code: § 355(a)(1)(B).

Regulations: § 1.355–2(d).

a. IN GENERAL

Section 355(a)(1)(B) provides that a corporate division may not be "used principally as a device for the distribution of the earnings and profits" of the distributing corporation or the controlled subsidiary. The historic mission of this requirement has been to prevent the conversion of ordinary dividend income into preferentially taxed capital gain through a bailout masquerading as a corporate division.[121] This goal is reaffirmed in the regulations, which provide:[122]

> * * * a tax-free distribution of the stock of a controlled corporation presents a potential for tax avoidance by facilitating 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. A device can include a transaction that effects a recovery of basis.

Ever since the device limitation was added to the Code, its meaning and scope have been mired in obscurity. The regulations initially fail to burn off the fog, declaring that "generally, the determination of whether a transaction was used principally as a device will be made from all of the facts and circumstances."[123] They go on to offer some guidance by identifying certain "device" and "nondevice" factors which are "evidence" of the presence or absence of a device, but the strength of this "evidence" still depends on "the facts and circumstances."[124]

The role of the device limitation is diminished but not eliminated as long as dividends and long-term capital gains of noncorporate taxpayers are taxed at the same preferential rate. A "device" still may include a transaction that effects a recovery of a shareholder's stock basis. In situations where shareholders have a nominal basis and are indifferent

will modify its postdistribution continuity rules in the corporate divisions context. For an extensive discussion of the Section 355 version of the continuity of interest doctrine, see Shores, "Reexamining Continuity of Shareholder Interest in Corporate Divisions," 18 Va. Tax Rev. 473 (1999).

121 See, e.g., Rev. Rul. 71–383, 1971–2 C.B. 180.

122 Reg. § 1.355–2(d)(1).

123 Id.

124 Reg. § 1.355–2(d)(2)(i), (3)(i).

to dividend vs. capital gain treatment, the question remains whether the Service might invoke the device limitation to tax the distributing corporation, which would be required to recognize gain on the distribution if the transaction does not qualify under Section 355, or whether it is sufficient to rely on more targeted corporate-level statutory watchdogs, such as Sections 355(d) and 355(e), which are discussed later in this chapter.[125]

Transactions Ordinarily Not a Device. Notwithstanding the presence or absence of the "device factors" to be discussed below, three transactions "ordinarily" are not considered a tax avoidance device. Distributions are presumed innocent if:

(1) the distributing and controlled corporations have neither accumulated nor current earnings and profits as of the date of the distribution, taking into account the possibility that a distribution of appreciated property by the distributing corporation as part of a divisive transaction would create earnings and profits if Section 355 did not apply;[126]

(2) in the absence of Section 355, the distribution would qualify as a redemption to pay death taxes under Section 303;[127] and

(3) in the absence of Section 355, the distribution would qualify, with respect to each distributee shareholder, as an exchange redemption under Section 302(a).[128]

Section 303 and Section 302(a)-type redemptions lose the benefit of the presumption, however, if they involve the distribution of stock of more than one controlled corporation and facilitate 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.[129]

Device and Nondevice Factors: In General. The regulations specify three factors that are "evidence" of a device ("device factors") and three factors that are evidence of a nondevice ("nondevice factors"). The device factors are: (1) a pro rata distribution; (2) a subsequent sale or exchange of stock of either the distributing or controlled corporation; and (3) the nature and use of the assets of the distributing and controlled corporations immediately after the transaction.[130] The three nondevice factors are: (1) the corporate business purpose for the transaction; (2) the fact that the distributing corporation is publicly traded and widely held;

125 See Section E of this chapter, infra.

126 Reg. § 1.355–2(d)(5)(ii).

127 Reg. § 1.355–2(d)(5)(iii). See Chapter 5H, supra.

128 Reg. § 1.355–2(d)(5)(iv). For this purpose, the waiver of family attribution rules apply without regard to the ten year look forward rule and the requirement to file a waiver agreement in Sections 302(c)(2)(A)(ii) and (iii). See Chapter 5C2, supra.

129 Reg. § 1.355–2(d)(5)(i). For an example, see Reg. § 1.355–2(d)(5)(v) Example (2).

130 Reg. § 1.355–2(d)(2).

and (3) the fact that the stock of the controlled corporation is distributed to one or more domestic corporations which would be entitled to a dividends received deduction under Section 243 if Section 355 does not apply to the transaction.[131] The presence of one or more of these factors is not controlling, however, and the "strength" of the evidence depends on the facts and circumstances.[132]

b. DEVICE FACTORS

Pro Rata Distribution. A pro rata distribution—for example, a spin-off—is considered to present the greatest potential for avoidance of the dividend provisions of Subchapter C and thus is more likely to be used principally as a device. As a result, the regulations provide that a pro rata or substantially pro rata distribution is evidence of a device.[133]

Subsequent Sale or Exchange of Stock. A parenthetical clause in Section 355(a)(1)(B) cryptically provides that the "mere fact" that stock or securities of either the distributing or controlled corporations are sold by all or some of the shareholders is not to be construed to mean that the transaction was used principally as a device. But the Service has long contended that a sale of stock of the distributing or controlled corporation shortly after a corporate division is evidence that the transaction was used as a bailout device. The "strength" of the evidence depends upon the percentage of stock disposed of after the distribution, the length of time between the distribution and the subsequent sale and the extent to which the subsequent sale was prearranged.[134]

A subsequent sale or exchange negotiated or agreed upon before the distribution is "substantial evidence" of a device.[135] A sale is always prearranged if it was "pursuant to an arrangement negotiated or agreed upon before the distribution if enforceable rights to buy or sell existed before the distribution."[136] The regulations are more equivocal if a sale was merely discussed by the parties but was "reasonably to be anticipated." In that event, it "ordinarily" will be considered to be previously negotiated or agreed upon.[137] Seemingly ignoring the express language of Section 355(a)(1)(B), the regulations also provide that even in the absence of prior negotiations or agreement, a subsequent sale nonetheless is "evidence of a device."[138] Presumably, the evidence would be fairly weak if the decision to sell were not made until after the distribution.

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131 Reg. § 1.355–2(d)(3).

132 Reg. § 1.355–2(d)(2)(i); –2(d)(3)(i).

133 Reg. § 1.355–2(d)(2)(ii).

134 Reg. § 1.355–2(d)(2)(iii)(A).

135 Reg. § 1.355–2(d)(2)(iii)(B).

136 Reg. § 1.355–2(d)(2)(iii)(D).

137 Id.

138 Reg. § 1.355–2(d)(2)(iii)(C).

The perceived bailout abuse of a subsequent sale normally is present only when the selling shareholders cash out their investment. The regulations logically provide that if the shareholders dispose of stock in a subsequent tax-free reorganization in which no more than an "insubstantial" amount of gain is recognized, the transaction will not be treated as a subsequent sale or exchange. Rather, because the shareholders maintain an interest in the continuing enterprise, the stock received in the exchange is treated as equivalent to the stock surrendered.[139] But any sale of the new stock received will be subject to the "subsequent sale" rules and could be evidence of a device.[140]

The Service's reliance on subsequent stock sales (whether or not prearranged) as substantial evidence of a device has always been questionable. To return to the earlier introductory example, assume that Diverse Corporation has actively conducted profitable winery and chicken ranch businesses for more than five years. If Diverse wished to spin off the chicken ranch as Poultry, Inc., it would have no difficulty satisfying the active business test. But what if the spin-off were the prelude to a prearranged sale of the Poultry, Inc. stock by the controlling shareholders? If gain on that sale were taxable to the shareholders at capital gains rates, or even if it merely effected a recovery of part of the shareholders' basis in their Diverse Corp. stock, should the spin-off be viewed principally as a device to bail out Diverse's earnings and profits?

In considering these questions, keep in mind the alternatives available to Diverse. If the corporation simply had sold the chicken ranch assets and distributed the proceeds to its noncorporate shareholders, the distribution likely would have qualified as a partial liquidation, entitling noncorporate shareholders to exchange (and thus capital gains) treatment.[141] The same result would have occurred if the chicken ranch assets were distributed pro rata to the shareholders and sold shortly thereafter. To be sure, a sale or distribution of the chicken ranch assets by the corporation would have triggered gain at the corporate and shareholder levels.[142] But, historically at least, the principal concern in Section 355 was not with the double taxation of corporate earnings but rather the tax treatment of a distribution to the shareholders. If an economically equivalent transaction (i.e., a partial liquidation) would have qualified for capital gain treatment, it seems anomalous to classify a spin-off followed by a prearranged sale of the same business as a device to convert ordinary dividend income to capital gain. In the last analysis, the correct answer from a policy perspective may be to treat partial liquidation distributions as dividends to noncorporate shareholders. Moreover, even if it is not a device, a distribution followed by a taxable

139 Reg. § 1.355–2(d)(2)(iii)(E).

140 Id.

141 See I.R.C. § 302(b)(4), (e). But see Rev. Rul. 75–223, 1975–1 C.B. 109, discussed at p. 247, supra, in which the Service ruled that a distribution of stock of a subsidiary may not qualify as a partial liquidation. See also Morgenstern v. Commissioner, 56 T.C. 44 (1971).

142 See Chapters 7 and 8, supra.

sale is unlikely to satisfy the business purpose test and, if the sale closely follows the distribution but somehow escapes the device limitation, the transaction also may fail the continuity of interest requirement. And, of course, much of this discussion is less important as long as dividends and capital gains of noncorporate taxpayers are taxed at the same preferential rate.

Nature and Use of the Assets. The regulations also enforce the device limitation by taking into account the "nature, kind, amount, and use of the assets of the distributing and the controlled corporations (and corporations controlled by them) immediately after the transaction."[143] Thus, the existence of assets that are not used in an active trade or business, such as cash and other liquid assets that are not related to the reasonable needs of the active business, is evidence of a device.[144] To illustrate, assume that Corporation P spins off Corporation S in order to comply with certain regulatory requirements under state law. As part of the separation, P transfers excess cash (not related to the reasonable needs of P's or S's business) to S and then distributes the S stock pro rata to P's shareholders. The result of this infusion of cash into S is that the percentage of liquid assets not related to the trade or business is substantially greater for S than for P. The regulations view this as suspect, providing in an example that the transfer of cash by P to S is "relatively strong evidence of device."[145] When coupled with the pro rata nature of the distribution, the transaction is considered to have been used principally as a device notwithstanding the "strong business purpose" because there was no business purpose for the infusion of cash into S.[146]

The regulations also consider the relationship between the distributing and controlled corporations and the effect of a sale of one of the businesses on the overall enterprise. Evidence of a device is presented if the distributing or controlled corporation is a business that principally serves the business of the other corporation (a "secondary business") and it can be sold without adversely affecting the business that it serves.[147] Thus, the spin-off of a captive coal mine from a steel manufacturer, a transaction which satisfied the active business test,[148] nonetheless presents evidence of a device if the principal function of the coal mine is to satisfy the requirements of the steel business and the coal mine could be sold without adversely affecting the steel business.[149] The apparent

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143 Reg. § 1.355–2(d)(2)(iv).

