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# Section 355 Revisited: Time for a Major Overhaul?

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# Section 355 Revisited: Time for a Major Overhaul?

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## Abstract

*Section 355 of the Internal Revenue Code permits a corporation that conducts multiple active businesses to distribute controlling stock ownership interests in one or more of such businesses to all or some of its shareholders on a tax-free basis, provided that various statutory and non-statutory requirements are met. Commonly known as "spin-offs", "split-offs" and "split-ups", qualifying section 355 distributions are often preceded by a transfer of assets (and sometimes liabilities) into the distributed controlled corporation, as part of an overall type "D" divisive "reorganization" described in section 368(a)(1)(D).*

*Non-recognition treatment for at least some forms of corporate separations dates back to the Revenue Act of 1918. The 1954 Code iteration of section 355, which continues to provide the basic statutory framework for tax-free treatment, has been amended several times in order to tighten various qualification requirements and, in certain instances, to impose a corporate level tax on the distributing corporation (via sections 355(d) and (e)) even through the transaction still generates tax –free treatment at the shareholder level. In general, however, the primary distinguishing tax feature of section 355 transactions is that they permit tax-free treatment at both the shareholder and corporate levels, thus constituting the principal exception to the statutory repeal of the so-called* General Utilities *doctrine during the mid-1980s. The main premise of this article is that section 355 is due for a major overhaul.*

*Following an Introduction in Part I, Part II of the article discusses the core principles that commonly underlie non-recognition treatment for both acquisitive and divisive reorganizations. Part III traces the evolution of section 355 and its statutory predecessors, including (i) the impact of the seminal Supreme Court decision in* Gregory v. Helvering*; (ii) the several sets of Treasury regulations under section 355 that have been promulgated, amended and proposed over the years; and (iii) the frequently changing and critically important IRS ruling policies with respect to section 355 transactions. Part IV suggests possible reform measures (summarized in Part IV.A) that would streamline and better objectify the statutory and non-statutory requirements of section 355 by (i) eliminating certain overlaps and discontinuities between such requirements; (ii) imposing specific restrictions and limitations regarding post-distribution stock and asset dispositions; and (iii) repealing or combining existing sections 355(d) and (e).*

*Part V, the Conclusion of the article, capsulizes the main thrust of any ultimate section 355 overhaul -- namely, to implement changes that (i) limit the application of section 355 to corporate separation transactions in which primarily active business assets of the distributing corporation are shifted into stand-alone corporations that continue to be owned primarily by the distributing corporation's shareholders; (ii) deny nonrecognition treatment where substantial amounts of nonbusiness assets change hands and a substantial complement of new shareholders enters the picture; and (iii) preserve the integrity of* General Utilities *repeal.*

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## I. <u>Introduction</u>

Section 355 of the Internal Revenue Code[1] provides very favorable tax treatment for various types of corporate divisions or separations that fall within its boundaries. If a myriad of statutory and nonstatutory qualification requirements can be met, it essentially permits a corporation ("Distributing") to distribute the stock of an 80 percent or more controlled subsidiary ("Controlled") to some or all of its shareholders without federal income taxation at either the shareholder or corporate levels.[2] The ability to avoid corporate-level tax on any gain inherent in the distributed Controlled stock became especially coveted in the mid-1980s, when Congress repealed the so-called *General Utilities* doctrine, effectively overturning a 1935 U.S. Supreme Court decision to the effect that corporate distributions of appreciated assets were not taxable events at the corporate-level.[3] The legislative reversal of this beloved corporate tax planning axiom extended to virtually all non-liquidating and liquidating distributions of non-cash corporate assets (via sections 311(b) and 336(a)), but <u>not</u> to qualifying section 355 distributions of Controlled stock[4]

Section 355 presently occupies several densely worded pages of the Code; and its many statutory definitions, exceptions and operating rules are elaborated upon in almost 50 pages of underlying Treasury regulations. It is, to say the least, a highly technical and very complicated provision. Despite substantial ongoing efforts by the IRS National Office and Treasury to provide useful published guidance in the form of revenue rulings and procedures, regulations and other

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1 Unless otherwise indicated, all statutory references are to provisions of the Internal Revenue Code of 1986, as most recently amended (the "Code" or "IRC"); and references to Treasury regulations are, as indicated, to final, proposed or temporary regulations under such provisions.

2 IRC §§355(a) and (c); 361(c).

3 <u>General Utilities & Operating Co. v. Helvering</u>, 296 U.S. 200 (1935).

4 <u>See</u> IRC §§355(c) and 361(c). In limited circumstances, a qualifying section 355 distribution may be tax-free to the Distributing shareholders, but nonetheless taxable to Distributing by reason of certain substantial stock ownership changes in Distributing or Controlled occurring during prescribed pre- and/or post-distribution periods. <u>See</u> IRC §§355(d) and (e) (added in 1990 and 1997, respectively) and discussion <u>infra</u> at 14-23.

administrative pronouncements, uncertainty continues to exist as to a host of issues arising under section 355. These issues have long provided substantial grist for endless discussion, debate and speculation at tax conferences and programs, commentary by tax professional organizations and numerous published articles authored by tax practitioners and academics.[5] Through it all, tax-free "spin-offs" and other divisive-type transactions continue to be frequently used by both publicly-traded and closely-held corporations. Since the "double-whammy" stakes of failing to qualify under section 355 can be prohibitive (i.e., both corporate and shareholder-level taxation),[6] most taxpayers historically have sought the comfort of a favorable private letter ruling before proceeding with such transactions. Beginning in 2003, however, the IRS National Office has implemented various "no rule" or limited ruling policies with respect to specific issues arising under section 355, as well as overall qualification for nontaxable treatment under the provision.[7] As a result, even where a limited or caveated ruling letter can be obtained, such transactions often do not proceed without an outside tax opinion to the effect that the taxpayer "would" or "should" prevail if the Service were to challenge the claimed section 355 treatment in court.[8]

The main premise of this article is that section 355 is due for a major overhaul. Reform measures along the lines I suggest would (*i*) significantly simplify, tighten and provide greater

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5 Two very thoughtful companion articles from 2003, published in the Southern Methodist University Law Review, specifically address tax reform proposals relating to section 355. See Schler, Simplifying and Rationalizing the Spinoff Rules, 56 SMU L. Rev. 239 (2003); and Yin, Taxing Corporate Divisions, 56 SMU L. Rev. 289 (2003). For especially exhaustive practitioner outlines covering virtually every nook and cranny of section 355, see Murray, The *Gregory* Rules of Section 355 (rev. 4/17), reprinted in Practising Law Institute, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-offs, Restructurings, Financings and Joint Ventures, Vol. 16 at ___ (rev. 2017) ("PLI"); and Wessel et al., Corporate Distributions Under Section 355, PLI, Vol. 16 at ___.]

6 The corporate-level tax bite is now less onerous than before (21 percent instead of 35 percent), but still high enough to generally make flunking section 355 a very unappealing prospect.

7 See discussion infra at 33-36.

8 A "more likely than not" opinion i.e., a better than 50 percent chance of prevailing if litigated, usually does not provide a high enough comfort level for such transactions. "Should" opinions generally reflect confidence levels in the 70-85 percent range; and even "will" opinions contemplate some possibility, albeit quite small (normally not more than in the 5 to 10 percent), of a successful Service challenge. Of course, no outside opinion, however strong, is binding upon the Service.

predictability regarding application of the various requirements of section 355; (*ii*) better harmonize the provision with the tax policy underpinnings of nonrecognition treatment for corporate reorganizations generally; and (*iii*) preserve the integrity of the *General Utilities* repeal exception that section 355 enjoys.

## II. Nonrecognition Treatment for Corporate Reorganizations

Since its earliest days, the Internal Revenue Code has accorded favorable federal income tax treatment to corporations and their shareholders in connection with various types of corporate "reorganizations." Apart from certain single-entity reorganizations (e.g., "recapitalizations" under section 368(a)(1)(E)), such transactions may be either "acquisitive" or "divisive" in nature. Both share a common underlying tax policy objective: to provide nonrecognition treatment only with respect to "exchanges" or "distributions" of stock that occur "incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms."[9]

Acquisitive reorganizations include statutory mergers, stock-for-stock exchanges and certain asset-for-stock acquisitions described in section 368(a)(1).[10] If the statutory definitional requirements of any of these "reorganization" types are met, along with related nonstatutory requirements articulated in underlying Treasury regulations,[11] the shareholders of the acquired (or "target") corporation generally do not recognize taxable gain or loss on the receipt of acquiring

9 Treas. Regs. §§1.368-1(b) and 1.355-2(b).

10 See IRC §§368(a)(1)(A) [state or federal law statutory merger or consolidation ("A" reorganization)]; (a)(1)(B) [stock for solely voting stock exchange) ("B" reorganization); (a)(1)(C) transfer of "substantially all" of target assets for voting stock followed by liquidation of transferor corporation ("C" reorganization)]; (a)(1)(D) [transfer of "substantially all" of target assets (per section 354(b)(2)(B)) followed by liquidation of transferor and resulting in at least 50 percent collective "control" of the transferee corporation by the target shareholder (acquisitive "D" reorganization)]; and (a)(1)(G) [bankruptcy reorganizations].

11 See Treas. Regs. §§1.368-1(b) [corporate business purpose]; -1(e) [continuity of proprietary interest]; and -1(d) [continuity of business enterprise]. See also IRC §368(a)(2)(C) and Treas. Reg. §1.368-2(k) [certain permitted post-reorganization transfers].

corporation stock in exchange for their target company stock.[12] The transfer of property by the target corporation to the acquiring corporation is likewise generally accorded nonrecognition treatment, as is the distribution of acquiring corporation stock by the target to its shareholders.[13]

Divisive reorganizations involve the distribution of Controlled stock to some or all of the Distributing shareholders, with the result that the active business lodged in Controlled no longer resides under the Distributing corporate umbrella. If Distributing and Controlled each conduct a qualifying 5-year "active trade or business" immediately after the distribution, and all other requirements of section 355 and the underlying regulations are satisfied, [14] the Distributing shareholders will not recognize dividend income or taxable gain or loss on their receipt of Controlled stock.[15] Further, notwithstanding repeal of the *General Utilities* doctrine, Distributing normally can avoid corporate-level gain recognition on the difference between the appreciated fair market value of the distributed Controlled stock and its tax basis in such stock.[16] If any of the statutory or nonstatutory section 355 qualification requirements is not met, the distribution would be taxable to the shareholder as a dividend, redemption or liquidation-type distribution (per sections 301, 302 or 331) and to Distributing as well (per sections 311(b) or 336(a)).

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12 See IRC §354(a)(1). In a type-"B" reorganization or a "C" reorganization, as well as a so-called "reverse triangular merger" under section 368(a)(2)(E), the acquiring corporation stock received must be voting stock. In all but a "B" reorganization, the target shareholders may also receive cash or other non-stock property, i.e., "boot," on a taxable basis pursuant to the rules of section 356. The amount of permitted boot generally ranges from 20 percent ("C" and (a)(2)(E) reorganizations) to generally 60 percent (other reorganizations). All acquisitive reorganizations may be triangular in form, with the target shareholders receiving stock of a controlling parent of the acquiring or transferee corporation; but the definitional requirements of triangular statutory mergers differ depending on the direction of the merger and are more stringent than those of 2-party statutory mergers. See IRC §§368(a)(2)(D) (forward triangular merger) and (a)(2)(E) (reverse triangular merger).

13 See IRC §§361(a) and (c).

14 See Treas. Reg. §§1.355-2(b) [corporate business purpose]; - 2(c) [continuity of proprietary interest]; and -1(b) [continuity of business]. These regulatory requirements differ in significant respects from the section 368 regulations that impose similarly named nonstatutory requirements in acquisitive reorganization contexts.

15 IRC §355(a)(1).

16 See IRC §§355(c) and 361(c).

Qualifying section 355 transactions may involve pro rata distributions of the Controlled stock to all Distributing shareholders without any surrender of their Distributing shares (a "spin-off"); non-pro rata non-liquidating distributions to some Distributing shareholders in exchange for all or part of their Distributing shares (a "split-off"); or pro rata liquidating distributions to all shareholders in exchange for all of their Distributing shares (a "split-up").[17] Regardless of whether Distributing shares are surrendered, an otherwise qualifying section 355 distribution often occurs as part of a so-called "divisive" type-"D" reorganization under section 368(a)(1)(D) (a "D/355" transaction). In those situations, prior to a qualifying section 355 distribution, Distributing transfers property to an existing or newly-formed Controlled. The transferred assets need not themselves constitute a qualifying "active business" or "substantially all" of the Distributing assets, so long as Controlled conducts a qualifying active business immediately after the distribution.[18] No gain or loss is recognized by Distributing on the pre-distribution transfer of assets to Controlled or on the distribution of the Controlled stock to the Distributing shareholders.[19] Assumptions of Distributing liabilities by Controlled are also generally protected from treatment as taxable boot (per section 357(a)), except where liabilities exceed asset basis (per section 357(c)) or the assumption is driven by tax avoidance/non-business purposes (per section 357(b)).

[17] A section 355 transaction also may involve a spin-off to some shareholders and a split-off to other shareholders. See Rev. Rul. 85-127, 1985-1 C.B. 177. The term "spin-off" is sometimes used as a short-hand reference to all types of section 355 transactions.

[18] A "substantially all" transfer must occur in an "acquisitive" type-"D" reorganization (which does not involve a section 355 distribution). See IRC §§354(b)(1)(B). A qualifying type-"G" bankruptcy reorganization may also involve a section 355 distribution. See IRC §§368(a)(1)(G).

[19] IRC §§361(a) and (c). In addition, if Distributing receives boot from Controlled, it generally can avoid corporate-level taxation of the boot if used to pay off Distributing creditors or distributed to Distributing shareholders pursuant to the plan of reorganization. IRC §§361(b) and (c).

## III. The Evolution of Section 355

### A. Early History

The statutory predecessors to section 355 date back to the Revenue Act of 1918, which accorded nonrecognition treatment to corporate reorganizations involving "split-up" transactions.[20] The 1924 and 1928 Acts extended such treatment to "spin-offs" and "split-offs."[21] As to the former, section 112(g) of the 1928 Act provided:

> If there are 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. [Emphasis supplied.]

Importantly, tax-free spin-off distributions had to be made pursuant to a "plan of reorganization." It was not enough for one corporation to simply distribute the stock or securities of a controlled subsidiary to its shareholders. Section 112(i)(1)(B) provided this required linkage to a specifically defined divisive "reorganization" involving "[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,. . . ."

In 1928 a taxpayer named Evelyn Gregory entered a series of transactions which, despite consonance with the literal language of these relevant statutory provisions, produced favorable tax results which the Government challenged as essentially too good to be true. The ensuing litigation, *Gregory v. Helvering*,[22] culminated in a 1935 Supreme Court decision that was the primary catalyst

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20 Rev. Act of 1918, §202(b), 40 Stat. 1060 (1919).