144 Reg. § 1.355–2(d)(2)(iv)(A), (B).

145 Reg. § 1.355–2(d)(4) Example (3).

146 Reg. § 1.355–2(d)(2)(iv)(B); 1.355–2(d)(4) Example (3). Compare Reg. § 1.355–2(d)(4) Example (2), where the transfer of cash and liquid securities from the distributing to the controlled corporation was "relatively weak evidence of device" because after the transfer the two corporations held liquid assets in amounts proportional to the values of their businesses.

147 Reg. § 1.355–2(d)(2)(iv)(C).

148 See Reg. § 1.355–3(c) Example (11).

149 Reg. § 1.355–2(d)(2)(iv)(C). Likewise, the separation of the sales and manufacturing functions will constitute evidence of a device if the principal function of the sales operation after

concern here is not so much with the potential for tax avoidance through non arm's length intercorporate transactions between the separated corporations. That type of abuse is adequately policed by Section 482, which authorizes the Commissioner to allocate income or deductions between or among commonly controlled trades or businesses.[150] What appears to be bothering the Service is the likelihood for avoidance of the dividend provisions of the Code when the "related function" is not truly integral to the business from which it has been separated.

c. NONDEVICE FACTORS

Acknowledging that the corporate business purposes for a transaction may be sufficiently compelling to outweigh any evidence of a device, the regulations provide that the corporate business purpose for a transaction is evidence of nondevice.[151] In keeping with the "sliding scale" approach that pervades the device regulations, the stronger the evidence of device, then the stronger is the business purpose required to prevent determination that the transaction was used principally as a device.[152] The strength of a corporate business purpose, of course, is based on all the facts and circumstances, including but not limited to the importance of achieving the purpose to the success of the business, 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 the distributing corporation, and the "immediacy of the conditions" prompting the transaction.[153]

The fact that the distributing corporation is publicly traded and widely held, having no shareholder who directly or indirectly owns more than five percent of any class of stock, also is evidence of nondevice.[154]

Finally, the fact that the stock of the controlled corporation is distributed to a domestic corporate distributee which, without Section 355, would be entitled to the Section 243 dividends received deduction, is evidence of a nondevice.[155]

4. DISTRIBUTIONS INVOLVING SIGNIFICANT CASH AND OTHER NONBUSINESS ASSETS

a. CASH-RICH SPLIT-OFFS

Section 355(g) was added to the Code to prevent transactions known as "cash-rich split-offs" from qualifying for nonrecognition treatment.

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the separation is to sell the output from the manufacturing operation and the sales operation could be sold without adversely affecting the manufacturing operation.

[150] See Chapter 13A, infra.

[151] Reg. § 1.355–2(d)(3)(ii).

[152] Id.

[153] Id.

[154] Reg. § 1.355–2(d)(3)(iii).

[155] Reg. § 1.355–2(d)(3)(iv).

The abuse at which Section 355(g) is directed is best illustrated by an example. Assume that for more than five years Investor Corp. ("I") has owned a highly appreciated 30 percent interest in Distributing Corp. ("D"). I wishes to accomplish what would appear to be impossible: a sale of its D stock for cash without paying any current tax. D wishes to buy back some of its stock and is willing to assist I plan a tax-efficient disposition. To accomplish these objectives, D transfers a small five-year active trade or business to Controlled Corp. ("C"), a newly formed subsidiary, along with a large amount of cash (or other liquid assets) in exchange for all the C stock. D then redeems I's D stock by distributing its C stock to I in exchange for I's entire holding in D. I then promptly liquidates C (its new cash-rich subsidiary), treating the transaction as a tax-free liquidation under Section 332.[156]

Prior to the enactment of Section 355(g), the transaction described above was likely to qualify as tax-free. As previewed earlier in this chapter, the active trade or business test, as it has been interpreted by the IRS, did not require the active business of the distributing or controlled corporations to constitute any minimum percentage of their overall asset value,[157] and the device limitation was not violated because the distributee shareholder (I, in the example above) completely terminated its interest in D. This "too good to be true" strategy was employed by several public companies in high stakes transactions, prompting the Treasury to seek corrective legislation.[158]

Section 355(g) provides that a distribution does not qualify as tax-free if: (1) either the distributing or controlled corporation is, immediately after the transaction, a "disqualified investment corporation," and (2) any person holds, immediately after the transaction, a 50-percent or greater interest (measured by voting power and value) in any disqualified investment corporation but only if such person did not hold such an interest in the corporation immediately before the transaction.[159] D or C is a disqualified investment corporation if the fair market value of its "investment assets" is two-thirds or more of the fair market value of all its assets.[160] Investment assets include cash; corporate stock or securities; partnership interests; debt instruments or other evidences of indebtedness; any option, forward, or futures contract, notional principal contract, or derivative; foreign currency; or any similar asset.[161] Various exceptions and special rules apply to determine a

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[156] For a good discussion of the cash-rich split-off strategy, see Willens, "Dividends, Capital Gains, and Spin-offs Affected by Increase, Prevention and Reconciliation Act," 104 J. Tax'n 327 (2006).

[157] Rev. Rul. 73–44, supra note 48. See Section B of this chapter, supra.

[158] In one reported transaction, Clorox distributed \$2.1 billion in cash and a business worth \$740 million to a U.S. subsidiary of a German company in redemption of that subsidiary's 29 percent interest in Clorox.

[159] I.R.C. § 355(g)(1).

[160] I.R.C. § 355(g)(2)(A)(i).

[161] I.R.C. § 355(g)(2)(B)(i).

corporation's investment assets and to measure whether a person has a 50-percent-or-greater interest.[162]

If Section 355(g) applies, the transaction is fully taxable at the corporate and shareholder levels, but cash-rich (albeit not as rich) split-offs still may be viable if the tainted liquid assets fall below the two-thirds threshold. Indeed, in an ironic twist, Section 355(g) appears to sanction the very transaction that it was trying to curtail for those who can wend their way through its requirements. An example of a successful navigator was Liberty Media Corporation, which shed its major stake in Time-Warner in a tax-free split-off exchange for the Atlanta Braves baseball team (an active and often successful trade or business) and $1.38 billion in cash. Liberty Media engaged in a similar deal when it exchanged its stake in News Corp. for $465 million in cash and News Corp.'s holdings in satellite provider DirecTV.

b. SPIN-OFFS OF SIGNIFICANT NONBUSINESS ASSETS

As noted above, some cash-rich split-offs are not disqualified by Section 355(g). That section also does not apply to transactions with similar characteristics, such as spin-offs where the distributing or controlled corporation ends up owning investment assets having substantial value relative to its business assets. These transactions raise issues under the active trade or business requirement, the device limitation, and the business purpose test.

Focusing first on the active trade or business requirement, recall again that the IRS historically did not require that any specific percentage of the distributing or controlled corporation's assets must be devoted to the active conduct of a trade or business. But what if either corporation emerges from an attempted Section 355 transaction with a relatively small active trade or business combined with substantial amounts of cash, corporate stock or securities, debt instruments, and similar investment assets? As one IRS official colorfully described the issue, should it matter if a company drops a hot dog stand into a bucket of investment assets or cash and then tries to spin off the entire business tax free?[163]

One of the most highly publicized transactions raising these Section 355 qualification issues was the proposed spin-off in 2015 by Yahoo! Inc. of its valuable stock holding in Chinese e-commerce company Alibaba Group Holding Ltd. Yahoo proposed to contribute Yahoo Small Business (a small-business-services unit with about 100 employees and $50 million in earnings before interest, taxes, and cost recovery) along with its Alibaba shares to a newly formed corporation, Aabaco Holdings, Inc. The Alibaba stock was estimated to be worth over 95 percent of the fair

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[162] I.R.C. § 355(g)(2)(B)(ii)–(iv); 355(g)(3)–(5).

[163] Hoffman, "IRS Raises Red Flag on Real-Estate Spin-offs," Wall St. J. (Sept. 15, 2015), at http://www.wsj.com/articles/irs-raises-red-flag-on-real-estate-spinoffs-1442359003 (referring to a statement by IRS official Isaac Zimbalist).

market value of Aabaco's total assets.[164] Yahoo Small Business was the "hot dog stand" added to the deal to satisfy the active trade or business requirement and qualify the spin-off (including the Alibaba shares) under Section 355. The IRS refused to issue a ruling on Yahoo's proposed transaction and later signaled it might change its longstanding position on the issue. Initial reports were that Yahoo planned to proceed with the deal without the IRS's blessing, relying instead on an opinion of counsel,[165] but in late 2015 Yahoo's board of directors abandoned the plan and began considering other options, including a spin-off or sale of its core online media and search businesses.[166] Two years later, Yahoo sold its core internet business to Verizon and changed its name to Altaba, which continued to hold the large stake in Alibaba. The saga ended in 2019, when Altaba announced its intention to sell its Alibaba stock and liquidate.

Shortly after declining to rule in the Yahoo-Alibaba transaction, the IRS announced that it would study transactions in which either the distributing or controlled corporation owned a substantial amount of nonbusiness assets, such as cash or publicly traded securities, as compared to the value of its active business assets.[167] It also announced that it ordinarily will not issue a ruling on any issue relating to qualification under Section 355 if immediately after the distribution the fair market value of the trade or business in the distributing or controlled corporation used to satisfy the active trade or business requirement was less than five percent of the total fair market value of the gross assets of such corporation.[168] And in 2016, the IRS issued proposed regulations to clarify the application of the active trade or business requirement and the device prohibition to those types of transactions.

Proposed Regulations. The proposed regulations would create a new active trade or business requirement under which the "Five-Year-Active-Business Asset Percentage" of both the distributing corporation and the controlled corporation must be at least five percent.[169] A corporation's Five-Year-Active-Business Asset percentage generally is equal to (1) the gross amount of its assets used in its five-year-active businesses, including cash or cash equivalents held as reasonable amounts of working capital and assets legally or contractually required to be held for exigencies of the business, regulatory purposes, financial obligations

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164 Id.; see also, Fleischer, "Yahoo's Trick Plan for Tax-Free Spinoff of Alibaba Stock," N.Y. Times, May 22, 2015, at http://www.nytimes.com/2015/05/23/business/dealbook/yahoos-tricky-plan-for-tax-free-spinoff-of-alibaba-stock.html?ref=dealbook&_r=0; Cornell, "Yahoo's Alibaba Spin-Off on Track," Forbes/Investing, Oct. 1, 2015, available at http://www.forbes.com/sites/joecornell/2015/10/01/yahoos-alibaba-spin-off-on-track/.