21 Rev. Act of 1924, §§203(c) and (b)(2); Treas. Reg. 65, art. 1578 (1924); Rev. Act of 1928, §§112(g) and (i)(1)(B). For discussions of the legislative history to these early provisions and the subsequent history through enactment of the Internal Revenue Code of 1954, see: Whitman, III Draining the Serbonian Bog: A New Approach to Corporate Separations under the 1954 Code, 81 Harv. L. Rev. 1194, 1198-1210 (1968); Jacobs, The Anatomy of a Spin-off, 16 Duke Law J. 1, 3-6 (1967); Schler, supra n. 5, 56 SMU L. Rev. at 242-44; Sheffield & Schlunk, Reconciling Spin-Offs With General Utilities Repeal, 74 Taxes 941, 943-45 (1996); and Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (7th ed.), ¶¶ 11.01[2][a]-[c].

22 27 B.T.A. 223 (1932), rev'd 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).

for the major qualification requirements of modern day section 355 and is frequently cited as a seminal case in numerous other tax contexts as well.

## B. The *Gregory* Case

Mrs. Gregory owned all the stock of UMC Corporation, which in turn owned 1,000 shares (a noncontrolling interest) of MSC Corporation. UMC transferred the MSC stock to newly-formed Averill Corporation in exchange for the Averill stock, all of which was distributed to Mrs. Gregory. Three days later, Averill was liquidated, distributing the MSC stock (its only asset) to Mrs. Gregory in exchange for her just acquired Averill stock. Mrs. Gregory then sold the MSC stock to an unrelated buyer for cash. So when the smoke cleared, she continued to own 100 percent of the UMC stock and had the cash proceeds from the sale of the MSC shares.

The transfer to Averill and the distribution of the Averill stock to Mrs. Gregory were reported as a tax-free spin-off/divisive reorganization under the above-quoted provisions of the Revenue Act of 1928. She allocated part of her UMC stock basis to her Averill shares and reported a taxable capital gain on the liquidating distribution equal to the excess of the value of the distributed MSC shares over the allocated stock basis.[23] Because the MSC shares were received by Mrs. Gregory with a fair market value basis, she reported no further gain on the prompt sale of such shares.

The Government asserted that because the transfer of the MSC shares to Averill and the following transactional steps were intended merely to avoid tax, they did not constitute a true "reorganization" within the meaning of the statute and should therefore be disregarded. As a result, it contended that Mrs. Gregory should be treated as having received an in-kind distribution of the

[23] The liquidation treatment was governed by section 115(c) of the Rev. Act of 1928, a predecessor to current section 331. There was no corporate-level gain in those days, as there eventually would be for liquidating distributions post-*General Utilities* repeal under section 336(a).

MSC shares from UMC taxable as a dividend in an amount equal to the full value of the MSC shares (i.e., the cash sale price of shares). The Board of Tax Appeals upheld the reported tax treatment, concluding that the literal requirements of the statute had been satisfied because (*i*) one corporation had transferred part of its assets to Averill; (*ii*) Mrs. Gregory was not legally required to surrender any of her UMC stock in exchange for the distributed Averill shares; and (*iii*) she controlled Averill immediately after the transfer and the distribution (albeit for only three days).

On appeal, the Second Circuit reversed. Judge Learned Hand concluded that although all of the successive transactional steps "were real" in the sense that they actually happened and had legal effect, "[t]hey were not what the statute means by a 'reorganization,' because the transactions were not part of the conduct of the business of either or both companies; so viewed they were a sham . . . ."[24] In a unanimous decision, the Supreme Court agreed that Mrs. Gregory had received a taxable dividend, characterizing "what actually occurred" as --

> [s]imply 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.[25]

## C. Congressional Response to *Gregory*

Not happy with the lower court decision in favor of Mrs. Gregory, and concerned about the prospect of continuing abusive taxpayer behavior in spin-off transactions, Congress eliminated

[24] 69 F.2d at 811. Judge Hand did disagree with the method through which the Government had calculated the tax deficiency, i.e., as a mere in-kind dividend of the MSC shares (as opposed to a dividend for the Averill shares). But since either construct resulted in the same dividend amount (because Averill's only asset was the MSC shares), he refused to overturn the asserted tax deficiency on that ground.

[25] 293 U.S. at 469 (emphasis supplied). The Government apparently did not argue, and neither of the appellate courts suggested, that the transactions should instead be recharacterized as a taxable capital gain sale of the MSC shares by UMC followed by a deemed taxable dividend distribution of the deemed sale proceeds to Mrs. Gregory. Judicial recharacterizations along such lines have occurred in situations involving shareholder sales of property received as both liquidating and nonliquidating distributions. See cases cited infra at n. 81.

the tax-free treatment of spin-offs in the Revenue Act of 1934.[26] Statutory nonrecognition treatment for spin-offs was not resuscitated until 1951. Split-ups remained protected during this hiatus, but the status of split-offs was unclear.[27]

The forerunner of present day section 355 began to take shape in the Revenue Act of 1951, with the addition of new section 112(b)(11) to the 1939 Code. That provision, titled "Distribution of Stock Not in Liquidation," permitted nonrecognition treatment for spin-off distributions of common stock (not preferred stock or securities) as part of a "reorganization" --

> unless it appears that (A) any corporation which is a party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization, or (B) the corporation whose stock is distributed is used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization.

The new "active business" and "device" requirements for spin-offs were clearly traceable to the *Gregory* decision. They did not apply, however, to split-ups or split-offs, both of which were protected under the general nonrecognition provisions of the 1939 Code governing exchanges of stock pursuant to a "plan of reorganization."[28]

Enactment of the 1954 Code represented a broad-scale revision of the 1939 Code, including the corporate tax provisions which became housed in subchapter C of the Code. Among these provisions was section 355, which significantly tightened and otherwise revised the spin-off provisions enacted in 1951, and extended nonrecognition treatment to split-offs and split-ups as well.[29] The other principal features of new section 355 included:

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26 It took such action notwithstanding that the Second Circuit reversal of the lower court decision in *Gregory* had come down during the 1934 Act deliberations. See Whitman, supra n. 21, 81 Harv. L. Rev. at 1201.

27 Id. at 1201-02.

28 Id. at 1205.

29 IRC §355(a)(2).

- **Distribution of control**. Distributing had to own at least 80 percent "control" of the Controlled stock immediately before a section 355 distribution,[30] and had to distribute at least 80 percent "control" to the participating Distributing shareholders.[31]

- **Preferred stock/securities**. The prior exclusion of distributions of Controlled preferred stock from nonrecognition treatment was removed; and the prior inclusion of Controlled debt "securities" was limited to securities for which equal principal amounts of Distributing securities were surrendered in exchange.[32]

- **Controlled stock treated as boot**. If the distributed Controlled stock included stock acquired by Distributing during the 5-year pre-distribution period in a wholly or partly taxable transaction (e.g., a straight stock purchase or an acquisitive reorganization with boot), such "hot stock" was treated by section 355(a)(3) as "other property" taxable as boot to the distributee shareholders.

- **New "active business" rules**. In replacement of the subjective "intended to continue the active conduct of a trade or business" requirement of the 1951 Revenue Act, new section 355(b) required that Distributing and Controlled each conduct, "immediately after" the distribution, an active business that had at least a 5-year history and was not acquired during the 5-year pre-distribution period in a taxable transaction.[33]

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30 For this purpose, the section 368(c) definition of "control" applies -- i.e., stock representing at least 80 percent of total voting power and 80 percent of the number of shares of each class or nonvoting stock, if any. See Rev. Rul. 59-259, 1959-2 C.B. 115 [pronouncing "each class" gloss for nonvoting stock].

31 IRC §355(a)(1)(D).

32 Taxable boot treatment results with respect to any excess principal amount of distributed controlled securities surrendered in exchange. IRC §356(d)(2)(C).

33 In split-up contexts (where Distributing completely liquidates), Distributing's assets immediately before the distribution has to consist solely of stock or securities in one or more Controlleds. IRC §355(b)(1)(B). The ban on pre-distribution taxable acquisitions extended to both asset and stock acquisitions. See IRC §§355(b)(2)(C) and (D). As

- **No "reorganization" required**. The section 355 distribution did not have to be part of a qualifying divisive "reorganization." Thus, if Controlled already conducted a qualifying 5-year active business, Distributing could simply distribute the Controlled stock to its shareholders, i.e., without first transferring some assets into a newly-formed or pre-existing Controlled.[34]

- **Continuation of "device" restriction**. The statutory "non-device" requirement of the 1951 Act was retained, with little change other than a somewhat confusing parenthetical clause suggesting that post-distribution sales of either Distributing or Controlled stock could constitute a proscribed "device" solely on the ground that the sale had been negotiated or agreed upon prior to the purported section 355 distribution.[35]

The 1954 Code changes to the criteria for tax-free qualification of corporate separations spawned many questions and uncertainties, especially as to the active business and non-device requirements. One commentator described new section 355 as "a highly rigid, highly technical provision allowing little leeway in application, and full of new and undefined terms that promised extensive litigation."[36] Another viewed it as "a breeding ground for substantial differences

under the "hot stock" provision, acquisitions via partly taxable transactions, such as a statutory merger with boot (no matter how small the taxable portion), were considered tainted and thus prevented satisfaction of the active business requirement.

34 At the same time, it was recognized that section 355 transactions would often occur pursuant to a plan of reorganization. In that regard, section 368(a)(1)(D), as enacted in 1954, encompassed both "acquisitive" and "divisive" reorganizations involving a corporation's transfer of all or part of its assets to another corporation followed by distributions of transferee stock resulting in the transferor corporation's shareholders being collectively in control of the transferee corporation. In a divisive type-"D" reorganization, the stock distribution has to qualify under section 355; but in contrast to an acquisitive "D" reorganization, Distributing need not transfer "substantially all" of its assets to Controlled. See IRC §354(b)(1)(B). Distributing can avoid corporate-level tax on cash or securities received from Controlled but distributed to its shareholders or used to pay off Distributing creditors pursuant to the plan of reorganization. See IRC §§361(a), (b)(3) and (c)(3).

35 IRC §355(a)(1)(B). Subsequently adopted regulations rely generally on an overall "facts and circumstances" approach to determining whether a proscribed device exists, but label pre-arranged/negotiated post-distribution stock sales as providing "substantial evidence" of device. See Treas. Regs. §§1.355-2(d)(1) and (d)(2)(iii)(B).

36 Whitman, supra n. 21, 81 Harv. L. Rev. at 1209.

between taxpayers and their government."[37] Thus, while the 1954 Code certainly appeared to provide a more structured approach to the tax treatment of corporate separations, it remained to be seen whether tax professionals would be able to comfortably advise clients regarding the application of new section 355 in other than the most "plain vanilla" circumstances.

## D. Treasury Regulations Under Section 355

The various sets of Treasury regulations issued under section 355 have been generally helpful, but do not provide clear guidance as to a number of important issues that continue to arise under the provision. Moreover, substantial portions of the section 355 regulations remain in proposed form, and whether, when or with what changes they may be finalized remains uncertain.

### 1. 1955 Regulations

Treasury very quickly issued regulations with respect to the 1954 Code version of section 355.[38] Those regulations (the "1955 Regulations") were most instructive as to the "active business" requirement,[39] an important premise of which -- that section 355 "does not apply to the division of a single business" -- was ultimately rejected by the courts.[40] The 1955 Regulations were rather sparse regarding the "device" requirement,[41] but did recognize that "business purpose," "continuity of interest" and "continuity of business enterprise" were all pre-requisites to qualification under section 355. In that regard, Treas. Reg. §1.355-2(c), captioned "Business purpose," stated:

> The distribution by a corporation of stock or securities of a controlled corporation to its shareholders with respect to its own stock or to its security holders in exchange

[37] Dean, Spin-offs; General Rules; Requirements as to Active Business; Some Practical Considerations (Section 355), 15th N.Y.U. Inst. on Fed. Tax 571, 590 (1957). See also, Caplin, Corporate Divisions Under the 1954 Code: A New Approach to the Five-Year "Active Business" Rule, 43 Va. L. Rev. 399 (1957); and Jacobs, Spin-Offs: the Pre-Distribution Two Business Rule -- *Edward P. Coady* and Beyond, 19 Tax L. Rev. 155 (1964).

[38] Treas. Reg. §1.355, T.D. 6152 (1955).

[39] Treas. Regs. §§1.355-1(c) and (d).

[40] Treas. Reg. §1.355-1(a)(1955). See Commissioner v. Coady, 289 F.2d 490 (6th Cir. 1961); and United States v. Marett, 325 F.2d 28 (5th Cir. 1963).

[41] Treas. Reg. §1.355-2(b)(1955).

> for its own securities will not qualify under section 355 where carried out for purposes not germane to the business of the corporations. The principal reason for this requirement is to limit the application of section 355 to certain specified distributions or exchanges with respect to stock or securities of controlled corporations incident to such readjustment of corporate structures as is required by business exigencies and which, in general, effect only a readjustment of continuing interest in property under modified corporate forms. Section 355 contemplates a continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange. All the requisites of business and corporate purposes described under [Treas. Reg.] §1.368 [relating to tax-free "reorganizations"] must be met to exempt a transaction from the recognition of gain or loss under [section 355].

### 2. <u>1989 Regulations</u>

The 1955 Regulations remained in effect for more than three decades, beyond *General Utilities* repeal and until substantially revised in 1989 "to reflect administrative and judicial experience under those existing regulations."[42] The principal revisions in the 1989 Regulations related to the business purpose, device and continuity of interest requirements. As to business purpose, the 1989 Regulations provide that (*i*) "that requirement is independent of the other requirements under section 355"; (*ii*) must be a "corporate business purpose (that) is a real and substantial non-Federal tax purpose germane to the business of" Distributing, Controlled or any member of their respective affiliated groups; and (*iii*) cannot be satisfied if the asserted corporate business purpose "can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive."[43]

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42 T.D. 8238 (Jan. 5, 1989) (the "1989 Regulations").

43 Treas. Reg. §1.355-2(b).

As to "device", the 1989 Regulations apply an overall "facts and circumstances" test that contemplates a weighing process involving various "device" and "non-device" factors,[44] as well as certain safe harbor rules for (*i*) split-off transactions that, absent section 355, would qualify for "exchange"/capital gain treatment under section 302 or section 303 (the "302 Safe Harbor") and (*ii*) situations in which neither Distributing nor Controlled has any earnings and profits.[45] With respect to "continuity of interest," it too is described as "independent of the other requirements under section 355." Not all of the Distributing shareholders must end up owing stock in Distributing and Controlled. Rather, it is enough that "one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange," i.e., shareholders of Distributing, collectively hold the requisite level of stock ownership in each of Distributing and Controlled after the distribution.[46] Examples in the 1989 Regulations indicate that 50 percent continuity would be sufficient, whereas 20 percent would not be.[47]

### 3. The 2007 and 2016 Proposed Regulations

A lengthy set of regulations was proposed in 2007 (the "2007 Proposed Regulations")[48] with respect to the "separate affiliated group" ("SAG") rules under section 355(b)(3). These regulations also restate and embellish upon the active business provisions of the 1989 Regulations.[49] It is unfortunate that they remain in proposed form after more than a decade.

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44 "Device" factors include pro rata distributions, post-distribution sales of Distributing or Controlled stock and the existence of substantial non-business assets in Distributing and/or Controlled. "Non-device" factors include (*i*) a strong business purpose; (*ii*) a publicly-traded and widely-held Distributing; and (*iii*) corporate shareholders of Distributing entitled to a 100 percent dividends-received deduction. See Treas. Regs. §§1.355-2(d)(2) and (3).

45 Treas. Reg. §1.355-2(d)(5).

46 See Treas. Reg. §1.355-2(c)(1).

47 Treas. Reg. §1.355-2(c)(2), Exs. (2) and (4).

48 Prop. Treas. Reg. §1.355-3 (June 5, 2007).

49 For example, the 2007 Proposed Regulations specifically address the attribution of an active business conducted by a partnership in which Distributing or Controlled holds a partnership interest. See Prop. Treas. Reg. §1.355-3(b)(2)(v).

More recently, in apparent reaction to a highly publicized and ultimately aborted spin-off transaction involving Yahoo, Inc. and its Chinese Alibaba affiliate, Treasury issued proposed regulations (the "2016 Proposed Regulations") that (*i*) strongly indicate, and in some instances mandate, a finding of "device" where Distributing or Controlled hold substantial and/or substantially disproportionate amounts of non-business assets;[50] and (*ii*) impose an absolute minimum threshold (5 percent of gross asset value) with respect to the size of a qualifying active business.[51] The 2016 Proposed Regulations (and the administrative pronouncements preceding them)[52] have spawned a substantial amount of commentary[53] and, if and when finalized, could be revised in significant respects.[54]

## E. Post-1954 Statutory Changes

### 1. Overview

The original 1954 Code version of section 355 remained virtually unchanged until the 1990s, when section 355(d) (in 1990) and section 355(e) (in 1997) were enacted to impose a corporate-level tax on certain otherwise qualifying section 355 distributions. As noted earlier, in 1984 Congress had repealed the *General Utilities* doctrine with respect to nonliquidating corporate distributions of non-cash property (i.e., dividend- and redemption-type distributions), but left section 355 distributions protected from corporate-level taxation in both straight section 355 and D/355 contexts. This important legislative deference to the *General Utilities* doctrine substantially

50 Prop. Treas. Reg. §1.355-2(d) (Aug. 1, 2016).

51 Prop. Treas. Reg. §1.355-9 (Aug. 1, 2016).

52 Notice 2015-59, 2015-2 C.B. 459 and Rev. Proc. 2015-43, 2015-2 C.B. 467 (both released Sept. 14, 2015).

53 See, e.g., Silverman & Gordon, Proposed Regs. Modify Device and Active Trade or Business Analysis, 153 Tax Notes 391 (Oct. 17, 2016); NYSBA Tax Section Report No. 1342, on Notice 2015-59 and Rev. Proc. 2015-43 (April 12, 2016); and NYSBA Tax Section Report No. 1356, on Proposed Regulations Under Section 355 Concerning the Device Prohibition and Active Trade or Business Requirement (Oct. 14, 2016).

54 Other outstanding proposed regulations under section 355 include Prop. Treas. Reg. §1.355-1 (Jan. 1, 2009, corrected Mar. 5, 2009) [relating to the allocation, for gain and basis determination purposes, of cash or other property distributed by Controlled with respect to or in exchange for Distributing stock or securities]; and Temp. Treas. Reg. §1.355-8T (Dec. 19, 2016), replacing Prop. Treas. Regs. §§1.355-8(a)-(i) (Nov. 22, 2004) [relating to "predecessor" and "successor" corporations for purposes of sections 355(e) and (f)].

enhanced the tax juice in a qualifying section 355 spin-off or split-off, since straight dividend and redemption distributions of appreciated property had also previously escaped corporate-level taxation. The final piece of *General Utilities* repeal, relating to liquidating distributions, was enacted as part of the Tax Reform Act of 1986, again without disturbing corporate-level nonrecognition treatment under section 355 -- i.e., qualifying "split-up" distributions were excused from corporate-level tax under new section 336(a), thus enhancing the tax overall benefits of section 355 qualification in liquidating contexts as well.

The rationale for not extending *General Utilities* repeal to section 355 distribution was explained in the Joint Tax Committee "Bluebook" with respect to the 1986 Act as follows:

> Congress felt that the same policy rationale that justifies nonrecognition by the shareholder on receipt of the stock -- namely, that the transfer merely effects a readjustment of the shareholder's continuing interest in the corporation in modified form and subject to certain statutory and other constraints -- also justifies nonrecognition of gain (or loss) to the distributing corporation in this situation…[55]

The 1986 Act also added new sections 337(d) and 336(e). The former conferred broad authority on Treasury to prescribe regulations necessary and appropriate to prevent circumvention of *General Utilities* repeal "through the use of any provision of law or regulations" (including section 355). Section 336(e) authorized Treasury to prescribe regulations permitting a parent corporation to elect to treat certain sales and distributions of the stock of a controlled subsidiary as a sale of the subsidiary's assets. Under regulations finalized in 2013 (more than a quarter century after enactment), this election can be made in connection with stock distributions that fail to qualify under section 355, or which do qualify for shareholder-level nonrecognition treatment but would trigger corporate-level gain under section 355(d) or (e).

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[55] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (May 13, 1987), at 337 (footnote omitted).

The addition of sections 355(d) and (e) both reflected congressional concern over the enhanced comparative tax advantage of section 355 in a post-*General Utilities* world. Sections 355(f) and 358(g) were added as companion provisions to new section 355(e). The former calls off section 355 treatment for internal (i.e., intra-group) spin-offs followed by external spins that trigger section 355(e) while the latter confers authority to make appropriate stock basis adjustments in connection with internal section 355 distributions. Other significant post-2000 amendments to section 355 include the addition of section 355(g) (prohibiting so-called "cash rich split-offs"); section 355(b)(3) (implementing the SAG rules for purposes of applying the "active business" requirement); and most recently, section 355(h) (prohibiting section 355 treatment for certain transactions involving "real estate investment trusts"). Taken together, these statutory changes have transformed the 1954 Code version of section 355 into a far more complicated provision, the application of which is often clouded by difficult technical and tax policy issues.

**2. Section 355(d): Disqualified Distributions**

Section 355(d) was designed to thwart the use of section 355 transactions to effectuate "disguised sales" without corporate-level taxation -- more specifically, "to prevent taxpayers from using section 355 to dispose of subsidiaries in sale-like transactions, or to obtain a fair market value stepped-up basis for future dispositions without incurring a corporate tax."[56] The provision comes into play only if (*i*) the distribution meets all of the qualification requirements for section 355 nonrecognition treatment at the shareholder level and (*ii*) a 50 percent or greater stock interest in Distributing or Controlled is acquired via a "purchase" transaction[57] during the 5-year pre-distribution period. A distribution of or with respect to such "disqualified stock" is considered a

56 H.R. Rep. No. 101-881, at 341 (1990).

57 The term "purchase," as defined in section 355(d)(5), generally refers to stock acquired with a cost basis in a taxable transaction, but can, in certain circumstances, include stock acquired in a section 351 transaction.

"disqualified distribution," with the result that Distributing is treated as having sold the Controlled stock to the distributee-shareholders for its fair market value in a taxable transaction which is not protected by section 355(c) or 361(c). There is no requirement under section 355(d) that the tainted stock purchases be part of a plan or arrangement including the section 355 distribution. The basis of the distributed stock in the hands of the Distributing shareholders is not increased by the taxable corporate-level gain; nor does such gain increase the basis of the Controlled assets, unless a section 336(e) election is made.[58]

Section 355(d) can apply to impose a corporate-level tax on distributions that otherwise avoid the reach of section 355(b)(2)(D). That provision causes the "active business" qualification requirement of section 355 to be violated where 80 percent or more control of the stock of Distributing or Controlled is acquired by a "distributee corporation" or Distributing in a wholly or partially taxable transaction during the 5-year period preceding the spin. Thus, while stock purchases of between 50 and 80 percent, or by noncorporate or multiple buyers, do not trigger an active business problem, they are caught by section 355(d).[59]

Regulations under section 355(d) were finalized in 2000.[60] With all due respect to the IRS National Office and Treasury attorneys who no doubt toiled mightily in this challenging effort, the result was a lengthy, highly technical and complicated set of regulations that are in many respects difficult to grasp and comfortably apply. Fortunately, as the legislative history directed, the

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[58] See discussion infra at 23-24.

[59] Prior to its amendment in 1987 (and to the enactment of section 355(d)), section 355(b)(2)(D) was avoided where all of the Distributing stock was purchased by an unrelated corporation ("P") in 1969, and in 1971 the stock of an existing 5-year active business subsidiary ("S") was distributed by Distributing to P under section 355. Rev. Rul. 74-5, 1974-1 C.B. 82, obsoleted by Revenue Ruling 89-37, 1989-1 C.B. 107. The 1972 distribution of the S stock to the Distributing shareholders, however, was held the subsequent distribution of the S stock to the Distributing shareholders in 1972 was held to violate section 355(b)(2)(D) and therefore did not qualify for section 355 treatment. Id. The 1987 amendment (and a 1988 technical correction) required that P, as a "distributee corporation" in the spin-off, hold the Controlled stock for five years before selling. See Reinhold, Section 355(e): How We Got Here and Where We Are, 82 Tax Notes 1485, 1486-88 (March 8, 1999).

[60] Treas. Reg. §1.355-6.

regulations contain several examples of specific situations in which, even though section 355(d) would literally apply, it is declared inapplicable because the described transactions do not violate the purposes of the provision.[61]

### 3. Section 355(e): Tainted Stock Acquisitions

In 1997 Congress decided that thwarting the potential for utilizing section 355 as an improper end-around *General Utilities* repeal required a broader statutory net. The legislative history describes the reason for new section 355(e) as follows:

> The Committee believes that section 355 was intended to permit the tax-free division of existing business arrangements among existing shareholders. In cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin-off, the transaction more closely resembles a corporate level disposition of the portion of the business that is acquired.[62]

In effect, section 355(e) serves as a super-"continuity of interest" requirement except, like section 355(d), it imposes only a corporate-level tax on Distributing and does so only if the distribution otherwise qualifies for section 355 nonrecognition treatment at the shareholder level.

Under a rebuttable statutory presumption, section 355(e) applies where, during a 4-year period beginning two years before and ending two years after a section 355 distribution, there occur one or more "acquisitions" of Distributing or Controlled stock which (*i*) represent, in the aggregate, a 50 percent or greater stock interest and (*ii*) are linked to the section 355 distribution by way of a "plan."[63] Unlike section 355(d) (which does not have a "plan" requirement), tainted stock acquisitions under section 355(e) are not limited to taxable stock "purchase" transactions.

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61 See Treas. Reg. §1.355-6(b)(3)(vi). The Conference Report to section 355(d) states that its purposes are not violated if "the effect of the distribution is neither (*i)* to increase ownership in the distributing Corporation or any controlled corporation by persons who have directly or indirectly acquired stock within the prior five years; nor (*ii*) to provide a basis step-up with respect to the stock of any controlled corporation." H.R. Conf. Rep. No. 101-964, 1092 (1990).

62 H.R. Rep. No. 105-148, at 462 (1997) (emphasis supplied); S. Rep. No. 105-33, at 130-140 (1997) (emphasis supplied).

63 IRC §§355(e)(2)(A) and (B).

Rather, they also may encompass stock acquisitions pursuant to section 368 acquisitive reorganizations (with or without boot), as well as stock issued by Distributing or Controlled in public offerings or private placements.[64]

**a.** **<u>The "Plan" Regulations</u>**. The section 355(e) "plan" regulations are generally quite helpful in enabling taxpayers and their advisers to determine, with a fair degree of confidence, whether a proscribed plan does or does not exist.[65] Of particular usefulness are various "safe harbor" rules that, if their criteria are met, assure a non-"plan" finding. These include the so-called "Super Safe Harbor," under which a "plan" cannot exist if, at the date of the section 355 distribution and throughout the preceding 2-year period, there was no "agreement, understanding, arrangement or substantial negotiations" (an "AUASN") with respect to the post-spin acquisition or a similar acquisition.[66]

Other "plan" safe harbors also key off the AUASN concept. For example, one protects acquisitions occurring more than six months after the acquisition, where the spin was motivated at least in substantial part by a corporate business purpose other than to facilitate the acquisition and there was no AUASN during the 18-month window beginning 12 months before and ending 6 months after the distribution.[67] Another blesses acquisitions for which there was no AUASN within the one year period following the distribution.[68]

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64 In situations where both section 355(d) and section 355(e) literally apply (<u>i.e.</u>, during the 2-year pre-distribution period), section 355(d) trumps. IRC §355(e)(2)(D).

65 Treas. Reg. §1.355-7. Several proposed versions of these regulations were thoroughly vetted with the tax community; and to Treasury's credit, each new version reflected significant changes responsive to expressed taxpayer concerns. <u>See</u> Silverman & Zarlenga, <u>Anti-Morris Trust Plan Regulations: The Final Chapter in the Saga</u>, 110 Tax Notes 967 (2006) ["plan regulations have evolved from an extremely rigid set of rules. . . to a very administrable set of rules that reflect both the purpose of section 355(e) and business realities"].

66 Treas. Reg. §1.355-7(b)(2). A "similar acquisition" for section 355(e) purposes can be found even if the potential (pre-spin) and actual (post-spin) acquisition have different timing or terms (<u>e.g.</u>, cash v. stock), so long as they involve a "direct or indirect" combination of all or a significant portion of the same business operations and substantially the same "ultimate owners" of the combined entities. Treas. Reg. §1.355-7(h)(2).