165 See Cornell, supra note 164.

166 Goel, "Yahoo to Keep Alibaba Stake but Spin Off Core Businesses," N.Y. Times, Dec. 9, 2015, available at http://www.nytimes.com/2015/12/10/technology/yahoo-alibaba-spinoff.html.

167 Notice 2015–59, 2015–40 I.R.B. 459.

168 Rev. Proc. 2019–3, supra note 40, § 4.01(30).

169 Prop. Reg. § 1.355–9(b).

reasonably expected to arise, and commitments to expand or improve the business, divided by (2) the corporation's total assets.[170]

The proposed regulations also modify the nature and use of assets device factor and add a new per se device test. In general, device potential will exist if the distributing or controlled corporation owns a large percentage of nonbusiness assets compared to total assets, or if the distributing and controlled corporation's percentages of these assets differ substantially. For this purpose, "business assets" would have the same meaning as it does under the active trade or business requirement but without regard to whether the business has been operated or owned for more than five years.[171] Nonbusiness assets are the corporation's gross assets that are not business assets.[172] The larger the percentage of nonbusiness assets of either corporation, the stronger the evidence of device. If neither the distributing nor the controlled corporation has nonbusiness assets that comprise 20 percent or more of its total assets, the ownership of nonbusiness assets ordinarily would not be evidence of device.[173] A difference in the nonbusiness asset percentages (nonbusiness assets divided by total assets) for the distributing corporation and controlled corporation ordinarily would not be evidence of device if the difference is less than 10 percent or, in the case of a non pro rata distribution, if the difference is attributable to a need to equalize the value of the controlled corporation stock and securities distributed and the consideration exchanged therefor by the distributees.[174]

The proposed regulations also revise the nondevice factor which relates to a corporate business purpose by limiting the circumstances when a business purpose may outweigh evidence of a device. Evidence of device presented by ownership of nonbusiness assets or a difference between the nonbusiness asset percentages of the distributing and controlled corporations generally can be outweighed by a corporate business purpose for the ownership or difference. Under the proposed revision, a corporate business purpose that relates to a separation of nonbusiness assets from one or more businesses or from business assets would not be evidence of nondevice unless the business purpose involves an exigency that requires an investment or other use of the nonbusiness assets in one or more businesses.[175] The proposed regulations illustrate this last rule with an example where there is a nonproportionate division of nonbusiness assets because the lease of one corporation will expire in six months and it retains the nonbusiness assets to purchase a building

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170 See Prop. Reg. § 1.355–9(a)(3)–(6).

171 Prop. Reg. § 1.355–2(d)(2)(iv)(B)(*2*) and see supra note 170 and accompanying text.

172 Prop. Reg. § 1.355–2(d)(2)(iv)(B)(*3*).

173 Prop. Reg. § 1.355–2(d)(2)(iv)(C)(*1*).

174 Prop. Reg. § 1.355–2(d)(2)(iv)(C)(*2*).

175 Prop. Reg. § 1.355–2(d)(3)(ii).

for relocation. The need to buy the building is an exigency which is a business purpose and evidence of a nondevice.[176]

Finally, the proposed regulations add a two-pronged per se device test for distributions involving separation of business assets from nonbusiness assets. Both prongs must be met for the distribution to be treated as a per se device. The policy underlying the per se test is that if either the distributing or controlled corporations holds a significant percentage of nonbusiness assets as compared to a much lower proportion of such assets held by the other corporation, the evidence of a device is so strong that it outweighs the presence of any countervailing nondevice factors. The first prong is satisfied if either the distributing or controlled corporation has a nonbusiness asset percentage (nonbusiness assets divided by total assets) of 66 $^{2}/_{3}$ percent or more.[177] The second prong of the test compares the nonbusiness asset percentages of the distributing and controlled corporations and is met if the nonbusiness asset percentage of one corporation is: (1) 66 $^{2}/_{3}$ percent or more but less than 80 percent, and the other corporation's is less than 30 percent, (2) 80 percent or more but less than 90 percent, and the other's is less than 40 percent, or (3) more than 90 percent, and the other's is less than 50 percent.[178] If the per se test is not satisfied, the general facts and circumstances test applies to determine if the transaction was a device. The only exceptions to this per se device rule are if the distribution is to a corporate distributee entitled to a dividends received deduction or is a transaction ordinarily not considered to be a device, such as transactions where both the distributing and controlled corporation have no earnings and profits.[179]

PROBLEM

Assume that Lemon Corporation from Problem 1 at page 483, operates a computer manufacturing business at only one location where it also conducts research and development through a separate division. Lemon also owns all the stock of Floppy Disk, Inc., a computer software manufacturer that Lemon purchased six years ago in a taxable transaction. The net worths of the computer and software businesses are approximately the same, and both corporations have substantial accumulated earnings and profits. The common stock of Lemon is owned equally by Ms. Micro and Mr. Chips. In each of the following alternatives, assume that the active trade or business requirement is met and consider whether the transactions described satisfy the other requirements of Section 355.

(a) To resolve a shareholder dispute, Lemon distributes all the stock of Floppy Disk, Inc. to Mr. Chips in complete redemption of his stock in Lemon. √ business purpose. spin-off.

presumed non-device transaction.

∵ 如果 complete redemption 是否 sale/exch treatment.

[176] Prop. Reg. § 1.355–2(d)(4) Example 4.

[177] Prop. Reg. § 1.355–2(d)(5)(iii)(A).

[178] Prop. Reg. § 1.355–2(d)(5)(iii)(B).

[179] Prop. Reg. § 1.355–2(d)(5)(i).

→ 但本身 attribution R 可 随时 of 10 yr look forward + IRS waiver.

for § 355 purpose 10 yr look forward & IRS waiver × apply. ∴ same as (a).

(b) Same as (a), above, except that Ms. Micro and Mr. Chips are mother and son. § 318 attribution R. → 但 × complete redemption.

(c) Same as (a), above, except that shortly before the distribution of Floppy Disk stock to Mr. Chips, Ms. Micro sold all of her Lemon stock to Mr. Modem, who wished to acquire the hardware business but not the software company.

× historical owner, there continuity of interest

(d) To enable the computer manufacturing business to maintain different retirement plans for its manufacturing and research employees, Lemon transfers the assets of the research division to a new corporation, Research, Inc., and distributes all the Research stock pro rata to Ms. Micro and Mr. Chips. After the distribution, Research, Inc. continues to perform services solely for Lemon.

valid business purpose? device factor: pro rata distribution, functional division. → if doing this has × cost, maybe as a way to extract E&P. Nondevice factor: business purpose.

(e) Same as (d), above, except that the purpose of the spin-off is to comply with a regulatory decree. (Compare your answer to Problem 1(e) at page 483.) ✓ valid business purpose.

(f) Same as (e), above, except that Lemon contributes cash and securities to Floppy Disk, Inc. before the distribution to Ms. Micro and Mr. Chips. After the contribution of cash and securities to Floppy Disk, Inc., the percentage of nonbusiness assets in Lemon Corporation is 10 percent and the percentage in Floppy Disk, Inc. is 40 percent.

active business ∴ ✓ active business. 但 likely a device 3ove under Pro Reg 4.

(g) To comply with a state law providing that computer hardware and software businesses may not be conducted by parent and subsidiary corporations, Lemon must spin off or sell its Floppy Disk, Inc. subsidiary. In anticipation of the new law, Lemon's board of directors informally negotiated a sale of Floppy Disk to Suitor, Inc. Before the agreement is reduced to an enforceable writing, Lemon distributes the Floppy Disk stock to Ms. Micro and Mr. Chips. Two months later, the shareholders sell the Floppy Disk stock to Suitor on the same terms negotiated by the Lemon board of directors.

§ 355(a)(1)(B): Device factor. The mere fact of subsequent sale/exch of stock × make it a device, other than sale is pursuant to prior-negotiated agreement.

(h) Same as (g), above, except that the Lemon board rejects Suitor's offer and instead distributes the Floppy Disk stock pro rata to the shareholders. Four months later, the shareholders sell their Floppy Disk stock to White Knight, Inc.

✓ business purpose + sale/exchange of stock subsequently, 不像 pursue a plan → likely OK.

(i) Same as (h), above, except the sale by the shareholders is made to Suitor, Inc. on essentially the same terms that had been rejected by the Lemon board of directors.

under Reg. such sale × pursuant to prior negotiation if × reasonably anticipated. 仍然 risky : prior discussion + same term. fact & circumstance.

D. TAX TREATMENT OF THE PARTIES TO A CORPORATE DIVISION

Code: §§ 311(a), (b)(1) & (2); 312(a), (b), (h); 336(c); 355(a)(1)(A), (3), (c); 356; 358(a)–(c); 361; 362(b), (e)(1); 1032. Skim §§ 301; 302; 355(d); 381(a); 1223(1) & (2).

Regulations: §§ 1.312–10; 1.358–2.

1. INTRODUCTION

If the requirements of Section 355 and the accompanying judicial doctrines are satisfied, other provisions come into play to govern the specific tax consequences (e.g., total or partial nonrecognition of gain, basis, holding period, etc.) to the parties. In this section, we consider the tax consequences if a corporate division is preceded by the formation of one or more new corporations in a Type D reorganization, the consequences of the division itself, and the results if the division fails to satisfy the statutory and judicial requirements.

If one or more corporations are formed as a preparatory step to a qualifying corporate division, the formation of the new subsidiary is a Type D reorganization.[180] The parent (distributing) corporation does not recognize gain or loss on the transfer of assets to the controlled corporation,[181] and it takes an exchanged basis in the new stock that it receives[182] and may tack the holding period of any capital assets or Section 1231 property that it exchanges for the stock.[183] The newly formed controlled corporation does not recognize gain on the issuance of its stock[184] and it takes the assets with a transferred basis and a tacked holding period.[185] The earnings and profits of the parent corporation are apportioned between the parent and controlled corporations according to rules provided in the regulations.[186] Section 381, providing for carryover of corporate attributes in certain corporate acquisitions, does not apply to divisive reorganizations and thus the parent corporation retains its tax attributes other than the earnings and profits which are allocated to the controlled corporation.

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180 I.R.C. § 368(a)(1)(D). A "divisive" D reorganization involves a transfer by one corporation of part of its assets to another corporation if, immediately after the transfer, the transferor "controls" the transferee and, pursuant to the same plan, stock or securities of the controlled corporation are distributed to the shareholders of the transferor corporation in a transaction that qualifies under Section 355. Id. For this purpose, the fact that the shareholders of the distributing corporation dispose of part or all of their distributed stock, or that the distributing corporation issues additional stock, is not taken into account. I.R.C. § 368(a)(2)(H).