67 Treas. Reg. §1.355-7(d)(1) ["Safe Harbor I"].

68 Treas. Reg. §1.355-7(d)(3) ["Safe Harbor III"].

For situations that do not fall under any of the regulatory safe harbors, the "plan" determination is made pursuant to an overall "facts and circumstances" test involving a weighing of various "plan" and "non-plan" factors articulated in the regulations. Among the "plan" factors are (*i*) discussions regarding a potential acquisition during the 2-year period preceding the distribution and (*ii*) distributions motivated by a business purpose to facilitate the acquisition.[69] "Non-plan" factors include (*i*) acquisitions for which "there was no identifiable, unexpected change in market or business conditions occurring after the distribution" and (*ii*) distributions that, regardless of any tainted acquisitions, would in any event have "occurred at approximately the same time and in similar form."[70]

**b.** ***Morris Trust* Transactions**. Long before the enactment of section 355(e), in *Commissioner v. Morris Trust*,[71] prior to merging into a national bank, a state banking corporation spun-off an unwanted insurance department that the acquiring bank could not legally operate under federal law. The post-spin statutory merger separately qualified as a type "A" reorganization (under section 368(a)(1)(A)); and despite its planned occurrence immediately after the spin-off, the disappearance of Distributing pursuant to the merger and the transfer of its active business assets to the acquiring corporation, the separate section 355 qualification of the spin-off was not disturbed. Consistent with the *Morris Trust* decision, similarly structured transactions subsequently flourished with the Service's blessing.[72]

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69 Treas. Regs. §§1.355-7(b)(3)(iii) and (v).

70 Treas. Regs. §§1.355-7(c)(4)(ii) and (vi). See Rev. Rul. 2005-65, 2005-2 C.B. 684 [no "plan" found to exist based on overall facts and circumstances analysis].

71 367 F.2d 794 (4th Cir. 1966).

72 See Rev. Rul. 68-603, 1968-2 C.B. 148 [Service announces agreement with Morris Trust]; Rev. Rul. 78-251, 1978-1 C.B. 89 [acquisition of Distributing stock by unrelated corporation in a "B" reorganization]; Rev. Proc. 96-30, App. A, §§2.07-.08, 1996-1 C.B. 696 [recognizing as acceptable section 355 business purpose distributions that facilitate taxable or nontaxable post-spin acquisitions by Distributing or Controlled and of Distributing (but not necessarily foreclosing acquisitions of Controlled)].

Section 355(e) is often referred to as the "anti-*Morris Trust* provision." That label stems from certain high profile *Morris Trust* transactions during the mid-1990s that involved substantial pre-spin borrowing by Distributing or Controlled and an ultimate separation of the borrowing proceeds from the debt obligation (which was effectively assumed by the corporation acquiring Distributing or Controlled as partial consideration for the acquisition).[73] It was the leveraging features of these transactions that initially caused "disguised sale" concerns at Treasury.[74] But as ultimately enacted, section 355(e) applies as well to non-leveraged *Morris Trust* transactions where the 50 percent change in ownership threshold is breached and a proscribed "plan" exists. For that and other reasons, the provision has been criticized by bar groups and other commentators as much broader than necessary to address the perceived abusive situations.[75]

In one early article, this concern was capsulized as follows:

> The considerable sweep of the statute is, at one level, explained by the legislative history that vividly defines all Morris Trust transactions as having similarities to sale transactions. At the same time, it seems difficult to believe that, in their nonleveraged form, such transactions had many enemies among policymakers, especially given that section 355 had been the subject of no fewer than six amendments since the Morris Trust decision was handed down in 1966, and three since 1986. Given the disconnect between the problem apparently sought to be solved and the solution professed, issues of statutory overbreadth seem particularly troublesome.[76]

Ironically, section 355(e) would not have triggered a corporate-level tax on the actual facts of *Morris Trust*. That is so because the Distributing shareholders received 54 percent of the stock of the acquiring national bank and therefore continued to own indirectly a more than 50 percent

[73] See Reinhold, supra n. 59, 82 Tax Notes at 1488-91 [discussing the Viacom/TCI, GM/Hughes/Raytheon and Disney/Capital Cities/Knight Ridder transactions]; Silverman & Zarlenga, supra n. 65, 110 Tax Notes at 967-68 ["It is important to keep in mind that these transactions involved prearranged acquisitions, the terms of which had been agreed between Distributing and/or Controlled and the acquirer prior to the distribution."] See also, Peaslee, The Viacom Ruling -- Two Ships Passing in the Night, 72 Tax Notes 1435 (Sept. 9, 1996).

[74] See U.S. Treasury Dept. General Explanation of the Administration's Revenue Proposals, March 1996 (at 86) and Feb. 1997 (at 62).

[75] See Reinhold, supra, n. 59, 82 Tax Notes at 1493, notes 52-54.

[76] Id. at 1496 [footnotes omitted].

equity stake in the Distributing assets and operations that were absorbed by the national bank.[77] Accordingly, the fact that the bank merger was clearly part of a "plan" including the spin-off would today have been irrelevant and no corporate-level tax would be imposed. In some instances, the acquiring corporation is sufficiently close in value to Distributing or Controlled (where Controlled is acquired post-spin) to permit preliminary transactional steps designed to avoid breaching the 50 percent threshold.[78] That is not the case, however, in so-called "whale swallows minnow" post-spin acquisitions, where the target corporation shareholders receive only a very small percentage, i.e., far less than 50 percent, of the acquiring corporation's stock. Thus, the only way to avoid a section 355(e) trigger in those situations, or any other case in which the Distributing or Controlled shareholders end up with less than 50 percent of the acquiring corporation's stock, is to demonstrate that the tainted stock acquisitions are not linked to the spin-off via a proscribed "plan" because of an applicable safe harbor or based on an overall facts and circumstances analysis.

**c. Post-Spin Acquisitions of Controlled**. In addition to setting the stage for an acquisition of Distributing (i.e., the traditional *Morris Trust* structure), a spin-off may instead by undertaken to facilitate acquisitions by Distributing or Controlled, as well as acquisitions of Controlled. The "acquisition by" configurations can still be problematic from a section 355(e) standpoint if shareholders of the acquiring corporation end up with at least 50 percent of the Distributing or Controlled stock. The "acquisition of Controlled" scenario (sometimes referred to as "reverse *Morris Trust* transactions") has historically been the most troublesome for the Service -- particularly in so-called "born-to-die" situations where (*i*) the assets of an active business that an unrelated corporation wants to acquire are transferred to a newly-formed Controlled; (*ii*) the

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77 See IRC §355(e)(2)(B) [stock acquisitions not tainted to extent Distributing or Controlled maintains at least 50 percent direct or indirect stock ownership (by voting power or value)].

78 See Kirkland & Ellis M&A Update, "Having Your Spin and Eating Your Deal Too – Spin-offs and Reverse Morris Trusts" (Feb. 1, 2010) ["Where the two companies are approximately the same size, the merger partner may 'right-size' itself by, for example, borrowing money and distributing the cash to its stockholder."]

Controlled stock is distributed to the Distributing shareholders under section 355; and (*iii*) Controlled is then merged into the acquiring corporation and goes out of existence. Two potential "control" issues arose in connection with the disposition of the Controlled stock in the subsequent merger: first, whether the "control immediately after" requirement of section 368(a)(1)(D) (as applicable to divisive reorganizations) had been satisfied; and second, whether the "distribution of control" requirement for section 355 qualification was violated because the transactions might instead be viewed as if Distributing had transferred the wanted business directly to the acquiring corporation in exchange for its stock (and any other merger consideration), and then distributed such stock and other deemed sale proceeds to the Distributing shareholders as a taxable dividend.

The first problem was eliminated by the enactment (in 1998) of section 368(a)(2)(H)(ii), which dictated satisfaction of the "control immediately after" requirement in a D/355 transaction notwithstanding when or how much of the distributed Controlled stock was disposed of by Distributing shareholders after the section 355 distribution. With respect to the second problem, a 1996 published ruling[79] upheld section 355 qualification of the distribution where negotiations for the acquisition of Controlled did not commence until after the distribution and approval of the merger was subject to an independent shareholder vote. In Revenue Ruling 98-27[80], however, citing the legislative policy behind the 1997 enactment of section 355(e), and the effective elimination of the "control immediately after" requirement in D/355 transactions by reason of new section 368(a)(2)(H)(ii), the Service obsoleted the 1996 ruling and announced that it --

> will <u>not</u> apply <u>Court Holding (or any formulation of the step-transaction doctrine</u>) to determine whether the distributed corporation was a controlled corporation immediately before the distribution under §355(a) solely because of any post-distribution acquisition or restructuring of the distributed corporation, <u>whether prearranged or not</u>. <u>In otherwise applying the step transaction doctrine, the Service will continue to consider all facts and circumstances.</u> <u>See</u>, <u>e.g.</u>, Rev. Rul. 63-260,

79 Rev. Rul. 96-30, 1996-1 C.B. 4.

80 1998-1 C.B. 1159, <u>obsoleting</u> Rev. Rul. 96-30, <u>supra</u> n. 79 and Rev. Rul. 75-406, 1975-2 C.B. 125.

1963-2 C.B. 147. An independent shareholder vote is only one relevant factor to be considered. [Emphasis supplied.][81]

Through its citation to Revenue Ruling 63-260, Revenue Ruling 98-27 apparently sought to reserve at least some "wiggle room" for applying the step-transaction doctrine in connection with the "distribution of control" requirement.[82] In Revenue Ruling 2003-79,[83] however, the Service relied on the rationale of Revenue Ruling 98-27 to respect, as separate transactions, a spin-off followed by an acquisition of Controlled via a purported type-"C" reorganization (one requirement of which is that the acquired corporation transfer "substantially all" of its assets to the acquiring corporation). At issue was whether the value of Controlled at the time of the spin-off had to be included in the total value of Controlled (i.e., the denominator) for purposes of determining whether "substantially all" of that value was transferred in the post-spin

[81] Commissioner v. Court Holding Co., 324 U.S. 331 (1945), involved a shareholder sale of property received as a liquidating distribution. The Supreme Court held that because the sale had in fact been negotiated, and its terms agreed to, by the liquidated corporation prior to the liquidating distribution, the "true seller" of the property was the corporation, not the shareholders. Compare U.S. v. Cumberland Public Service Co., 338 U.S. 451 (1950) [post-liquidation sale by shareholder respected where corporation had rejected an earlier offer to sell the property and sale negotiations were in fact conducted by shareholders after the liquidating distribution of the property]. See also Waltham Netoco Theatres, Inc. v. Commissioner, 69 T.C. 399 (1968) [Court Holding rationale applied in non-liquidating context].

[82] In Revenue Ruling 63-260, A owned all the stock of X, which owned 70 shares of Y; and A owned the remaining 30 shares of the Y stock. A contributed 10 shares of Y stock to X (giving X 80 percent control of Y), and X then distributed its Y stock to A in a purported section 355 spin-off. The ruling held that the "distribution of control" requirement had not been met because X's brief control over Y was "transitory and illusory." In a later ruling, Revenue Ruling 69-407, 1969-2 C.B. 50, the spin was preceded by a tax-free recapitalization which resulted in Distributing's voting stock ownership interest in Controlled increasing from 70 to 80 percent. The ruling concluded that the "distribution of control" requirement was satisfied because, in contrast to Revenue Ruling 63-260, the pre-spin recap had resulted in "a permanent realignment of voting control." More recently, there have been a rash of public company spins preceded by recapitalizations of the Controlled stock to attain the 80 percent control threshold, but with a possible (or likely probable) restoration of the pre-spin voting power allocation at some point following the section 355 distribution. Based on various representations to the effect that restoration to the pre-spin stockownership requirement would not occur for a specified period of years, or would in all events be subject to approval by the Controlled directors and shareholders, the Service issued a number of favorable private letter rulings in such situations. See Beller & Pauls, The Aftermath of a Section 355 Transaction (Part II), 41 J. Corp. Tax 3, 20, n. 199 (2014). After announcing in 2013 that it would no longer rule on such situations "pending further study", in Revenue Procedure 2016-40, 2016-2 C.B. 228, the Service announced certain "safe harbors" for such transactions, but also indicated that Revenue Ruling 98-27 does not provide automatic protection against violation of the "distribution of control" requirement when a "substance"/"facts and circumstances" analysis (along the lines of Revenue Ruling 63-260) dictates otherwise.

[83] 2003-2 C.B. 80.

reorganization.[84] The Service concluded that it was unnecessary to backtrack to the pre-distribution state of affairs and held that the "substantially all" determination should therefore be made solely with reference to the post-distribution value of Controlled, i.e., so measured, 100 percent of Controlled's asset value was considered transferred in the acquisition transaction. In contrast, where Distributing engages in a pre-planned post-spin "substantially all" transaction, consistent with the decision in *Elkhorn Coal Co. v. Commissioner*,[85] the Service takes the position the value of the spun-off Controlled does "count against" Distributing for "substantially all" purposes. These differing results appear to contradict the directive in the legislative history to section 355(e) that "the difference in treatment of certain transactions following a spin-off, depending on whether the distributing or controlled corporation engages in the transaction, should be minimized."[86]

Whatever the exact parameters of Revenue Ruling 98-27 may be, the ruling certainly does not rule out generally the application of step-transaction principles in connection with post-spin acquisitions of Distributing or Controlled. Again, section 355(e) can apply only if the distribution met all of the statutory and nonstatutory qualification requirements of section 355. The fact that a post-distribution acquisition may be linkable to the distribution under the section 355(e) "plan" rules normally compels a separate inquiry as to whether the timing and other circumstances surrounding the acquisition may in the first instance jeopardize compliance with the "device,"

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[84] There is no statutory definition of "substantially all". For ruling purposes, the Service generally requires that the value of the transferred assets represent at least 90 percent of the value of the transferor's net assets and 70 percent of its gross assets [Rev. Proc. 77-37, §3.01, 1977-2 C.B. 565, as amplified by Rev. Proc. 86-42, 1986-2 C.B. 722, §§7.05-7.06]; but published rulings and case law apply a generally more forgiving "facts and circumstances" analysis. See, e.g., Rev. Rul. 57-518, 1957-2 C.B. 253 [key focus on "the nature of the properties retained by the transferor, the purpose of the retention, and the amount thereof"]; Moffat v. Commissioner 42 T.C. 558, 578 (1964) ["(The) term 'substantially all' is a relative term, dependent on the facts of any given situation."], aff'd 363 F.2d 262 (9th Cir. 1966).

[85] 95 F.2d 732 (4th Cir. 1957). In addition to "C" reorganizations, other types of reorganizations with a "substantially all" requirement include forward and reverse triangular mergers (under sections 368(a)(2)(D) and (a)(2)(E)), as well as acquisitive-type "D" reorganizations (under section 354(a)(2)(B)) and certain bankruptcy reorganizations (under section 368(a)(1)(G).)

[86] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (Dec. 17, 1997), at 197.

"continuity of interest," "active business" or "continuity of business" qualification requirements of section 355. That risk will likely be highest where the acquisition involves a taxable sale of Distributing or Controlled stock or assets that occurs immediately or soon after the spin, and was certain or reasonably anticipated to occur at the time of the spin.[87] Conversely, the fact that the particular circumstances do not rise to the level of a proscribed "plan" for section 355(e) purposes does not necessarily mean that the same circumstances would also prevent the post-spin transaction from triggering a device, continuity of interest or other section 355 qualification problem.[88]

**d. Preliminary Internal Spins**. As a backstop to section 355(e), Congress enacted section 355(f), which provides special rules with respect to internal spin-off distributions within an affiliated group that precede an external section 355 distribution that triggers section 355(e). The 1997 Act also added section 358(g), which grants Treasury broad authority to issue regulations to adjust the stock basis in a group member to "appropriately reflect the proper treatment of" intragroup section 355 distributions.

To illustrate, assume that D, a public company, owns all the stock of C1, which owns all the stock of C2. C1 distributes the C2 stock to D, which then distributes the C2 stock to the D shareholders. The thrust of section 355(f) is to treat the internal spin (C2 to D) as a section 301 dividend-type distribution, as opposed to a qualifying section 355 distribution. Assuming a consolidated return, the value of the distributed stock is eliminated from the taxable income of the distributee corporation and generates a section 311(b) corporate-level gain to C1 equal to the excess of the fair market value of the distributed C2 stock over C1's tax basis in such stock.[89]

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87 See Beller & Pauls, supra n. 82, 40 J. Corp. Tax (Part I) at 9 (Case 2) and 41 J. Corp. Tax (Part II) at 7 (Case 15).

88 See Treas. Reg. §1.355-7(j) ["no inference" to be drawn from any of the "plan" examples re: how any other section 355 requirement might apply under same facts].

89 See Treas. Regs. §1.1502-13(f)(7), Ex. (1). Absent a consolidated return, the distribution would generate a 100 percent dividends-received-deduction under section 243(a)(3). The internal section 311(b) gain would be triggered upon the immediate distribution of the C2 stock outside the D group via the external spin. Id. and Treas. Reg. §1.1502-13(f)(7), Ex. (7).

Because D takes a fair market value in the distributed C2 stock (per section 301(d)),[90] there is no further corporate-level gain when section 355(e) is triggered in connection with the external spin of C2 to the D shareholders.[91]

The regulatory authority under section 358(g) relates to internal spins which are not linked to an external section 355(e) spin and otherwise separately qualify for nonrecognition treatment under section 355, including the normally applicable allocation of D's stock basis in C1 to the C2 stock received via the internal spin. No regulations requiring an alteration of these stock basis rules have as yet been issued.[92]

**4. Section 336(e) Elections.**

In order to avoid multiple layers of tax on the same economic income, a parent corporation can elect to treat certain dispositions of the stock of an 80 percent or more controlled subsidiary (per the section 1504 "affiliation" rules) as if the subsidiary had instead sold its assets. This election is available with respect to sales, exchanges or distributions of the subsidiary stock, including qualifying section 355 distributions which trigger corporate-level gain under section 355(d) or (e), as well as failed section 355 distributions which trigger corporate-level gain under section 311(b).

Absent an election, if corporate-level gain is triggered, Controlled cannot increase the basis of its assets to reflect such gain, with the result that the same gain would be taxed again upon a subsequent asset sale by Controlled (i.e., after the section 355 distribution). Under regulations

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[90] If section 355 governed the internal spin, part of D's existing stock basis in C1 would instead be allocated to the C2 stock on a relative fair market value basis. See IRC §§358(b)(2) and (c).

[91] If instead of distributing the C2 stock after the internal spin, D distributes the C1 stock (and again assuming a consolidated return), D's stock basis in C2 would be increased by the section 311(b) gain from the internal spin and decreased by the full fair market value of the C1 stock (per the investment adjustment rules of Treas. Reg. §1.1502-32). As a result, the application of section 355(e) to the external spin would likely increase the full amount of corporate-level gain from the two spins.

[92] For discussion of particular situations that might be targeted in such regulations, see H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 535 (1997).

finalized in 2013,[93] if a valid election is made (by Distributing and Controlled), Controlled will be treated as having sold its assets in a taxable transaction and having repurchased such assets with a stepped-up basis. No further corporate-level gain will result from the section 355 distribution (even though section 355(d) or (e), or section 311, would otherwise apply). If and when Controlled ultimately sells its stepped-up basis assets, that gain will also escape further taxation (except, of course, to the extent of any post-spin changes in the basis or value of such assets).[94] It may be prudent to make a "protective" section 336(e) election in connection with section 355 transactions, especially if there is any concern that the Service might on audit challenge section 355 qualification or assert a corporate-level tax under section 355(d) or (e).[95]

**5. Section 355(g): Cash-rich Split-offs**.

Yet another congressional response to perceived "disguised sale" abuses in connection with section 355 distributions was the 2005 enactment of section 355(g), addressing so-called "cash-rich split-offs." Like section 355(e), this provision also was prompted by certain high-profile public company transactions involving pre-split transfers into Controlled of cash and/or investment assets having an aggregate value substantially greater than the value of Controlled's qualifying active business.[96] Although relatively small, the active businesses involved in these transactions typically represented a significantly higher percentage of Controlled's total value than the 5 percent or sometimes lower threshold that the Service had historically found acceptable.[97]

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93 T.D. 9619 (5/10/13), amended by T.D. 9811 (1-18-17).

94 See Treas. Regs. §§1.336-2(b)(2)(i)-(iii).

95 See Treas. Reg. §1.336-2(j).

96 In one such transaction, Time-Warner (Distributing) transferred into a newly-formed subsidiary the Atlanta Braves baseball team (worth around $450 million) and $1.35 billion in cash. Time Warner then transferred the Controlled stock to Liberty Media, a major Time-Warner shareholder, in exchange for Liberty's $1.8 billion stock interest in Time-Warner -- i.e., a redemption distribution that qualified as a good section 355 split-off. See Block, Corporate Taxation (4th ed. 2010), at 518. Other cash-rich split-offs included transactions involving Clorox Company (74 percent cash), Janus Capital Group (78 percent) and Houston Exploration Company (87 percent). See Ginsburg & Levin, Mergers, Acquisitions and Buyouts, Vol. 2 at Ch. 10, ¶ 1002.3, n. 70.

97 The 5 percent ruling threshold was originally set forth in Revenue Procedure 96-43, 1996-2 C.B. 330. It was withdrawn in connection with revised "no rule" policies announced in Revenue Procedure 2003-48, 2003-2 C.B. 86,

Moreover, because the redemption distributions presumably would have qualified for section 302(a) "exchange"/capital gain treatment in the absence of section 355, the 302 Safe Harbor would protect against the device restriction.[98]

Section 355(g) now prevents section 355 nonrecognition treatment in such transactions where, immediately after the distribution, (*i*) either Distributing or Controlled is a "disqualified investment corporation" ("DIC") <u>and</u> (*ii*) any person who held a less than 50 percent stock interest (by vote or value) in the DIC immediately before the transaction holds a 50 percent or greater interest immediately after.[99] Distributing or Controlled will be considered a DIC if "investment assets" represent at least two-thirds of the aggregate fair market value of all its assets.[100] For purposes of calculating the relevant before and after stockownership percentages, a modified version of the constructive stock ownership rules of section 318 applies. In addition, for purposes of determining whether "investment assets" exceed the two-thirds threshold, 20 percent or greater stock interests and certain partnership interests trigger special "look-thru" rules, <u>i.e.</u>, the DIC is treated as owning directly its ratable portion of the assets (including any investment assets) owned by its corporate or partnership affiliate.[101]

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but was recently rejuvenated as an absolute requirement in the 2016 Proposed Regulations. <u>See</u> Prop. Treas. Reg. §1.355-9 (7/15/16).

[98] <u>See</u> Treas. Reg. §1.355-2(d)(5)(iv)

[99] One area in need of clarification relates to whether the "below to above 50 percent ownership" prohibition is triggered where Controlled is a DIC formed as a new subsidiary pursuant to a D/355 transaction and a Distributing shareholder owns (directly or via distribution) more than 50 percent of the Controlled stock immediately after the transaction. If the relevant "transaction" includes the formation of Controlled, then that shareholder would have zero ownership immediately "before the transaction" and section 355(g) would be triggered; but if the relevant transaction was the split-off distribution itself, the DIC shareholder would already own more than 50 percent, with the result the prohibited ownership shift would not occur. Section 355(g)(4), which provides that the term "transaction" for purposes of section 355(g) "includes a series of transactions," appears to support the zero ownership result.

[100] IRC §355(g)(2)(A)(ii). The term "investment assets" generally encompasses (*i*) cash; (*ii*) any stock or securities in a corporation; (*iii*) any interest in a partnership; (*iv*) any debt instrument or contract, notional principal contract or derivative; (*v*) foreign currency or (*vi*) any similar asset. IRC §355(g)(2)(B)(i).

[101] IRC §§355(g)(2)(B)(iv) and (v). The look-thru threshold for corporations requires at least 20 percent of voting power and value; and the partnership look-thru rule kicks in if the partnership conducts a business that Distributing or Controlled would rely upon for purposes of the section 355 "active business" requirement. Less than 20 percent stock or partnership interests are counted as directly-held investment assets.

Section 355(g)(5) grants broad authority to Treasury to promulgate regulations "to carry out, or prevent the avoidance of the purposes of" section 355(g), including with respect to specifically identified subject areas.[102] No regulations have as yet been issued. The 2016 Proposed Regulations with respect to the "device" implications of Distributing and/or Controlled having substantial and disproportionate "nonbusiness" assets adopt, among other rules, a similar two-thirds threshold, but the intended interface, if any, between those proposed regulations and section 355(g) is unclear. [103]

### 6. <u>Section 355(b)(3): The SAG Rules</u>

In 2006 section 355 was once again significantly amended -- this time in connection with the 5-year "active business" requirement, which Distributing and Controlled must each meet "immediately after" the distribution of the Controlled stock. Section 355(b)(3) permits Distributing and Controlled to rely for this purpose not only upon a directly conducted 5-year active business, but also upon any qualifying active business conducted by any member of Distributing's or Controlled's "separate affiliated group" ("SAG").[104] The Distributing SAG ("DSAG") and the Controlled SAG ("CSAG") includes any subsidiary (first- or lower-tier) at least 80 percent of the stock of which is owned directly or indirectly by Distributing or Controlled under the "affiliation" test of section 1504(a)(2), <u>i.e.</u>, 80 percent or more stock ownership in terms of voting power <u>and</u>

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[102] Such regulations could address, <u>inter</u> <u>alia</u>, the application of section 355(g) to split-off redemption transactions that could not otherwise qualify for "exchange"/capital gain treatment under the dividend equivalency rules of section 302, as well as "the use of related persons, intermediaries, pass-thru entities, options, or other arrangements" to avoid section 355(g), IRC §§355(g)(5)(A)(i) and (B).

[103] <u>See</u> Prop. Treas. Reg. §1.355-2(d)(5)(iii)(A) (7/15/16) and discussion <u>infra</u> at 55-56.

[104] Prior to this amendment, Distributing and Controlled generally had to directly conduct the 5-year active business, unless it was a holding company "substantially all" of the assets of which consisted of 80 percent or more controlling stock interests (per the section 368(c) definition of "control") in first-tier subsidiaries that directly conducted qualifying active businesses. <u>See</u> old IRC §355(b)(2)(A). For ruling purposes, the Service applied a 90 percent "substantially all" threshold which would be difficult to meet with comfortable certainty. <u>See</u> Rev. Proc. 77-37, <u>supra</u> n. 84 at §3.04. As a result, it was often necessary to move active businesses into Distributing or Controlled prior to the section 355 distribution via tax-free internal restructurings (<u>e.g.</u>, mergers, section 332 liquidations and/or section 351 transfers) that while not usually controversial from a tax standpoint, could be cumbersome and expensive to implement.

value.[105] For this purpose, foreign subsidiaries, insurance companies and other corporations normally excepted from "affiliate" status under section 1504(b) are eligible for SAG membership.[106]

In essence, all DSAG and CSAG members are treated for active business purposes as a single corporation, with stock owned in SAG members being disregarded and any 5-year active business conducted anywhere within the SAG being treated as directly owned and conducted by Distributing or Controlled. The principal impact of this "single-entity" construct falls upon taxable stock acquisitions that bring the acquired corporation into the SAG. For example, if during the 5-year period preceding a spin Distributing purchases all the stock of Controlled from its former shareholders, Controlled will become a member of the DSAG and the transaction will be treated as a purchase of the Controlled assets (as opposed to the Controlled stock).[107] As a result, the active business requirement could not be violated by reason of section 355(b)(2)(D) (which only applies to taxable stock acquisitions). Instead, the transaction must be tested under section 355(b)(2)(C), which similarly taints taxable asset acquisitions unless they can be viewed as a mere "expansion" of the qualifying active business conducted by Distributing (as opposed to "the acquisition of a new or different business").[108]

Importantly, the 80 percent section 1504(a)(2) threshold for SAG membership is different than the 80 percent section 368(c) threshold which applies for purposes of triggering the application of section 355(b)(2)(D) and satisfying the "distribution of control" requirement of

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105 For example, assume Distributing owns 100 percent of S1, which owns 80 percent of S2, which owns 80 percent of S3, which owns 75 percent of S4. S1 and S2 would be members of the DSAG but not S3 or S4 (in which Distributing's indirect ownership would be less than 80 percent).

106 Nor is there any requirement that the DSAG or CSAG file a consolidated return with all or some of its members if otherwise eligible to do so.

107 See IRC §355(b)(3)(C); Prop Treas. Regs. §§1.355-3(b)(1)(ii), (b)(4)(iv)(F) and (b)(4)(i)(A).

108 See Treas. Reg. §1.355-3(b)(ii) [acquisition of another business in "same line of business... ordinarily treated as an expansion of the original business"].

section 355(a)(1)(D)(ii). The former includes indirect stock ownership and is determined with reference to both voting power and value; whereas the latter requires direct stock ownership in terms of voting power and each class of nonvoting stock. Thus, assume that Controlled has outstanding Class A and Class B common stock (both voting stock), with the Class B representing 15 percent of total voting power and 25 percent of the total value of Controlled. If Distributing purchases all of the Class A stock in 2017, Controlled will not become a DSAG member (because the Class A shares will represent less than 80 percent of Controlled's total value). The acquired Class A shares, however, will constitute section 368(c) "control" -- because such shares would represent more than 80 percent of total voting power, there are no nonvoting shares and stock value is irrelevant under section 368(c). As a result, if Distributing spins off Controlled in 2020, the prior purchase of the Class A shares will prevent section 355 qualification because of section 355(b)(2)(D) (which will not be "called off" under the SAG rules because the stock purchase did not cause Controlled to be brought into the SAG).

On the other hand, if the Class B stock is nonvoting (and still represents more than 20 percent of total value), Distributing's purchase of only the Class A voting stock will not constitute an acquisition of section 368(c) "control." It therefore will not bring section 355(b)(2)(D) into play or bring Controlled into the DSAG. Without section 368(c) control, Distributing could not spin-off Controlled under the protection of section 355.