181 I.R.C. § 361(a).

182 I.R.C. § 358(a).

183 I.R.C. § 1223(1).

184 I.R.C. § 1032(a).

185 I.R.C. §§ 362(b); 1223(2).

186 I.R.C. § 312(h); Reg. § 1.312–10(a), (c). In the case of a newly created corporation, this allocation generally is made in proportion to the relative fair market values of the assets retained by the parent corporation and the assets transferred to the controlled corporation. Reg. § 1.312–10(a). In a "proper case," the regulations provide that this allocation should be made in proportion to the "net basis" (after reduction for liabilities) of the transferred and retained assets. Id.

2. CONSEQUENCES TO SHAREHOLDERS AND SECURITY HOLDERS

No Boot Received. If the requirements of Section 355 are met, the shareholders or security holders of the distributing corporation generally do not recognize gain or loss on the distribution of stock or securities of the controlled corporation.[187] The aggregate basis of the stock or securities in the distributing corporation held by the shareholder is allocated among the stock and securities of both the distributing and controlled corporations in proportion to their relative fair market values,[188] and the shareholder's holding period in the stock or securities of the controlled corporation received in the distribution includes the holding period of the stock or securities of the distributing corporation.[189]

Treatment of Boot. As with most other types of reorganizations, the receipt of boot in an otherwise qualifying corporate division does not necessarily spell doom for the transaction but results in the recognition of gain to the shareholder receiving the boot. For this purpose, boot includes: (1) cash, (2) any property other than stock or securities of the controlled corporation (e.g., short-term debt obligations), (3) securities of the controlled corporation to the extent that their principal amount exceeds the principal amount of any securities surrendered,[190] (4) any stock of the controlled corporation that was acquired by the distributing corporation in a transaction in which gain or loss was recognized within the five-year period prior to the distribution (known as "hot stock"), and (5) nonqualified preferred stock received in a distribution with respect to stock other than nonqualified preferred stock.[191]

The rule treating "hot stock" as boot does not apply, however, to any acquisition of stock of a controlled corporation that becomes a member of the separate affiliated group of the distributing corporation at any time after the stock is acquired and before it is distributed in the Section 355 transaction under scrutiny.[192] This modification was made by regulations that reflect a policy decision to avoid conflicts between the boot rules and the treatment of separate affiliated groups under the active trade or business test discussed earlier in this chapter.[193] For example, if the

187 I.R.C. § 355(a)(1).

188 I.R.C. § 358(b), (c).

189 I.R.C. § 1223(1).

190 For purposes of determining boot, stock rights generally are considered securities with no principal amount. Reg. § 1.355–1(c).

191 I.R.C. §§ 355(a)(3), (4); 356(a), (b), (d)(2)(C). For the definition of nonqualified preferred stock, see I.R.C. § 351(g)(2) and Chapter 2B3, supra.

192 Reg. § 1.355–2(g)(2)(i). The regulations also provide relief from the hot stock rule for transfers of controlled corporation stock among members of the distributing corporation's affiliated group. Id. For some basic examples of the hot stock relief rule, see Reg. § 1.355–2(g)(5) Examples 1 and 2.

193 See Section B of this chapter, supra. To better understand the hot stock relief rule, it may be helpful to recall that Section 355(b)(3)(A) provides that, for purposes of determining whether a corporation is engaged in the active conduct of a trade or business, all members of

distributing corporation had acquired all of the controlled corporation's stock in a taxable transaction that qualified as an expansion of the distributing corporation's existing trade or business and later distributed all of that stock within five years of the acquisition in an unrelated transaction, the distribution would satisfy the active trade or business requirement.[194] But without the relief provided by the regulations, it would be fully taxable hot stock. The IRS concluded that such a result was inconsistent with Congressional intent.

The tax treatment of boot depends on the form of the division. In the case of a spin-off, the receipt of boot is treated as a distribution to which Section 301 applies (without regard to the shareholder's realized gain) and is thus a dividend to the extent of the distributing corporation's current and accumulated earnings and profits and a return of capital to the extent of any balance.[195] In the case of a split-off or split-up, both of which involve an exchange rather than a distribution, Section 356(a)(1) requires the shareholder to recognize any realized gain to the extent of the boot received in the distribution. The characterization of that gain is more problematic. Section 356(a)(2) adopts the same rule used for acquisitive reorganizations by providing that if the exchange has "the effect of the distribution of a dividend," the gain recognized is treated as a dividend to the extent of the shareholder's ratable share of accumulated earnings and profits of the distributing corporation.[196] The balance of any recognized gain is treated as gain from the exchange of property.[197] As explained in Revenue Ruling 93–62, which follows this Note, dividend equivalence is tested by applying the "before" and "after" ownership principles of Section 302 (i.e., meaningful reduction of the shareholder's proportionate interest) using an assumption that the shareholder had retained the distributing corporation stock that actually was exchanged for controlled corporation stock and then had received the boot in exchange for distributing corporation stock equal in value to the boot.[198] Whether or not this hypothetical redemption results in a dividend is tested by comparing the shareholder's percentage ownership in the distributing corporation before the transaction with the interest the

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that corporation's separate affiliated group are treated as one corporation. Prop. Reg. § 1.355–3(b)(3)(ii).

194 Prop. Reg. § 1.355–3(d)(2) Examples 18 & 20.

195 I.R.C. § 356(b). For noncorporate shareholders, virtually all such dividends will be "qualified" and thus taxable at the applicable 15 and 20 percent long-term capital gains rates.

196 In one of the many curiosities in the world of reorganizations, neither Section 356(a)(2) nor the applicable regulations refer to *current* earnings and profits.

197 See Reg. § 1.356–1(b)(2).

198 Rev. Rul. 93–62, infra p. 504. See also Commissioner v. Clark, 489 U.S. 726, 109 S.Ct. 1455 (1989), which uses a similar approach in testing for dividend equivalence in acquisitive reorganizations where T shareholders receive boot. For discussion of the Service's approach, see Steinberg, "Selected Issues in the Taxation of Section 355 Transactions," 52 Tax Law. 7, 11–16 (1997). The author suggests that Revenue Ruling 93–62, while purporting to follow the Supreme Court's approach to dividend equivalence in *Clark*, actually is inconsistent with *Clark's* "postreorganization" approach insofar as the ruling treats the boot as having been received in a hypothetical redemption occurring *prior* to the split-off.

shareholder would have retained in the distributing corporation if the shareholder surrendered only the stock exchanged for the boot. Any loss realized by a shareholder in a Section 355 exchange may not be recognized.[199]

Basis and Holding Period. Section 358 again governs the basis of the boot and nonrecognition property received in the distribution. The boot takes a fair market value basis and its holding period commences as of the date of the distribution.[200] The aggregate basis of the nonrecognition property (i.e., stock and securities) is the same as the basis of the stock or securities of the distributing corporation plus any gain recognized and less any cash and the fair market value of any boot property received in the exchange.[201] That aggregate basis is then allocated among the old and new stock or securities (or the new stock or securities, in the case of a split-up) in proportion to their relative fair market values.[202] Similar to the approach used for acquisitive reorganizations, if the "old stock" was acquired at different times or for different prices, the distributee shareholders generally must trace their bases in the various blocks of old stock (rather than using an average basis) in determining the basis of the new stock under Section 358. If tracing is impossible, the taxpayer may designate how the Section 358 basis is to be allocated to the new stock received in a manner that minimizes the disparity in holding periods of the surrendered shares to any particular share of stock received.[203] The nonrecognition property ordinarily is eligible for a tacked holding period.[204]

Revenue Ruling 93–62

1993–2 Cum. Bull. 118.

ISSUE

Whether gain recognized on the receipt of cash in an exchange of stock that otherwise qualifies under section 355 of the Internal Revenue Code is treated as a dividend distribution under section 356(a)(2).

FACTS

Distributing is a corporation with 1,000 shares of a single class of stock outstanding. Each share has a fair market value of $lx. A, one of five unrelated individual shareholders, owns 400 shares of Distributing stock. Distributing owns all of the outstanding stock of a subsidiary

199 I.R.C. § 356(c).

200 I.R.C. § 358(a)(2).

201 I.R.C. § 358(a)(1).

202 I.R.C. § 358(b)(2), (c); Reg. § 1.358–2. The Service has never provided any guidance as to the precise date to be used in valuing the corporations for purposes of this allocation. In the case of publicly held companies, the date selected ordinarily is the first day that the stock of the controlled corporation was traded on a listed exchange. For other possibilities, see Bittker & Eustice, supra note 2, ¶ 11.12[1].

203 See Reg. § 1.358–2(a)(2)(i), (iv), –2(c) Example 12.

204 I.R.C. § 1223(1).

corporation, Controlled. The Controlled stock has a fair market value of $200x.

Distributing distributes all the stock of Controlled plus $200x cash to A in exchange for all of A's Distributing stock. The exchange satisfies the requirements of section 355 but for the receipt of the cash.

LAW AND ANALYSIS

Section 355(a)(1) of the code provides, in general, that the shareholders of a distributing corporation will not recognize gain or loss on the exchange of the distributing corporation's stock or securities solely for stock or securities of a controlled subsidiary if the requirements of section 355 are satisfied.

Section 356(a)(1) of the Code provides for recognition of gain on exchanges in which gain would otherwise not be recognized under section 354 (relating to tax-free acquisitive reorganizations) or section 355 if the property received in the exchange consists of property permitted to be received without gain recognition and other property or money ("boot"). The amount of gain recognized is limited to the sum of the money and the fair market value of the other property.

Under section 356(a)(2) of the Code, gain recognized in an exchange described in section 356(a)(1) that "has the effect of the distribution of a dividend" is treated as a dividend to the extent of the distributee's ratable share of the undistributed earnings and profits accumulated after February 28, 1913. Any remaining gain is treated as gain from the exchange of property.

Determinations of whether the receipt of boot has the effect of a dividend are made by applying the principles of section 302 of the Code. Commissioner v. Clark, 489 U.S. 726 (1989), 1989–2 C.B. 68. Section 302 contains rules for determining whether payments in redemption of stock are treated as payments in exchange for the stock or as distributions to which section 301 applies.

Under section 302(a) of the Code, a redemption will be treated as an exchange if it satisfies one of the tests of section 302(b). Section 302(b)(2) provides exchange treatment for substantially disproportionate redemptions of stock. A distribution is substantially disproportionate if (1) the shareholder's voting stock interest and common stock interest in the corporation immediately after the redemption are each less than 80 percent of those interests immediately before the redemption, and (2) the shareholder owns less than 50 percent of the voting power of all classes of stock immediately after the redemption.

In *Clark*, the Supreme Court determined whether gain recognized under section 356 of the Code on the receipt of boot in an acquisitive reorganization under section 368(a)(1)(A) and (a)(2)(D) should be treated as a dividend distribution. In that case, the sole shareholder of the target corporation exchanged his target stock for stock of the acquiring corporation and cash. In applying section 302 to determine whether the boot payment had the effect of a dividend distribution, the Court considered whether section 302 should be applied to the boot payment as if it were made (i) by the target corporation in a prereorganization hypothetical redemption of a portion of the shareholder's target stock, or (ii) by the acquiring corporation in a postreorganization hypothetical redemption of the acquiring corporation stock that the shareholder would have received in the reorganization exchange if there had been no boot distribution.

The Supreme Court stated that the treatment of boot under section 356(a)(2) of the Code should be determined "by examining the effect of the exchange as a whole," and concluded that treating the boot as received in a redemption of target stock would improperly isolate the boot payment from the overall reorganization by disregarding the effect of the subsequent merger. Consequently, the Court tested whether the boot payment had the effect of a dividend distribution by comparing the interest the taxpayer actually received in the acquiring corporation with the interest the taxpayer would have had if solely stock in the acquiring corporation had been received in the reorganization exchange.

Prior to the decision in *Clark*, the Service considered the facts and issue presented in this revenue ruling in Rev. Rul. 74–516, 1974–2 C.B. 121. The determination of whether the exchange of Distributing stock for Controlled stock and boot under section 355 of the Code had the effect of a dividend distribution under section 356(a)(2) was made by comparing A's interest in Distributing prior to the exchange with the interest A would have retained if A had not received Controlled stock and had only surrendered the Distributing stock equal in value to the boot. The Court's decision in *Clark* does not change the conclusion in Rev. Rul. 74–516, because, like Clark, the ruling determined whether the exchange in question had the effect of a dividend distribution based on an analysis of the overall transaction.

The exchange of A's Distributing stock for stock of Controlled qualifies for nonrecognition treatment under section 355 of the Code in part because the overall effect of the exchange is an adjustment of A's continuing interest in Distributing in a modified corporate form. See section 1.355–2(c) of the Income Tax Regulations. The Controlled stock received by A represents a continuing interest in a portion of Distributing's assets that were formerly held by A as an indirect equity interest. The boot payment has reduced A's proportionate interest in the overall corporate enterprise that includes both Distributing and Controlled. Thus, the boot is treated as received in redemption of A's Distributing stock, and A's interest in Distributing immediately before the exchange is compared to the interest A would have retained if A had surrendered only the Distributing shares equal in value to the boot.

Under the facts presented here, before the exchange, A owned 400 of the 1,000 shares, or 40 percent, of the outstanding Distributing stock. If A had surrendered only the 200 shares for which A received boot, A would still hold 200 of the 800 shares, or 25 percent, of the Distributing stock outstanding after the exchange. This 25 percent stock interest would represent 62.5 percent of A's preexchange stock interest in Distributing. Therefore, the deemed redemption would be treated as an exchange because it qualifies as substantially disproportionate under section 302(b)(2) of the Code.

HOLDING

In an exchange of stock that otherwise qualifies under section 355 of the Code, whether the payment of boot is treated as a dividend distribution under section 356(a)(2) is determined prior to the exchange. This determination is made by treating the recipient shareholder as if the shareholder had retained the distributing corporation stock actually exchanged for controlled corporation stock and received the boot in exchange for distributing corporation stock equal in value to the boot.

EFFECT ON OTHER RULINGS

Rev. Rul. 74–516 is superseded.

3. CONSEQUENCES TO THE DISTRIBUTING AND CONTROLLED CORPORATIONS

Nonrecognition of Gain or Loss: General Rules. The tax consequences to the distributing corporation in a Section 355 transaction initially are determined by Section 361(c) if the distribution is preceded by a Type D reorganization and by Section 355(c) if it is not. In either case, the results generally are the same. If a Section 355 transaction occurs in conjunction with certain changes in shareholder ownership, the distributing corporation also may be required to recognize gain under Section 355(d).[205]

If a Section 355 distribution is part of a reorganization plan—i.e., where the distributing corporation first transfers property to the controlled corporation—no gain or loss is recognized if the property is contributed solely in exchange for stock or securities of the controlled corporation.[206] The distributing corporation recognizes gain, however, if the liabilities assumed by the controlled corporation exceed the aggregate adjusted basis of the transferred property or if it otherwise receives boot that is not distributed to shareholders or creditors as part of the reorganization plan.[207]

The distributing corporation also does not recognize gain on the distribution to its shareholders of "qualified property"—i.e., stock or debt

[205] See Section E1 of this chapter, infra.

[206] I.R.C. §§ 368(a)(1)(D); 361(a).

[207] I.R.C. §§ 357(c), 361(b). The amount of cash and property that a distributing corporation may distribute to creditors without gain recognition is limited to the aggregate adjusted basis of the assets contributed to the controlled corporation in the Type D reorganization. I.R.C. § 361(b)(3).

obligations of the controlled corporation.[208] Thus, in the typical spin-off or split-off, where the distributing corporation's basis in the stock of the controlled corporation is less than its fair market value, no corporate-level gain is recognized on the distribution. Section 311(b), which otherwise might have required gain recognition, is not applicable because it only applies to distributions under Subpart A of Subchapter C (Sections 301–307), and Section 355 is not within that portion of the Code.[209] The same result occurs on a split-up. Section 336, which otherwise might have required the recognition of corporate-level gain on a liquidating distribution, does not apply to distributions that are part of a reorganization.[210] Gain is recognized, however, in the rare case where appreciated boot is distributed in a Section 355 transaction that is part of a reorganization.[211]

If the distribution is not preceded by a Type D reorganization—e.g., where the controlled corporation is not a newly formed subsidiary—Section 355(c) determines the tax consequences of all forms of divisions,[212] providing generally that the distributing corporation recognizes no gain or loss on any distribution to which Section 355 applies.[213] Gain must be recognized, however, on a distribution of appreciated property other than "qualified property,"—i.e., other than stock or securities in the controlled corporation.[214] Thus, no gain will be recognized on a distribution of stock or securities of the controlled corporation in a qualifying corporate division even if the recipient shareholder is taxed,[215] but gain is recognized on a distribution of any other appreciated boot.[216]

Recognition of Gain on Certain Disqualified Distributions. The general nonrecognition rule in Section 355(c) does not apply if the distributing corporation makes a "disqualified distribution" of "disqualified stock" within the meaning of Section 355(d). In general, a disqualified distribution is any distribution of stock or securities of a controlled subsidiary ("S") if, immediately after the distribution, any person holds a 50 percent or greater interest in either the distributing corporation or the controlled subsidiary and that interest consists of "disqualified stock," which is defined generally as any stock acquired by

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208 I.R.C. § 361(c)(1), (2).

209 See also I.R.C. § 361(c)(4).

210 I.R.C. § 361(c)(4); see also § 336(c).

211 I.R.C. § 361(c)(2).

212 Section 355(c)(3) makes it clear that Sections 311 (relating to nonliquidating distributions) and 336 (relating to liquidating distributions) do not apply to a distribution governed by Section 355.

213 I.R.C. § 355(c)(1).

214 I.R.C. § 355(c)(2). The definition of "qualified property" in Section 355(c)(2)(B) is somewhat narrower than the one used to define the same term in Section 361(c)(2)(B), where "qualified property" includes both rights to acquire stock and nonsecurity debt obligations.

215 The recipient would be taxed, for example, if the principal amount of securities received exceeds the principal amount of any securities surrendered. I.R.C. § 355(a)(3)(A).

216 I.R.C. § 355(c)(2)(A).

"purchase" within the five-year period preceding the distribution.[217] This rule, which is designed to prevent the use of Section 355 to facilitate the tax-free sale of part of a business following a takeover (and in related transactions), is discussed later in the chapter,[218] as is Section 355(e), which taxes the distributing corporation on distributions of controlled corporation stock in certain situations where as part of a "plan" a 50-percent or greater interest in either the distributing or controlled corporations was acquired within two years before or after the distribution.[219]

Carryover of Tax Attributes. The method of allocating the earnings and profits of the various parties to a corporate division depends on the form of the transaction. If a division is preceded by a Type D reorganization, the earnings and profits of the distributing corporation are allocated between the distributing and controlled corporations in proportion to the relative fair market values of the assets retained by each corporation.[220] If the division is not preceded by a Type D reorganization—e.g., where the stock of a preexisting subsidiary or subsidiaries is distributed—the regulations provide methods for determining the decrease in the distributing corporation's earnings and profits.[221] In no event may any deficit of the distributing corporation be allocated to the controlled corporation.[222]

Earnings and profits are the only tax attributes affected by a corporate division. The carryover rules of Section 381 relating to other tax attributes are not applicable to divisive reorganizations, and thus the tax history of the distributing corporation will remain intact in a spin-off or a split-off. Since a split-up involves the liquidation of the distributing corporation, its tax attributes will disappear as a result of the transaction.[223]

4. CONSEQUENCES OF FAILED DIVISIONS

If a corporate division fails to qualify under Section 355, the tax consequences depend on the form of the transaction. If the defective division is preceded by the formation of a new corporation, that formation still qualifies for nonrecognition—but under Section 351 rather than Section 368(a)(1)(D).[224]

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217 I.R.C. § 355(d)(2)–(5).

218 See Section E1 of this chapter, infra.

219 See Section E2 of this chapter, infra.

220 I.R.C. § 312(h); Reg. § 1.312–10(a). The regulations also state that in a "proper case" the allocation should be made in proportion to the net bases of the transferred and retained assets.

221 Reg. § 1.312–10(b).

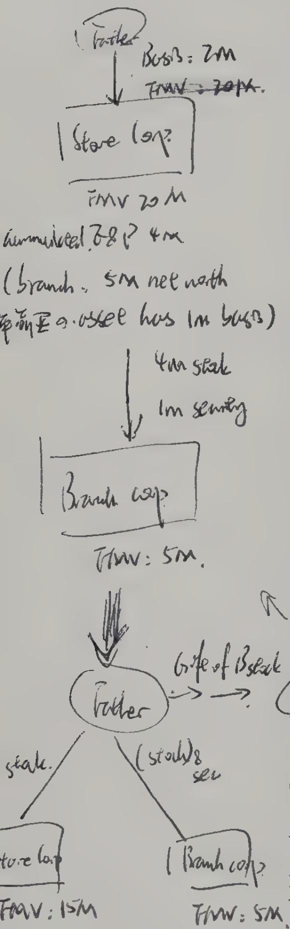
222 Reg. § 1.312–10(c).