Yet another variation along these lines would arise if the Class B shares were nonvoting <u>preferred</u> stock that qualified as so-called "plain vanilla preferred" under the definitional criteria of section 1504(a)(4).[109] As such, the Class B shares would not be considered outstanding "stock"

[109] Plain vanilla preferred must be nonvoting; limited and preferred as to dividends; non-participating in corporate growth to any significant extent; have redemption and liquidation rights that do not exceed the issue price of the stock beyond a reasonable premium; and not convertible into another class of stock. IRC §§1504(a)(4)(A)-(D).

of Controlled for purposes of applying the 80 percent affiliation test. Distributing would thus be considered as owning 100 percent of the Controlled stock in terms of both voting power and value for purposes of determining whether the purchase of the Class A shares caused Controlled to become a DSAG member. Nevertheless, "non-stock" treatment of the nonvoting Class B preferred shares would not excuse Distributing from needing actual ownership of at least 80 percent of such shares in order to meet the "distribution of control" requirement of section 355 in connection with a subsequent spin-off of Controlled.

In short, despite the laudable objective of simplifying compliance with the active business requirement where Distributing or Controlled does not itself conduct a qualifying 5-year active business, the SAG rules are in fact quite complicated and harbor potential traps for the unwary.[110] It is especially concerning, moreover, that the proposed regulations in this important area have remained unfinalized for more than a decade.

### 7. Section 355(h): REIT Spin-offs

Section 355(h), added in 2015, addresses spin-offs of certain real estate assets previously held in connection with Distributing's operating business (e.g., land and buildings used by department store chains), with Controlled then leasing such property back to Distributing and electing to be treated as a "real estate investment trust" ("REIT") described under section 856(c). Although REITs are "C" corporations, they are essentially taxed as pass-through entities by reason of a corporate-level deduction for dividends paid in an amount equal to at least 90 percent of the REIT's taxable income (per sections 561 and 857(a)). Thus, a post-spin conversion to REIT status would produce substantial tax savings going forward and, if the spin qualified under section 355,

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[110] For examples of such traps, and the Service's efforts to neutralize them, see Notice 2007-60, 2007-2 C.B. 466 and n. 150 infra.

would also avoid corporate-level tax on the gain inherent in the usually highly appreciated real estate assets housed in Controlled.

In Revenue Ruling 2001-29,[111] the Service concluded that "[a] REIT can be engaged in the active conduct of a trade or business" for section 355 purposes "solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of section 856(d)." The ruling cautioned, however, that it did "not imply a view as to whether a distribution of stock involving a REIT election by a distributing or controlled corporation would otherwise satisfy the requirements of section 355, including the corporate business purpose requirement."[112]

Despite potential business purpose, active business[113] and device[114] issues, a number of REIT spin-off transactions were consummated based on favorable private letter rulings.[115] In Notice 2015-59,[116] however, the Service announced that it had "significant concerns" regarding the "increasing number" of REIT spin-off transactions, including with respect not only to the device, business purpose and active business requirements, but also as to "the Code provisions intended to repeal the *General Utilities* decision." A contemporaneously issued revenue procedure (Revenue Procedure 2015-43) advised that absent "unique and compelling reasons to justify the issuance of a ruling," the Service would no longer entertain private letter ruling requests with

111 2001-1 C.B. 1348, obsoleting Rev. Rul. 73-236, 1973-1 C.B. 183.

112 A "federal tax purpose" which is the sole or primary purpose for the purported section 355 distribution will not suffice. See Treas. Regs. §1.355-2(b)(2) and (5), Exs. (6) and (7).

113 Where the Controlled leases to Distributing were "triple net" (i.e., the lessee paid for taxes, insurance and maintenance), and little, if any, management or operational services were performed by Controlled officers/employees, Distributing might also transfer a relatively small operating business into Controlled, i.e., the proverbial "hot dog stand," to serve as its qualifying active business.

114 The pro rata nature of the spin-off distribution was clear evidence of "device" which had to be outweighed by "non-device" evidence -- e.g., a strong non-tax corporate business purpose and widely-held Distributing stock. See Treas. Reg. §1.355-2(d)(2)(ii) and (3)(ii).

115 See, e.g., PLR 201528006 (7/18/14); PLR 201433007 (8/15/14); and PLR 201337007 (9/13/13).

116 Supra n. 52, Notice 2015-59 (§2).

respect to such transactions.[117] The "no-rule" policy also covered similar transactions involving "regulated investment company" ("RIC") elections.[118]

The ink was barely dry on these administrative pronouncements when Congress essentially mooted the REIT spin-off issue with the enactment of section 355(h) as part of the Protecting Americans from Tax Hikes Act of 2015.[119] Under that new provision, a distribution generally cannot qualify under section 355 if either Distributing or Controlled is a REIT. This restriction does not apply, however, if (*i*) Distributing and Controlled are both REITs or (*ii*) Distributing has been a REIT for at least three years and, throughout that period, Controlled has been a "taxable REIT subsidiary" (per section 856(e)) at least 80 percent controlled by Distributing (per section 368(c)).

An additional limitation with respect to REIT spin-offs was added as new section 856(c)(8), which generally prohibits Distributing or Controlled from making a REIT election during the 10-year period following the spin-off. A post-distribution REIT election can be made by Controlled, however, if, Distributing and Controlled are both REITs immediately after the distribution.[120]

## F. Service Ruling Policy

Section 355 transactions have long been a frequent subject of requests for private letter rulings in both public and closely-held company contexts. Historically, the IRS National Office was generally willing to rule on all aspects of such transactions, even where no serious issue

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117 Supra n. 52, Rev. Proc. 2015-43 (§2).

118 The taxable income of mutual funds and other RICs (as defined in section 851(a) is specially computed under section 852(b), including, among other adjustments, a dividends-paid deduction and exclusion of net capital gains.

119 P.L. 114-113, §311(a).

120 Where Distributing is not a REIT, the distribution may still result in section 355 nonrecognition treatment if the active business, device and all other section 355 qualification requirements are satisfied. See Treas. Reg. §1.355-3(b)(2)(ii) [Service will "carefully scrutinize" separations of owner-occupied real estate property in determining compliance with the active business requirements].

existed as to any of the section 355 qualification requirements. In light, however, of several important changes in section 355 ruling policy since the mid-1990s, the advance ruling process for section 355 transactions is now less forgiving and often difficult to navigate..

**1. Revenue Procedure 96-30**

The volume of section 355 ruling requests began to increase substantially in the 1980s after *General Utilities* repeal, principally because failure to qualify under section 355 resulted in both shareholder- and corporate-level taxation (instead of only a shareholder-level tax, as was the case before *General Utilities* repeal). By the mid-1990s the National Office was continuing to receive a high volume of section 355 requests, placing much strain upon the limited number of Chief Counsel personnel and other resources of the Corporate Tax Division required for the processing of such requests.

In 1996 the Service released Revenue Procedure 96-30[121] in an effort to relieve this mounting pressure by providing comprehensive guidance regarding how to seek and obtain private letter rulings under section 355. In addition to articulating various procedural requirements for all section 355 requests, Revenue Procedure 96-30 set forth the specific language of numerous factual representations that had to be provided with respect to each of the substantive statutory and nonstatutory requirements for qualification under section 355.[122]

Another key feature of the 1996 guidance was the inclusion of a separate Appendix (Appendix A), which set forth a non-exhaustive list of acceptable corporate business purposes for doing a section 355 transaction, together with a detailed description of specific criteria that, at least

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[121] 1996-1 C.B. 696.

[122] For example, the following representation was required as to the "non-device" restriction: "There is no plan or intention by the shareholders or security holders of the distributing corporation to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in, as securities of, either the distributing or controlled corporation after the transaction." For public companies, a similar representation was couched in terms of management "not being aware" of any such plan or in mention on the part of any 5 percent or more shareholder of Distributing. Id. at §4.05.

for ruling purposes, had to be satisfied in connection with each such purpose. For the most part, the Appendix A purposes had been previously blessed by the Service in private letter rulings. In what was a most welcome development, however, the Appendix A roster also included an important previously unacceptable corporate business purpose known as "fit and focus", where the motivation for the separation is to

> enhance the success of the businesses by enabling the corporations to resolve management, systemic or other problems that arise (or are exacerbated) by the corporation's operation of different businesses within a single corporation or affiliated group.[123]

The recognition of fit and focus as a good corporate business purpose extended to pro rata spin-offs or split-off distributions by publicly traded companies that did not have a significant (i.e., *5* percent or more) shareholder. It also extended to split-off distributions by closely-held corporations that enabled a significant shareholder or a shareholder group to own and concentrate on a particular business previously conducted by Distributing.[124]

In point of fact, many, if not most, public company spins are motivated primarily, if not entirely, by fit and focus considerations. A common example of fit and focus arises where the profitability or growth potential of a non-core or relatively smaller business is thought to be adversely impacted because that business does not receive a sufficient allocation of management time and capital resources (as compared to the core or main business). The IRS National Office's historical reluctance to rule on fit and focus grounds stemmed from a concern that government tax

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[123] Rev. Proc. 96-30, supra n. 121 at §2.05. In addition to fit and focus, the Appendix A purposes included: key employees borrowing; cost savings; competition; reduction of risk; public offerings; and facilitating an acquisition. See generally, Beller, Rev. Proc. 96-30: A Business Purpose Roadmap for Section 355 Transactions, 50 Tax Lawyer 1 (1997); and Murray, supra n. 5, PLI at 160-183.

[124] This closely-held split-off scenario covers situations where shareholder desire to "go their separate ways" with respect to ownership and involvement in different businesses previously owned and operated by Distributing. It is specifically blessed by an example in the section 355 "business purpose" regulations. See Treas. Reg. §1.355-2(b)(5), Ex. (2). See also Rev. Rul. 2003-52, 2003-1 C.B. 960 [split-off by closely-held family corporation permitted shareholders to pursue their own "business direction" vision, as well as to promote family harmony and further personal estate planning of the older generation]; and Murray, supra n. 5, PLI at 98-190.

attorneys did not have sufficient knowledge or expertise to make determinations regarding matters requiring non-tax business judgments. After the issuance of Revenue Procedure 96-30, however, section 355 private letter rulings often reflected fit and focus purposes in connection with both external and internal spin offs;[125] and in 2003, the Service issued a spate of published revenue rulings expressly confirming that fit and focus type purposes are acceptable.[126]

### 2. Revenue Procedure 2003-48

In 2003, after several years of substantial ruling activity under Revenue Procedure 96-30, the Service announced that it would no longer rule on "business purpose," "device" or the "plan" requirement of section 355(e).[127] Instead, otherwise favorable section 355 rulings were to be "caveated" with respect to those particular requirements based on certain standard language factual representations to the effect that such legal requirements had been met.

Revenue Procedure 2003-48 also tightened the availability of so-called "supplemental rulings" with respect to post-spin events that were unanticipated or otherwise unknown to the Service at the time the favorable section 355 ruling letter was considered and issued. Such rulings previously had been especially common in connection with larger section 355 transactions. Under the new policy, they were limited to "significant issues" -- i.e., issues that were not inherently

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[125] See, e.g., PLR 200611006 (Dec. 16, 2005) [enable Distributing and Controlled to develop management teams whose only focus will be upon their respective businesses to help each realize full potential]; PLR 20149012 (Jan. 27, 2014) [optimize potential of each business within corporate group by allowing its managers to focus on that business and to establish separate capital structures and financial policies for such businesses accordingly]; and numerous other private letter rulings cited in Murray, supra n. 5, PLI at notes 165 and 172. The requests for such rulings usually included extensive reports prepared by outside management consultants explaining the particular business and economic benefits that were expected to result from the separation and, more importantly, why it was necessary for Distributing and Controlled to become stand-alone corporations to achieve such benefits.

[126] See Rev. Rul. 2003-52, supra, n. 124; Rev. Rul. 2003-110, 2003-2 C.B. 1083 [spin-off by public company of pesticide business to relieve its baby foods business of adverse market perception caused by association with the pesticides business]; Rev. Rul. 2003-74 2003-2 C.B. 77 spin-off by public company of paper products business to permit senior management to devote more time to its core and significantly larger software business]; and Rev. Rul. 2003-75, 2003-2 C.B. 79 [spin-off by public company of cosmetics business to eliminate competition for limited capital resources between that business and the company's pharmaceuticals business.]

[127] Rev. Proc. 2003-48, 2003-2 C.B. 86, modified and superseded by Rev. Procs. 2013-32, infra n. 131; 2016-45, infra, n. 132; and 2017-52, infra n. 133.

factual in nature and the resolution of which, under existing legal authorities, was not essentially free from doubt.[128]

Despite the limitations implemented by Revenue Procedure 2003-48, the appetite for obtaining section 355 rulings, even in caveated form, was not appreciably affected. With respect to the business purpose caveat, taxpayers typically continued to include in ruling requests full blown descriptions of the asserted corporate business purpose(s); and it was generally assumed that the National Office would not issue an otherwise favorable ruling letter if there were any serious concerns about the credibility of such asserted purposes. Moreover, the Service issued a number of published rulings that provided helpful guidance regarding acceptable business purposes in particular circumstances.[129] With respect to the "significant issue" restriction, the volume of post-2003 supplemental rulings decreased, but the Service did continue to issue such rulings in situations deemed to fall within the "not inherently factual" and "not essentially free from doubt" parameters of Revenue Procedure 2003-48.[130]

### 3. Revenue Procedure 2013-32 and Since

In 2013 the Service tightened the "no rule" noose dramatically, announcing in Revenue Procedure 2013-32[131] that it would no longer rule (on even a caveated basis) on whether a transaction qualified for nonrecognition treatment under section 355(a). This pronouncement also confirmed that the Service would continue to consider requests for "significant issue" rulings,

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[128] A legal issue for which the taxpayer could not obtain a favorable outside opinion at a "will" level (i.e., generally at least 90 percent certainty), generally is not considered essentially free from doubt. Id. at §4.06.

[129] See rulings cited supra, at n. 126. See also Rev. Rul. 2003-55, 2003-1 C.B. 961 [spin to facilitate public offering by Distributing subsequently aborted due to advance market conditions; "[a]n unexpected change in market or business conditions following a distribution that prevents achievement of the business purpose will not prevent satisfaction of the business purpose requirement"]; and Rev. Rul. 2004-23, 2004-1 C.B. 585 [spin-off intended to increase trading price of Distributing's stock held acceptable corporate business purpose where believed that increased stock value would enhance value of employee equity-based incentive compensation and facilitate future acquisitions by having less dilutive effect on existing shareholders].

[130] See Beller & Pauls, supra, n. 82, 41 J. Corp. Tax (Part II) at 20, n. 194.