223 See Rev. Rul. 56–373, 1956–2 C.B. 217.

224 Although the formation of the new corporation still qualifies for nonrecognition, different operative provisions come into play to govern the transaction. See I.R.C. §§ 351; 358;

As for the division itself, the distribution of stock or securities in a nonqualifying spin-off is treated as an ordinary distribution to which Section 301 applies. That means it will be a dividend to the extent of current and accumulated earnings and profits and a return of capital to the extent of any balance. If the distribution takes the form of a split-off, it is tested under the stock redemption rules of Section 302. To avoid being subject to Section 301, the redemption thus must come within one of the Section 302(b) tests for exchange treatment.[225] If the failed division is a split-up, the transaction logically should be governed by the complete liquidation rules, allowing the shareholders to recognize capital gain or loss under Section 331(a).[226]

At the corporate level, the distributing corporation will be required to recognize gain on a distribution of appreciated property in a failed spin-off or split-off under Section 311(b). Section 311(a)(2), however, denies recognition of loss on a distribution of property that has declined in value. In a split-up, the distributing corporation will be required to recognize gain or loss under Section 336(a), subject to the limitations on recognition of loss in Section 336(b).



PROBLEM

Father is the sole shareholder of an incorporated department store which he has owned for 45 years. He has a basis of $2 million in his Store Corporation stock, which is currently worth $20 million. Store has $4 million of accumulated earnings and profits. Three years ago, Store acquired land in Suburb, where it constructed and then opened a new branch store. The branch has been quite successful and represents $5 million of the $20 million net worth of Store Corporation. The assets of the branch have a $1 million basis.

Father recently celebrated his 75th birthday and is exploring some estate planning alternatives. His attorney has suggested that he should have Store Corporation transfer the Suburb store to newly created Branch Corporation in exchange for Branch stock worth $4 million and Branch securities worth $1 million. Store Corporation, which would be worth $15 million after this transaction, then would distribute the Branch stock and securities to Father who in turn would give the Branch stock to his children.

Discuss all the income tax consequences of the above transactions to Father, Store Corporation and Branch Corporation, assuming first that the

362(a); 1032. See Reg. § 1.312–11(a) for the allocation of earnings and profits in these circumstances.

[225] If the distribution is pro rata, dividend treatment is thus assured. The distribution of stock in a failed split-off would not qualify for partial liquidation treatment under Section 302(b)(4). See Morgenstern v. Commissioner, supra note 141; Rev. Rul. 75–223, supra note 141.

[226] It is possible, however, that certain split-ups will be treated as a reorganization coupled with a dividend. This might occur on a split-up involving a failed division of an operating business from liquid assets in preparation for a sale of the liquid assets. See Bittker & Eustice, supra note 2, ¶ 11.15[3]. But it may not matter when dividends and long-term capital gains are taxed at the same rate.

...ralal 355 trans? : ...ontrol? -> had control & distribute all stock in B corp.
...ere Business? 新设立 Branch 3 yrs ago. 不足 5 yst, ...eated as expansion of original business. whole enterprise ... together 5 yst.
...usiness purpose? solely for fed tax purpose, x! ...usiness R: could be business succession / distribute property to heirs.
...evice? -> later distribution to kid -> pro-device factor if x business purpose -> x
continuity of interest: do father has continuity interest in each corp? depend on the spin-off ...

corporate division totally or partially qualifies under Section 355 and then that it fails to qualify.

E. USE OF SECTION 355 IN CORPORATE ACQUISITIONS

1. LIMITATIONS ON USE OF SECTION 355 IN TAXABLE ACQUISITIONS

a. INTRODUCTION

The repeal of the *General Utilities* doctrine led tax advisors to search for new techniques to avoid corporate-level gain on the sale of all or part of a business. In one common transactional pattern, a corporate buyer of a controlling stock interest in a target corporation may seek to dispose of unwanted pieces of the target, perhaps to help finance the acquisition or maximize overall shareholder value. The tax goal is to consummate those dispositions without recognizing gain. After Congress blocked several other promising techniques, taxpayers turned to Section 355 to facilitate tax-free sales of unwanted assets in corporate solution. Congress reacted by curtailing the benefits of nonrecognition for certain transactions that previously would have qualified as tax-free divisions. These anti-avoidance limitations, which were previewed earlier in this chapter, are best explained in the context of the transactions at which they were directed.

b. DISPOSITIONS OF RECENTLY ACQUIRED BUSINESSES

Code: § 355(a)(2)(D).

Congress's first line of attack was to amend the active trade or business requirement in Section 355(b)(2)(D) in order to prevent a purchasing corporation ("P") that had recently acquired a controlling stock interest in a target corporation ("T") from disposing of a target subsidiary ("S") without paying a corporate-level tax. To illustrate the prototype transaction at which this rule is aimed, assume that P purchases all the stock of T, which has engaged directly in the active conduct of a trade or business for more than five years. T owns the stock of S, which also has engaged in the active conduct of a trade or business for the requisite five-year period. Both T and S have highly appreciated assets. P does not make a Section 338 election when it purchases T's stock and, as a result, T and S retain their historic asset bases. P intends to dispose of S shortly after the takeover of T.

At one time, the parties could have used a two-step transaction to sell S without recognizing gain. T would first distribute the S stock to P in a tax-free distribution under Section 355.[227] The Service ruled that

[227] To avoid problems under the continuity of interest doctrine, P needed to hold the T stock for a respectable period of time (two years was considered safest) to become a "historic" shareholder of T. See Section C2 of this chapter, supra.

such a distribution qualified as tax-free and did not violate the active trade or business requirement unless P attempted a bailout by distributing the S stock to its shareholders.[228] P would allocate the cost basis in its T stock under Section 358 between the T stock and the S stock it received in the distribution, obtaining essentially a fair market value basis in the stock of both corporations.[229] After a respectable interval, P then would sell the S stock without recognition of any corporate-level gain by S. Although the new buyer would take a cost basis in the S stock, S would retain its historic lower asset bases. This is noteworthy because the gain inherent in S's assets was not avoided by this technique; it merely was deferred. Moreover, that gain did not accrue while P owned T (and thus indirectly S), and any economic gain that did accrue during P's ownership would be taxed on P's sale of the S stock.[230]

Section 355(b)(2)(D) forecloses this strategy by providing that the active trade or business requirement is not met if control (as measured by the 80 percent tests in Section 368(c)) of the distributing corporation (T) was acquired by a corporate distributee (P) within the five-year period preceding the distribution of stock in the controlled corporation (S). The limitation does not apply, however, if P acquired T in a wholly tax-free transaction, such as an acquisitive reorganization.[231] Distributee corporations that are members of the same affiliated group (as defined in Section 1504(a)) are treated as a single corporate distributee for this purpose.[232]

The principal sanction from denying Section 355 treatment to the above fact pattern is that T must recognize gain on the distribution of its S stock to P. In addition, assuming that T has ample earnings and profits, P has a dividend on receipt of the S stock, but as a corporate parent of T, P likely would be entitled to a 100 percent dividends received

[228] Rev. Rul. 74–5, 1974–1 C.B. 82. The key to the ruling was that T (the distributing corporation) and S (the controlled corporation) both had been engaged in the active conduct of a trade or business for five years. It did not matter that P (the distributee shareholder of T) had acquired a controlling interest in T in a taxable transaction within the five-year period preceding the distribution.

[229] P thus obtained a basis in the S stock that usually was significantly higher than T's basis in the S stock. T's basis would disappear if the spin-off qualified under Section 355. Cf. I.R.C. §§ 332; 336(e); 338(h)(10).

[230] Of course, T could not have sold its S stock without recognizing at least one level of gain. Query whether P should be able to avoid gain on a sale of a piece of T's business when T could not have done so. On the other hand, no corporate-level gain was recognized when T's shareholders sold all their T stock to P and no Section 338 election was made. Query why T or P should not be able to sell S without corporate-level gain provided that gain is preserved through transferred asset bases.

[231] I.R.C. § 355(b)(2)(D)(ii); see also Rev. Rul. 89–37, 1989–1 C.B. 107.

[232] Thus, if in the example P had two existing wholly owned subsidiaries (X and Y) and each acquired 50 percent of the T stock for cash, a distribution by T of its S stock within five years after the acquisition would not qualify under Section 355 because X and Y, as members of the same affiliated group, are treated as a single corporation that acquired a controlling stock interest in T within five years preceding the distribution.

deduction.[233] P would obtain a fair market value basis in the distributed S stock[234] and thus recognize no further gain on the subsequent sale. But in the likely event that the buyer of the S stock does not make a Section 338 election, the gain inherent in S's assets is preserved through their transferred bases, raising the specter of yet another corporate-level tax.[235]

PROBLEM

T Corporation ("T") and its wholly owned subsidiary, S Corporation ("S") each have actively conducted a trade or business for more than five years. P Corporation ("P") wishes to acquire T but is not interested in owning the business conducted by S. The assets of T (including its S stock) and S are highly appreciated, and the businesses operated by T and S are equal in value. Consider generally the tax consequences of the following alternative transactions:

(a) T sells its S stock to Buyer Corporation. T's shareholders then sell their T stock to P.

(b) In 2018, P purchases all of T's stock from T's shareholders for cash and does not make a Section 338 election. In 2020, for a valid business purpose, T distributes its S stock to P and nine months later P sells the S stock to Buyer Corporation.

(c) Same as (b), above, except that P is an individual.

(d) Same as (b), above, except that P acquired all the stock of T in a tax-free Type B reorganization.

(e) In 2018, P purchases 50% of the T stock from T's shareholders and Buyer Corporation ("B") purchases the remaining 50%. In 2020, T distributes all of its S stock to B in exchange for all the T stock held by B.

c. DIVISIVE TRANSACTIONS IN CONNECTION WITH CERTAIN CHANGES OF OWNERSHIP

Code: § 355(c), (d).

The active business requirement may disqualify a divisive transaction if P acquires a controlling stock interest in T within the five years preceding the distribution of S stock.[236] The requirement does not apply, however, in some other situations that offer promising avenues of

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[233] I.R.C. § 243(a)(3), (b). If P, T and S were members of a consolidated group, the dividend would be deferred and P's basis in its T stock would be reduced by the amount of the distribution. Reg. §§ 1.1502–14(a)(1); 1.1502–32(b)(2).

[234] I.R.C. § 301(d).

[235] This double *corporate*-level tax could be avoided if T sold its S stock directly to the new buyer, and the parties jointly made an election under Section 338(h)(10). In that event, T could ignore the gain on the sale of its S stock but S would recognize gain on a deemed sale of its assets, and "new S" would obtain a stepped-up basis in those assets. See Chapter 8C3, supra. Query why the result is worse in a comparable transaction caught by the Section 355(b)(2)(D) trap?

[236] I.R.C. § 355(b)(2)(D).

escape from corporate-level tax in ostensibly divisive transactions that are really sales. For example, if P did not acquire a controlling stock interest in T, the active business limitation would not preclude essentially the same transaction described in the example above. This opportunity may be illustrated through a simple fact pattern in which four unrelated corporations (A, B, C and D) each purchase a portion of the stock of T with the ultimate objective of winding up with different pieces of T's business that are conducted through separate T subsidiaries. After waiting two years to establish their status as historic shareholders for continuity of interest purposes, A, B and C could exchange their T stock for stock of the desired T subsidiary in a split-off that would qualify under Section 355.[237] All of this could be accomplished without waiting five years after the acquisition of T because no single corporate distributee acquired a controlling stock interest in T. The five-year holding period requirement also does not apply to acquisitions of a controlling interest in T through a partnership or by any other noncorporate purchaser. A variety of other avoidance techniques quickly revealed that Congress had not successfully curtailed the use of Section 355 to avoid corporate-level gain on essentially acquisitive transactions.

The Treasury might have attacked a Section 355 transaction that was inconsistent with *General Utilities* repeal by exercising its authority to issue regulations under Section 337(d).[238] Instead, it returned to Congress for a more comprehensive solution. The result is Section 355(d), which imposes a corporate-level tax on divisive transactions in connection with certain changes of ownership. The House Ways and Means Committee explained the reasons for the change:[239]

> Some corporate taxpayers may attempt, under present-law rules governing divisive transactions, to dispose of subsidiaries in transactions that resemble sales, or to obtain a fair market value stepped-up basis for any future dispositions, without incurring corporate-level tax. The avoidance of corporate-level tax is inconsistent with the repeal of the *General Utilities* doctrine as part of the Tax Reform Act of 1986.
>
> Under the present-law rules, individual purchasers, or corporate purchasers of less than 80 percent, of the stock of a parent corporation may attempt to utilize section 355 to acquire a subsidiary (or a division incorporated for this purpose) from the parent without the parent incurring any corporate-level tax.

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[237] For this purpose, it is assumed that all relevant business of T have a five-year history; the business purpose requirement can be satisfied; and the parties could structure the transaction to avoid the step transaction doctrine.

[238] Section 337(d) grants the Service authority to promulgate regulations to prevent circumvention of the purposes of certain amendments made by The Tax Reform Act of 1986 (i.e., repeal of the *General Utilities* doctrine) through the use of any provision of the Code or regulations.

[239] House Ways and Means Committee, Explanation of the Revenue Provisions to 1991 Budget Reconciliation Bill (Oct. 16, 1990), 101st Cong., 2d Sess. 90–92 (1990).

The purchaser may acquire stock of the parent equal in value to the value of the desired subsidiary or division, and later surrender that stock for stock of the subsidiary, in a transaction intended to qualify as a non pro-rata tax-free divisive transaction. Alternatively, the transaction might be structured as a surrender of the parent stock by all shareholders other than the acquiror, in exchange for a distribution (intended to be tax-free) of all subsidiaries or activities other than those the acquiror desires.

In addition, a noncorporate purchaser, or a corporate purchaser of less than 80 percent of the stock of another corporation, may attempt to utilize section 355 to obtain a stepped up fair market value basis in a subsidiary of an acquired corporation, enabling a subsequent disposition of that subsidiary without a corporate-level tax.

The provisions for tax-free divisive transactions under section 355 were a limited exception to the repeal of the *General Utilities* doctrine, intended to permit historic shareholders to continue to carry on their historic corporate businesses in separate corporations. It is believed that the benefit of tax-free treatment should not apply where the divisive transaction, combined with a stock purchase resulting in a change of ownership, in effect results in the disposition of a significant part of the historic shareholders' interests in one or more of the divided corporations.

The present-law provisions granting tax-free treatment at the corporate level are particularly troublesome because they may offer taxpayers an opportunity to avoid the general rule that corporate-level gain is recognized when an asset (including the stock of a subsidiary) is disposed of. There is special concern about the possibility for the distributing corporation to avoid corporate-level tax on the transfer of a subsidiary. Therefore, although the provision does not affect shareholder treatment if section 355 is otherwise available, it does impose tax at the corporate level, in light of the potential avoidance of corporate tax on what is in effect a sale of a subsidiary.

The bill is not intended to limit in any way the continuing Treasury Department authority to issue regulations to prevent the avoidance of the repeal of the *General Utilities* doctrine through any provision of law or regulations, including Section 355.

Because Section 355(d) attempts to reach such a wide range of transactions, its operation is complex. Very generally, Section 355(d) requires recognition of gain by the distributing corporation (but not the distributee shareholders) on a "disqualified distribution" of stock or securities of a controlled corporation regardless of whether the distribution is part of a reorganization.[240] A "disqualified distribution" is any Section 355 distribution if, immediately after the distribution, any person holds "disqualified stock" in either the distributing corporation or any distributed controlled corporation constituting a 50 percent or greater interest (measured by total combined voting power or value) in such corporation.[241] "Disqualified stock" includes: (1) any stock in either the distributing corporation or any controlled corporation acquired after October 9, 1990 by purchase during the five-year period before the distribution, and (2) any stock in any controlled corporation received in a distribution attributable to stock in the distributing corporation described in (1).[242]

In effect, Section 355(d) creates a five-year statutory predistribution continuity of interest test. If violated, the test requires the distributing corporation to recognize gain on the distribution of stock or securities of a subsidiary to a person who ends up with 50 percent or more of the stock of the subsidiary. Some typical examples of the application of Section 355(d) are illustrated by the following excerpt from the legislative history:[243]

> Example 1. Assume that after the effective date, individual A acquires by purchase a 20-percent interest in the stock of corporation P and a 10-percent interest in the stock of its subsidiary, S, and 40 percent or more of the stock of S is distributed to A within 5 years in exchange for his 20-percent interest in P. (The remainder of the S stock distributed in the section 355 distribution is distributed to other shareholders). Under the provision P must recognize gain with respect to the distributed stock of S because all 50 percent of the stock of S held by A is disqualified stock.
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> Example 2. Assume that after the effective date individual A acquires by purchase a 20-percent interest in corporation P and P redeems stock of other shareholders so that A's interest in P increases to a 30 percent interest. Within 5 years of A's purchase, P distributes 50 percent of the stock of its subsidiary, S, to A in exchange for his 30 percent interest in P (the remainder of the stock of S distributed in the section 355 transaction is distributed to the other shareholders). P recognizes gain on the distribution of the stock of S because all 50 percent of the stock of S held by A is disqualified stock.

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240 This is technically accomplished by removing the stock or securities of the controlled corporation from the category of "qualified property" under Sections 361(c)(2) and 355(c)(2). I.R.C. § 355(d)(1). As a result, the distributing corporation must recognize gain as if the stock and securities were appreciated boot.

241 I.R.C. § 355(d)(2).

242 I.R.C. § 355(d)(3). See I.R.C. § 355(d)(5)(B) for the details on the "purchase" requirement.

243 H. Rep. No. 101–964, 101st Cong., 2d Sess. 85 (1990).

For purposes of the definition of disqualified stock, stock or securities generally are considered acquired by "purchase" if they do not have either a transferred basis or a Section 1014 date-of-death basis, and were not acquired in an exchange to which Section 351 or the corporate reorganization provisions apply.[244] An acquisition of property in a Section 351 exchange, however, is considered a purchase to the extent such property is acquired for cash or a cash item, marketable stock or securities, or any debt of the transferor.[245] In the case of carryover basis property which was purchased by the transferor, the acquirer of the property is treated as having purchased the property on the date it was purchased by the transferor.[246] This tacking rule may enable a distributing corporation to achieve purchase status and a five-year holding period, thus avoiding the gain triggered on a disqualified distribution.

To prevent easy avoidance of the 50 percent or more ownership test, an array of aggregation and attribution rules are applied to test shareholder ownership after a distribution. First, a shareholder and all persons related to the shareholder under Sections 267(b) or 707(b) are treated as one person.[247] If two or more otherwise unrelated persons act pursuant to a plan or arrangement with respect to acquisitions of distributing corporation or controlled corporation stock or securities, they are treated as a single person for purposes of Section 355(d).[248] Special rules also apply to attribution of stock from a corporation to its shareholders. The Section 318(a)(2) attribution rules apply to both stock and securities with the threshold for attribution from a corporation reduced to 10 percent.[249] In addition, if a person acquires by purchase an interest in an entity through which stock or securities are attributed, such stock or securities are deemed purchased on the later of the date of the purchase of the interest in the entity or the date the stock or securities are acquired by purchase by the entity.[250]

In yet another anti-avoidance provision, the running of the five-year predistribution period for holding stock or securities is suspended during any period in which the holder's risk of loss with respect to the stock or securities or any portion of the corporation's activities is substantially diminished. Such a reduction in risk can be accomplished by an option in

[244] I.R.C. § 355(d)(5)(A). The legislative history states that there will be an exception for reorganization exchanges in which gain is recognized on receipt of boot. H.Rep. No. 101–964, supra note 243, at 90.

[245] I.R.C. § 355(d)(5)(B). The legislative history states that it is expected that regulations will provide an exception for Section 351 exchanges in which such items are transferred as part of an active trade or business (including debts incurred in the ordinary course of the trade or business) and do not exceed the reasonable needs of the business. H.Rep. No. 101–964, supra note 243, at 91.

[246] I.R.C. § 355(d)(5)(C).

[247] I.R.C. § 355(d)(7)(A).

[248] I.R.C. § 355(d)(7)(B).

[249] I.R.C. § 355(d)(8)(A).

[250] I.R.C. § 355(d)(8)(B).

favor of the holder, a short sale, a special class of stock or any other device or transaction.[251] The Service also is granted broad power to prescribe regulations which modify the definition of "purchase" and prevent avoidance of Section 355(d) through the use of related persons, intermediaries, pass-thru entities, options or other arrangements.

2. DISPOSITIONS OF UNWANTED ASSETS IN CONJUNCTION WITH TAX-FREE REORGANIZATIONS

Introduction. As discussed earlier in this chapter, a corporate division may be used as the vehicle for a tax-free spin-off of unwanted assets in preparation for an acquisition of the rest of the target corporation's business. Consider a typical scenario. An attractive takeover candidate ("T"), engaged in two different businesses, is approached by a motivated buyer ("P") whose interest is limited to only one of those businesses. To facilitate the transaction and maximize shareholder value, T spins off the unwanted business to its shareholders and then is acquired by P in a tax-free acquisitive reorganization. Should the spin-off qualify under Section 355? What if T spins off the wanted business ("Newco") to its shareholders, who then exchange their Newco stock for P stock? Should the form of the transaction make any difference? These and other scenarios present a challenge to the target corporation's tax advisor and provide the student of Subchapter C with an opportunity to relate the requirements for a tax-free corporate division to the acquisitive reorganization concepts encountered in the previous chapter.