[131] 2013-2 C.B. 55.

including supplemental requests. In that regard, Revenue Procedure 2013-32 instructed that: (*i*) a post-spin change in circumstances "ordinarily" will not present a significant issue; (*ii*) a factual issue can never be considered a significant issue; and (*iii*) other existing "no rule" policies with respect to particular section 355 requirements or scenarios (e.g., business purpose, device and the section 355(e) "plan" requirement) would continue to apply. In 2016, however, the Service removed the "business purpose" and "device" issues from the "never rule" category,[132] with the result that "significant issues" in those areas became eligible for rulings for the first time since 2003.

More recently, in Revenue Procedure 2017-52,[133] the Service announced an 18-month pilot program under which it will consider requests for so-called "transactional rulings" under section 355. Hopefully, this initiative (which ends March 21, 2019) will be successful and permanently extended. Its core feature is to expand the ruling process to permit ruling requests with respect to the general nonrecognition tax consequences of transactions intended to qualify under section 355. The new policy also continues to permit requests for "significant issue" rulings, but keeps in place existing ruling limitations and restrictions with respect to the business purpose, device and the section 355(e) "plan" requirements. Thus, pursuant to Revenue Procedure 2016-45, only significant issue rulings will be considered as to business purpose and device; and the "no-rule" policy as to the section 355(e) "plan" requirement (first implemented in 2003) remains in effect.

Although Revenue Procedure 2017-52 supersedes Revenue Procedure 96-30 (and Revenue Procedure 2003-48), there is little reason to think that Appendix A business purposes will not remain acceptable to the Service if the previously required administrative criteria are satisfied. The

132 Rev. Proc. 2016-45, 2016-37 I.R.B. 344.
133 2017-41 I.R.B. 283, superseding Rev. Proc. 2003-48, supra n. 127 and Rev. Proc. 2016-45, supra n. 132.

ruling request must fully describe the specific corporate business purpose(s) for the transaction;[134] and if that is done, it is reasonable to assume that the Service would not issue a favorable transactional ruling if it has significant doubts as to the bona fides of the asserted business purpose(s). Likewise, the ruling request must describe the facts relevant to determining whether a proscribed device exists, including a discussion of the applicability or non-applicability of the relevant device and non-device factors set forth in the regulations.[135] Again, a favorable general transactional ruling is not likely to be forthcoming if the National Office finds the described facts and legal discussion relating to device to be inadequate or unpersuasive. In all events, any favorable "significant issue" ruling obtained with respect to business purpose or device presumably will say only that the particular facts and circumstances underlying the significant issue request will not cause those section 355 qualification requirements to be violated -- as opposed to unqualifiedly ruling that the business purpose or device requirements will be considered satisfied.

In terms of the form and content of section 355 ruling requests, Revenue Procedure 2017-52 streamlines considerably the process prescribed by Revenue Procedure 96-30. For one thing, the cumbersome and often largely inapplicable detailed "checklist" is eliminated and replaced with required narrative descriptions and legal analysis with respect to twenty specific items relevant to the application of section 355.[136] Moreover, as did Revenue Procedure 96-30, Revenue Procedure 2017-52 contains numerous factual representations that must be made in connection with all 355 transactional ruling requests; but rather than requiring an express statement of each representation,

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[134] Id. at §3.03(7).
[135] Id. at §3.03(6).
[136] Id., at §§3.03(1)-(20).

the request need only contain a single statement that all of the representations required by Revenue Procedure 2017-52 are being made.[137]

It remains to be seen whether the new ruling policy will trigger a significant increase in the volume of section 355 ruling requests and ruling letters and, if it does, whether the Corporate Tax Division will have sufficient resources to handle the increased caseload. Subsequent ruling letters (both general transactional rulings and significant issue rulings) will hopefully clarify the Service's position with respect to at least some technical issues arising under section 355. At the same time, there remain certain section 355 issues on which the Service ordinarily will not rule;[138] or will in no case rule pending further study and resolution of the issue via a published revenue ruling or procedure, regulations or otherwise.[139] Moreover, a recently issued "Statement Regarding Private Letter Rulings on Certain Corporate Transactions" identifies two section 355 issues on which the Service has previously issued favorable rulings but is now reconsidering its views and may issue new guidance with respect to such issues.[140] Although the Service may continue to rule in these areas, the Statement is intended to warn taxpayers that they should not assume that the criteria for obtaining a favorable ruling will necessarily be the same as those applied in prior letter rulings.

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[137] The required representations (46 in all) are set forth in Section 3 of the Appendix to Revenue Procedure 2017-52. Explanations are required to the extent that particular representations are inapplicable, can be given only in modified form or cannot be given at all. See id., at §3.04.

[138] Rev. Proc. 2018-3, 2018-1 I.R.B. 130, §§4.01(29) [whether active business requirement met where Distributing acquires control of Controlled by transferring cash or other liquid/inactive assets in a nontaxable section 351 or D/355 transaction]; 4.01(3) [any section 355 qualification issue if value of Distributing or Controlled's qualifying ATB is less than 5 percent of the total value of all Distributing or Controlled assets; and 4.01(31) [generally any non-"plan" issue arising under section 355(e)]

[139] Id. at §4.01(3) [any section 355 qualification issue if (*i*) the value of the gross investment assets of Distributing or Controlled is 66-2/3 percent or more of the value of its total gross assets; (*ii*) the value of the gross assets of Distributing's or Controlled's qualifying ATB is less than 10 percent of the value of its gross investment assets; and (*iii*) that ratio of the fair market value of the gross investment assets to the value of the other assets of Distributing or Controlled is three times or more such ratio for the other corporation.

[140] 198 TNT 198-42 (Oct. 16, 2017). The identified section 355 ruling areas include (*i*) delayed distributions in connection with a spin-off and (*ii*) so-called "drop-spin-liquidate" transactions in which Controlled is distributed to Distributing's corporate parent and then liquidated or merged into a related corporation. As to the latter, see Alexander & Wood, The General's Orders? Reconciling General Utilities Repeal With the Nonrecognition Provisions of Subchapter C, 96 Taxes 31 (2018) [arguing that drop-spin-liquidate transactions do not contravene General Utilities repeal].

In any case, the private letter ruling process is not an appropriate vehicle for addressing serious structural and substantive problems that generally can be better fixed by Congress or new Treasury regulations. The remainder of this article identifies various elements of section 355 that are candidates for major overhaul, if not total elimination, and offers some specific proposals toward that end.

## IV. <u>Possible Section 355 Reform Measures</u>

Section 355 is unquestionably a far different animal than it was in Mrs. Gregory's day and as configured at the time of its 1954 Code enactment. Moreover, much else has happened in the corporate tax world that bears on the attractiveness and application of section 355. Of particular importance in this regard are (*i*) repeal of the *General Utilities* doctrine in the mid-1980s (from which section 355 distributions are generally excepted; (*ii*) the uniform capital gain/qualified dividend rate (in effect since 2003); and (*iii*) the relief against multiple levels of taxation now afforded in section 355 contexts under the section 336(e) regulations.

Both shareholder and corporate level nonrecognition treatment under section 355 is clearly appropriate in transactions where: (*i*) the asserted corporate business purpose for separating Distributing and Controlled is a purpose traditionally accepted by the Service; (*ii*) all or the great bulk of Controlled's assets are the assets of a qualifying 5-year active business; (*iii*) Distributing and Controlled continue to conduct indefinitely the same active business that they conducted at the time of the spin; and (*iv*) apart from public trading, the stock ownership of Distributing or Controlled did not substantially change during some period of years surrounding the distribution date. These ideal circumstances, however, often do not exist, with the result that satisfaction of one or more of the statutory or nonstatutory requirements of section 355 may be uncertain. A number of these requirements seem ripe for substantial change or possibly repeal.

## A. Summary of Suggested Changes

A new and improved section 355 might incorporate at least some of the following significant changes:

- **Replace existing "control" test.** In place of the section 368(c) "control" test (80 percent of voting power and nonvoting shares), Distributing must own and distribute at least 80 percent of the Controlled stock in terms of voting power and value (per the "affiliation" test of section 1504(a)(2)). The same test should apply for purposes of determining whether an acquisition of Distributing or Controlled stock representing control violates the active business requirement under section 355(b)(2)(D).

- **Minimum ATB size**. A qualifying 5-year "active trade or business" ("ATB") of Distributing or Controlled should represent substantially more than the existing 5 percent of total gross asset value threshold. A 50 percent threshold would be reasonable. Whatever the qualifying ATB threshold might be, consideration would be given to treating as taxable "boot" the value of the distributed Controlled stock attributable to nonbusiness assets that are not substantial enough to cause a device problem.

- **Continuity of business**. Distributing and Controlled should be required to continue to conduct their respective qualifying ATBs for at least two years following the distribution, unless the taxpayer can demonstrate that earlier dispositions, terminations or substantial changes in the activities of the ATB were not planned or contemplated at the time of the distribution.

- **Continuity of interest**. If the existing section 355 continuity requirement is retained, historic Distributing shareholders at the time of the distribution must collectively continue to own at least 50 percent of the Distributing and Controlled stock (in terms of voting power or value) for at least two years following the distribution, unless the taxpayer can demonstrate that earlier stock dispositions above the 50 percent threshold were not planned or contemplated at the time of the distribution (disregarding stock ownership changes resulting from public trading). Consideration should be given, however, to conforming the section 355 continuity requirement to the section 368 continuity requirement for tax-free acquisitive reorganizations (i.e., reducing the minimum threshold to 40 percent and dispensing with any post-spin holding period requirement), or perhaps to eliminating the section 355 continuity requirement altogether. In all events, substantial post-spin dispositions of Distributing or Controlled stock could still be considered tainted for purposes of the device requirement and section 355(e).

- **Device**. Sales or other taxable dispositions of up to 20 percent of the Distributing or Controlled stock following the spin-off would not be considered evidence of device unless pre-negotiated or otherwise planned at the time of the distribution. Pre-planned stock dispositions of more than 20 percent -– or perhaps some lower percentage (e.g., 10 percent) -- of the Distributing or Controlled stock would constitute substantial evidence of device. In addition, if (*i*) the minimum ATB threshold is raised to 50 percent and (*ii*) Distributing or Controlled also holds, immediately after the distribution, investment or other nonbusiness assets representing more than some specified percentage) of total gross asset value (e.g., 25 percent), such assets would constitute substantial evidence of device. An acceptable non-federal tax corporate business purpose for the distribution could not neutralize or outweigh substantial evidence of device attributable to pre-planned taxable stock dispositions, excessive nonbusiness assets or other circumstances considered "substantial" evidence of device under the regulations.

- **Section 355(g)**. If the minimum ATB threshold is raised above 33-1-3 percent, the two-thirds "investment assets" threshold of section 355(g) would have to be reduced. Instead, even if the qualifying ATB threshold were to remain at or around 5 percent, section 355(g) could be repealed; and split-off situations in which Distributing or Controlled held investment or other nonbusiness assets exceeding the applicable percentage thresholds of the "nature and use of assets" device regulations could still fail to qualify under section 355 even though the redemption transaction normally would be protected by the 302 Safe Harbor.

- **Sections 355(d) and (e)**. If the section 355 qualification requirements are strengthened along the lines suggested, consideration should also be given to repealing sections 355(d) and (e), and replacing those provisions (as well as the continuity of interest requirement) with a new condition for section 355 qualification -- namely that during a prescribed period spanning the distribution (e.g., 2 years before until 2 years after), Distributing and Controlled must not undergo a 50 percent or more change in stock ownership via taxable or nontaxable transactions that are part of a plan including the spin-off. Alternatively, the combined replacement provision might perpetuate the main thrust of sections 355(d) and (e) by triggering only a corporate-level tax if violated.

## B. Tightening of Section 355 Qualification Requirements

### 1. Definition of "Control"

The threshold qualification requirement under section 355 is that Distributing directly own immediately before the distribution, and distribute, Controlled stock representing "control" of Controlled as defined by section 368(c) -- i.e., 80 percent of voting power and 80 percent of the outstanding shares of any outstanding class of nonvoting stock.[141] The same control test applies for purposes of section 355(b)(2)(D), which triggers an active business requirement violation

[141] IRC §§355(a)(1)(A) and (D). As noted earlier, per a longstanding revenue ruling, the 80 percent threshold must be met with respect to each class of nonvoting stock. See Rev. Rul. 59-259, supra n. 30.

where a controlling stock interest in Controlled or Distributing is acquired during the 5-year period preceding the distribution in a wholly or partially taxable transaction.

The section 368(c) definition also applies in several other subchapter C contexts.[142] But for purposes of section 332 (relating to tax-free liquidations of controlled subsidiaries), control is instead defined with reference to the "affiliation" test of section 1504(a)(2) -- i.e., at least 80 percent of total voting power and value.[143] This "vote and value" test determines eligibility to file as part of a consolidated return group. It also applies for purposes of determining SAG membership under section 355(b)(3) and in other section 355 contexts that require measuring stock ownership interests in Distributing or Controlled.[144] In all of these section 355 contexts, the ownership of any nonvoting stock is relevant only if the value attributable to some or all of such stock needs to be included to meet the applicable percentage threshold.[145]

Proposals to change to the section 1504(a)(2) "affiliation" test for section 355 and other subchapter C purposes have periodically surfaced over the years in a number of Administration

[142] These include: section 351 (tax-free incorporation transfers); section 368(a)(1)(B) (tax-free type-"B" reorganizations); section 368(a)(1)(D) (acquisitive and divisive type-"D" reorganizations); sections 368(a)(2)(D) and (a)(2)(E) (tax-free forward and reverse triangular mergers) and section 368(a)(2)(C) (post-reorganization transfers to controlled subsidiaries)

[143] Prior to 1984 section 1504(a) "affiliation" status was determined with reference to the section 368(c) "control" test. See also IRC §§338(d)(3) ["qualified stock purchase" of a target corporation with respect to which a section 338 election is made must meet requirements of section 1504(a)(2)]; and 336(e)(1) [same for "qualified stock disposition" eligible for section 336(e) election].

[144] See: IRC §§355(d)(4) [defining "50 percent or greater interest" for purposes of sections 355(d) and (e) in terms of total voting power and total value of all classes of stock]; 355(g)(2)(B)(iv)(III) [a "20 percent controlled entity" for purposes of "disqualified investment corporation" look-thru rule requires ownership of stock representing at least 20 percent of vote and value]; and section 355(f) [section 355 not applicable to certain distributions between members of an affiliated group]. Cf. IRC §304(c)(i) [special definition of "control" for section 304 purposes, requiring at least 50 percent stock ownership in terms of vote or value].

[145] So-called "plain vanilla preferred stock" (defined in section 1504(a)(4)) does not count as "stock" for purposes of determining whether affiliation exists under section 1504(a)(2). That same gloss should apply if the affiliation test is adopted for purposes of section 355, i.e., any value attributable to such preferred stock would not be taken into account for purposes of determining whether the 80 percent threshold is met.