In Commissioner v. Morris Trust,[252] the Fourth Circuit held that a spin-off of an unwanted business followed by a prearranged merger of the parent "distributing" corporation with an unrelated acquiring corporation qualified as tax-free—specifically, a Type D reorganization coupled with a Section 355 corporate division, and a Section 368 Type A acquisitive reorganization. The Service ultimately blessed the *Morris Trust* form of transaction[253] and even acknowledged that a spin-off to prepare for an acquisition of a separate business was a valid Section 355 business purpose,[254] but it was less receptive to other transactional patterns despite their economic similarity. For example, a spin off of unwanted assets followed by a Type C reorganization or a forward triangular merger was likely to be treated as an integrated transaction, with the unfortunate result that the unwanted assets would be considered in determining whether P transferred substantially all of its properties in the subsequent reorganization. If the unwanted assets were

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[251] I.R.C. § 355(d)(6).

[252] 367 F.2d 794 (4th Cir.1966).

[253] Rev. Rul. 68–603, 1968–2 C.B. 148. See also Rev. Rul. 70–434, 1970–2 C.B. 83 (Type B reorganization followed spin-off of unwanted business).

[254] Rev. Proc. 96–30, 1996–1 C.B. 696, superseded by Rev. Proc. 2017–52, 2017–41 I.R.B. 283.

a substantial part of P's overall business, the acquisition would not qualify as a reorganization, and the spin-off also was unlikely to qualify under Section 355.[255]

Other transactional forms also were vulnerable to challenge under the step transaction doctrine. For example, if P contributed the assets of a *wanted* business with a five-year history to newly created S, retained another (unwanted) business, distributed the S stock to its shareholders, and then S was acquired by an unrelated corporation ("X") in an attempted tax-free reorganization, the Service took the position that neither the spin-off nor the reorganization qualified for tax-free treatment. If the steps were prearranged, S was disregarded and P was treated as having made a taxable sale of the wanted assets to X and having distributed the consideration received from X to P's shareholders as a dividend.[256] If P was publicly traded and S was an "old and cold" (i.e., not newly formed) subsidiary, however, the Service ruled that a spin-off of S stock followed by X's acquisition of S in a Type A or Type B reorganization did qualify as tax-free if no formal negotiations with respect to the subsequent acquisition took place prior to the spin-off.[257]

After repeal of the *General Utilities* doctrine, Congress became concerned (some might say paranoid) that Section 355 was being used to avoid corporate-level gain on the sale of a business. Section 355(d), discussed earlier in this chapter, was an early response. Congress followed up by enacting Section 355(e), which virtually eliminates the time-tested *Morris Trust* technique.[258] The legislative history explains that where new shareholders acquire ownership of a business in connection with a spin-off, the transaction more closely resembles a taxable corporate-level disposition of the portion of the business that is acquired rather than a tax-free division among existing shareholders.[259]

Recognition of Gain by Distributing Corporation: Section 355(e). Section 355(e) is a typically complex anti-avoidance provision and this discussion is limited to an overview. It requires the distributing (parent) corporation to recognize gain as if it had sold the stock of the distributed controlled subsidiary for its fair market value on the date of the distribution if, as part of a "plan" or series of related transactions, one or more persons acquire[260] (directly or indirectly) a 50-percent or greater

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255 See, e.g., Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir.1937), cert. denied, 305 U.S. 605, 59 S.Ct. 65 (1938). But see Rev. Rul. 2003–79, 2003–2 C.B. 80.

256 Rev. Rul. 70–225, 1970–1 C.B. 80.

257 Rev. Rul. 96–30, 1996–1 C.B. 36, obsoleted by Rev. Rul. 98–27, 1998–1 C.B. 1159.

258 See also I.R.C. § 355(f), which disqualifies a transaction in its entirety under Section 355 when one member of an affiliated corporate group makes a distribution to another member if the distribution is part of a plan or series of related transactions to which Section 355(e) applies.

259 S.Rep. No. 105–33, 105th Cong., 1st Sess. 139–140 (1997).

260 Acquisitions, for this purpose, are not limited to cost basis purchase transactions but also can include tax-free acquisitions. Certain acquisitions that do not involve a shift in control are disregarded. I.R.C. § 355(e)(3)(A). If the assets rather than the stock of either corporation are acquired, the shareholders of the acquiring corporation are deemed to have acquired the

interest in either the distributing or controlled corporation within two years before or after the distribution.[261] Put differently (and, one hopes, more coherently), the distributing corporation (but not its shareholders) must recognize corporate-level gain on an otherwise tax-free spin-off if "pursuant to a plan" stock of either the distributing or controlled corporation is acquired and the historic shareholders of the distributing corporation do not retain more than 50 percent (by vote and value) of both corporations. Significantly (and inexplicably), neither the distributing nor controlled corporations may adjust the basis of their assets or stock to reflect this recognition of Section 355(e) gain.

Plan Requirement. Section 355(e) applies only if the transaction is part of a "plan" (or a series of related transactions) to acquire the requisite 50 percent or greater interest in the target. For this purpose, if one or more persons directly or indirectly acquire a 50-percent or greater interest in the distributing corporation or any controlled corporation during the four-year period beginning two years before the distribution, the acquisition is presumed to be pursuant to a plan unless the taxpayer establishes that such a plan did not exist.[262] Whether or not a prohibited "plan" exists is based on all the facts and circumstances.[263]

The regulations have gone through several iterations, and the final version provides considerable flexibility in making this factual determination.[264] In the case of acquisitions (other than public offerings) of the distributing or controlled corporation after a distribution, the distribution and acquisition will be considered as part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition (collectively referred to below as "Talks") at some time during the two-year period preceding the distribution.[265] Although not labelled as a safe harbor, this "two year lookback rule" operates as a security blanket in many situations, especially in light of the narrow definitions of several critical terms. An "agreement, understanding or arrangement," for example, is generally considered to exist only if the parties have reached a common understanding on most of the significant terms of the transaction.[266] "Substantial negotiations" exist only if the significant economic terms of the acquisition have been discussed at the highest levels (directors, officers, shareholders, or their representatives).[267] In

target stock for purposes of determining whether the gain-triggering shift of control has occurred. I.R.C. § 355(e)(3)(B).

261 I.R.C. § 355(e)(1), (2). Technically, this result occurs because the stock or securities in the controlled corporation is not treated as "qualified property" for purposes of Section 355(c)(2) or Section 361(c)(2), and thus gain is recognized on the distribution under Section 311(b).

262 I.R.C. § 355(e)(2)(B).

263 Reg. § 1.355–7(b)(1).

264 See generally Reg. § 1.355–7.

265 Reg. § 1.355–7(b)(2).

266 Reg. § 1.355–7(h)(1)(i)–(iii)F.

267 Reg. § 1.355–7(h)(1)(iv).

short, for a plan to exist, the dealings must have reached a fairly advanced stage.

The regulations go on to provide that, even though the existence of Talks between the parties within the two years preceding the distribution "tend to show" that the distribution and acquisition are part of a plan, all the facts and circumstances still must be considered, and the existence of a corporate business purpose (apart from facilitating the acquisition) will help the taxpayer rebut the statutory presumption.[268] Further comfort is available from seven safe harbors.[269] A key factor under most of these safe harbors is whether there were bilateral Talks during a specified time period. For example, if the acquisition occurred more than six months after the distribution and there were no Talks during the period commencing one year before and ending six months after the distribution, the transactions are not considered part of a plan if the distribution was motivated by a substantial business purpose other than facilitating the acquisition.[270] If a transaction does not fit within any of the safe harbors, the regulations include a list of "plan" and "nonplan" factors to consider in determining whether a plan exists.[271]

Practical Impact of Section 355(e). Section 355(e) obliterates many typical "planned" *Morris Trust* transactions but leaves open the possibility that a spin-off followed by an acquisition will continue to qualify under Section 355 if there was a valid business purpose and Talks with potential acquirers did not occur prior to the distribution and within six months thereafter. On the other hand, the existence of an agreement, understanding or negotiations to sell either the distributing or controlled corporations at the time of the spin-off likely will doom the transaction. In an ironic twist, Section 355(e) would not have changed the tax-free treatment in the actual *Morris Trust* transaction, because the distributing corporation's shareholders received 54 percent of the equity of the acquiring corporation as part of the transaction and thus the "control shift" required to trigger Section 355(e) would not have occurred. As a practical matter, Section 355(e) does not apply when the equity value of the distributing corporation after the spin-off exceeds that of the acquiring corporation.

PROBLEM

Leisure, Inc. is a publicly held corporation that operates a chain of motels and manufactures leisure apparel. Each business has roughly the same net worth and has been operated by Leisure for over five years. Denim Corporation wishes to acquire the apparel business but is not interested in the motels. Leisure would like to dispose of the apparel business, preferably in a tax-free reorganization, and it will continue to operate the motel

[268] Reg. § 1.355–7(b)(2).

[269] Reg. § 1.355–7(d).

[270] Reg. § 1.355–7(d)(1).

[271] Reg. § 1.355–7(b)(3) & (4).

business for the indefinite future. Consider the tax consequences of the following alternative plans for carrying out the objectives of the parties:

(a) Leisure will transfer the motel assets to a newly formed subsidiary, Motel, Inc., and distribute the Motel stock pro rata to the Leisure shareholders. Leisure then will transfer the assets and liabilities of the apparel business to Denim in exchange for Denim voting stock (representing less than 50 percent of the total outstanding voting stock of Denim after the acquisition), and then Leisure will liquidate, distributing the Denim stock pro rata to its shareholders.

(b) Same as (a), above, except that after the spin-off, Leisure merges into Denim. Under the terms of the merger, Leisure shareholders receive Denim nonvoting preferred stock.

(c) What result if Leisure transfers the apparel business to a new corporation, Cords, Inc., and then distributes the Cords stock pro rata to the Leisure shareholders. Leisure continues to operate the motel business, but Cords, Inc. merges into Denim, Inc., and the Cords shareholders receive Denim voting stock.

(d) Same as (c), above, except that after the merger, the Denim voting stock received by Cords shareholders represents more than 50 percent of the total outstanding stock of Denim.

(e) Same as (b), above, except that the merger of Leisure into Denim occurred one year after the spin-off. What factors are relevant in determining whether the transaction was part of a "plan" to acquire Leisure?

(f) Same as (b), above, except that the business purpose for the spin-off was unrelated to any acquisition of the apparel business, and the merger of Leisure into Denim occurred three years after the spin-off.

(g) Is § 355(e) necessary? How did the typical *Morris Trust* transaction violate the policy of Subchapter C?