Budget Proposals[146] that have drawn mixed reactions by tax professional groups.[147] While the section 368(c) test is more mechanical and thus generally easier to apply, nonrecognition treatment under section 355 would seem more appropriately available in connection with corporate separations that shift all or substantially all of the voting power and asset value of Controlled into a stand-alone entity.[148] Use of the affiliation test for purposes of section 332 can be viewed as a supportive analogy in that regard. Moreover, replacing the section 368(c) test for section 355 purposes would achieve simplification in at least two respects. First, the "high-vote/low-vote" pre-spin recapitalization technique would likely disappear because it would no longer facilitate the requisite "distribution of control" unless minority shareholders held less than 20 percent of the Controlled stock value.[149] Second, using the same control threshold for purposes of determining SAG membership and applying section 355(b)(2)(D) -- both being elements of the active business

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146 See Joint Tax Committee, 106th Cong., Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal, at 220-22 (1999) [adopt affiliation test for purposes of tax-free incorporations, reorganizations and distributions (including section 355 distributions)]. Similar proposals were advanced in the 2001 and 2015 Budget Proposals. See, Joint Tax Committee, 106th Congr., Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal, at 363-66 (2000); and Joint Tax Committee, Description of Certain Tax Provisions Contained in the President's Fiscal Year 2015 Budget Proposal, at 114-116 (2014) [including "indirect" control through chains of 80 percent controlled entities]. See also, Joint Tax Committee, "Option to Improve Tax Compliance and Reform Tax Expenditures" (Jan. 27, 2005) [adopt affiliation test for purposes of section 355 "distribution of control" requirement and indirectly satisfying active business requirement through lower-tier affiliates of Distributing or Controlled (ultimately enacted as section 355(b)(3)].

147 See, e.g., ABA Tax Section Comments on Administration's 2000 Budget Proposal to Change the Section 368(c) Definition of Control (April 7, 1999), reprinted in 83 Tax Notes 1357 (1999) ["[I]f the control definition is to be reformed for purposes of section 351 and 368, a different treatment for section 355 would require a major reanalysis of section 355, which we assume no one is prepared to do at this juncture."]; NYSBA Tax Report No. 958 on Administration's 2000 Budget Proposal, reprinted in 1999 TNT 135-28 (1999) [majority of Committee members support use of 80 percent vote and value test for purposes of the section 355 distribution of control requirement and the acquisition of control active business rule under section 355(b)(2)(D)]. See also, ABA Tax Section Corporate Tax Committee, Subcommittee on Tax-Free Acquisitions, Report on Section 355 (July 21, 1988), at 12-15 [recommending that section 368(c) test be retained but possibly liberalized to permit section 355 distribution of subsidiaries that have substantial minority interests.]

148 See Schler, supra n. 5, 56 SMU L. Rev. at 259-60 [Distributing's voting control of Controlled "should be necessary but not sufficient for a spin-off, and [Distributing] should also be required to own most of the economic interest in [Controlled]. On the other hand, a spin-off should be allowed even if [Controlled] has a small amount of nonvoting stock, none of which is owned by [Distributing]"].

149 The Service is uncomfortable with such situations because of concern that the recapitalization will likely be "unwound" after the spin, and uncertainty as to whether such unwinds could be successfully challenged on step-transaction grounds in light of Rev. Rul. 98-27. See Rev. Proc. 2016-40, supra n. 82.

requirement --- would make sense from a consistency standpoint; permit a section 355 distribution of Controlled stock only if it is a member of the DSAG (even though minority nonvoting stock interests carrying less than 20 percent of total value remain outstanding); and eliminate incongruities that can arise under the existing "dual-test" regime.[150]

One possible downside of eliminating the section 368(c) control test is the potential for valuation disputes under the affiliation test. That risk already exists, however, in all of the section 355 contexts in which stock ownership interests are presently measured with reference to value.[151] Moreover, in most spin-offs the issue is probably moot because all of the outstanding Controlled stock is typically distributed. In any case, if necessary, valuation issues can usually be managed via outside appraisals.

### 2. Active Business

Distributing and Controlled must each be engaged, "immediately after" the distribution of the Controlled stock, in the conduct of an active trade or business ("ATB") that has existed for at least five years and was not acquired during the 5-year pre-distribution period in a taxable (or partially taxable) transaction.[152] At least two aspects of the ATB requirement warrant re-

[150] For example, assume that Controlled (which operates Bus. 1) has Class A and Class B voting common stock outstanding. Distributing (which operates Bus. 2) has owned all of the Class A stock, and X has owned all of the Class B stock, since 2005. The Class B stock represents 15 percent of total voting power and 25 percent of Controlled's total value. In 2014 X sells the Class B stock to Distributing for cash, and in 2016 Distributing spins off Controlled. Although Distributing could have successfully spun off Controlled without acquiring the Class B stock (because it already had section 368(c) control, i.e., 85 percent, and there was no nonvoting stock), the acquisition of the Class B shares in a taxable transaction (to X) brought Controlled into the DSAG (because it now had 180 percent of both vote and value) and therefore caused the acquisition to be tested under section 355(b)(2)(C) (instead of (b)(2)(D)). Assuming Bus. 2 could not be treated as a mere expansion of Bus. 1, the active business requirement is not satisfied. In Notice 2007-60, supra n. 110, the Service announced a temporary fix for this unintended result (calling off both sections 355(b)(2)(C) and (b)(2)(D)). If the affiliation test were to apply, Distributing could not have spun-off Controlled without acquiring enough Class B shares to give it at least 80 percent of the total value; the acquisition of the Class B shares would bring Controlled into the DSAG and trigger a violation of section 355(b)(2)(C) unless Distributing waited 5 years to do the spin-off.

[151] See supra, n. 144. While replacing the section 368(c) "control" definition with the affiliation test may also deserve consideration in other subchapter C contexts, this article does not purport to analyze or express views in that regard.

[152] IRC §§355(b)(2)(C) and (b)(2)(D). A qualifying ATB can be conducted directly by Distributing or Controlled or indirectly through a member of Distributing's or Controlled's "separate affiliated group" (per section 355(b)(3)). In addition, a qualified ATB conducted by a partnership can be attributed to Distributing or Controlled if either (*i*) owns

examination: First, how big must the qualifying ATB be relative to the total assets of Distributing or Controlled? Second, what is the relationship of the ATB requirement to the nonstatutory "continuity of business" requirement, which does not reference an "immediately after" or any other express temporal limitation?[153]

**a.** **Size of ATB**. Historically, the Service has tolerated a very small qualifying ATB relative to the total assets of Distributing or Controlled. In 1996 it announced a minimum 5 percent of gross asset value threshold for ruling purposes,[154] but also preserved the possibility of issuing favorable rulings in less than 5 percent situations "if it can be established that, based on all the relevant facts and circumstances, the trades or businesses are not de minimis compared with the other assets or activities of the corporation and its subsidiaries." This 5 percent no-rule benchmark was eliminated without any replacement or explanation in 2003,[155] but was resurrected in the 2016 Proposed Regulations as an absolute minimum threshold.[156] The preamble to the 2016 Proposed Regulations states that since the removal of the 5 percent ruling threshold (including the "not de minimis" exception), the Service had "issued numerous letter rulings on section 355 distributions involving active businesses that were de minimis in value compared to the other assets of Distributing or Controlled."[157]

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a 33-1/3 percent or greater partnership interest or (*ii*) owns at least a 20 percent partnership interest and actively participates in the management of the partnership business. See Rev. Rul. 2007-42, 2007-2 C.B. 44; Prop. Treas. Regs. §§1.355-3(b)(2)(v)-3(d)(2), Exs. (22) and (23); and Beller & Pauls, supra n. 82, 40 J. Corp. Tax (Part I) at 20-21 (Case 13).

[153] See Treas. Reg. §1.355-1(b) ["Section 355 contemplates the continued operation of the business or businesses existing prior to the separation."]

[154] Rev. Proc. 96-43, 1996-2 C.B. 330.

[155] Rev. Proc. 2003-48, 2003-2 C.B. 86 [also announcing "no rule" policy as to "business purpose," "device" and section 355(e) "plan" issues].

[156] Prop. Treas. Reg. §1.355-9 (July 15, 2016).

[157] Preamble, REG-134016-15, 2016-31 I.R.B. 205, at 11. The aborted Yahoo spin-off of its Chinese affiliate (in which it held a 15 percent stock interest worth approximately $40 billion) was apparently a major catalyst for the Service's change of heart regarding less than 5 percent ATBs. An active Yahoo business unit worth around $500 million would also have been part of the spin-off company -- i.e., the ATB would have represented less than 2 percent of total asset value. Yahoo's "significant issue" ruling request (including, presumably, with respect to the size of the ATB) was ultimately withdrawn after the National Office said that it would not rule on any aspect of the proposed transaction. See Yahoo, Inc. Form 8-K (Sept. 8, 2015). Very soon thereafter, the Service released Revenue Procedure

It is difficult to understand why the Service has consistently taken such a generous position with regard to ATB size, particularly since the existence of substantial amounts of investment or other nonbusiness type assets -- in addition to (and notwithstanding) a qualifying smallish ATB -- may separately preclude section 355 qualification on "device" grounds under regulations relating to the "nature and use of assets" as potential evidence of device.[158] In his 2003 article (prior to enactment of the SAG rules), Michael Schler observed that "the 5% test ameliorates the unfairness of applying the trade or business test on an entity-by-entity basis", and that "[i]f the trade or business test were modified to apply on a group-wide basis" (as is now the case under section 355(b)(3)), "there would be little remaining justification for permitting a low threshold of business assets."[159]

The Service's taxpayer-favorable stance with respect to ATB size draws at least facial support from Revenue Ruling 73-44,[160] which flatly states that "[t]here is no requirement in section 355(b) that a specific percentage of the corporation's assets be devoted to the active conduct of a trade or business." The stated facts of that published ruling, however, do not suggest that the asserted qualifying ATB was by any means tiny. Rather, the assets of such business were referred to as representing "less than half" and "a substantial portion" of the corporation's total asset value, the rest of which was represented by assets of other active businesses having a less than 5-year history. The preamble to the 2016 Proposed Regulations (which imposes an absolute 5 percent

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2015-43 and Notice 2015-59, supra note 52, the precursors to the 2016 Proposed Regulations. Under these administrative pronouncements, the Yahoo transaction, if consummated as proposed, would plainly have flunked section 355 qualification on both device and active business grounds.

[158] See Treas. Reg. §1.355-2(d)(iv); Prop. Treas. Reg. §1.355-2(d)(iv) (July 15, 2016); and discussion infra, at 55.

[159] Schler, supra n. 5, 56 SMU L. Rev. at 264.

[160] 1973-1 C.B. 182.

ATB threshold) states that the Service "intends to modify" Revenue Ruling 73-44 in order to negate any implication from the language of the ruling that even a de minimis ATB can qualify.[161]

**b.** **Interface with Device**. Once it is determined that the ATB is large enough to meet the 5 percent or other applicable threshold, does the nature and use of the corporation's remaining assets matter? The Service apparently has little concern where, as in Revenue Ruling 73-44, the remaining assets are largely or entirely nonqualifying business assets (i.e., with a less than 5-year history). But where a substantial amount of nonbusiness assets makes up the balance (e.g., cash, portfolio securities, and other investment-type assets), the separation of those assets via a purported section 355 distribution (instead of distributing them to Distributing's shareholders as taxable dividends) clearly raises at least some concern as to whether the transaction constitutes a proscribed "device". In that regard, the 1955 Regulations stated:

> The fact that at the time of the transaction substantially all of the assets of each of the corporations involved are and have been used in the active conduct of trades or businesses which meet the requirements of section 355(b) [i.e., the "active business" requirements] will be considered evidence that the transaction was not used principally as … a device.[162]

Although the 1989 Regulations do not repeat this specific language, they do make clear that "[t]he existence of assets not used in a trade or business that satisfies the requirements of section 355(b) is evidence of device."[163] The strength of such evidence depends on all the facts and circumstances, including the ratio, for each of Distributing and Controlled, of the value of qualifying ATB assets to the value of the nonqualifying assets.[164]

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161 Interestingly, the IRS General Counsel Memorandum which served as the basis for Rev. Rul. 73-44 involved an ATB representing only 5 percent of the net book value (not fair market value) of the corporation's total assets. GCM 34238 (Dec. 15, 1969) In contrast to Rev. Rul. 73-44, there was no reference in that GCM describing the ATB as "substantial." For a discussion of the history of the actual case addressed in the GCM, and its aftermath, see Cummings, Jr., Finding Device in Spins Will Be Easier, 152 Tax Notes 1571, 1574 (Sept. 28, 2016).

162 Treas. Reg. 1.355-2(b)(3) (1955) (emphasis supplied).

163 Treas. Reg. 1.355-2(d)(2)(iv)(B) (1989).

164 Id.

The 2016 Proposed Regulations sensibly change the focus of the "nature and use of assets" device factor to "business" v. "nonbusiness" assets -- with the former including assets associated with both qualifying and nonqualifying ATBs; and the latter including investment assets, cash not needed for working capital of a business and other assets not used in a business.[165] Under both the existing and proposed device regulations, the higher the value of the qualifying ATB assets relative to the value of the other corporate assets, the lower the risk that the existence of the nonbusiness assets will be considered significant evidence of device. Thus, a 5 percent qualifying ATB should not garner much traction in this regard unless nonqualifying business assets comprise a substantial portion of the total ATB assets. On the other hand, if the qualifying ATB represents substantially all of the total assets, the risk of a device problem would likely be non-existent.[166]

These dynamics present an opportunity to harmonize the criteria and application of the active business and device requirements by substantially increasing the minimum ATB percentage threshold beyond 5 percent. This is not a new idea. As observed in the 2003 Schler article, "there is no policy reason that such a low proportion of business assets should be permissible as a statutory matter, even aside from the device test," and "[o]ne reasonable possibility would be to have the required percentage for qualifying assets set at 50 percent."[167] A 50 percent ATB threshold would indeed be appropriate.

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[165] Prop. Treas. Regs. §§1.355-2(d)(iv)(A) and (B)(1)-(5).

[166] Under longstanding ruling guidelines, applicable in connection with certain types of tax-free acquisitive "reorganizations," the term "substantially all" generally means at least 90 percent of the value of the net assets, or 70 percent of the value of the gross assets, of a corporation. Rev. Proc. 77-37, supra n. 84 at §3.01. In another section 355 context (since obsolete), it meant 90 percent of the total value of Distributing. (Prior to enactment of SAG rules, Distributing could indirectly meet the ATB requirement if 90 percent of its assets consisted of the stock of 80 percent controlled subsidiaries that conducted qualifying ATBs (id., §3.04)). The 2016 Proposed Regulations provide a "device" safe-harbor where the nonbusiness asset percentage for Distributing and Controlled is less than 20 percent, apparently permitting in such cases a 5 percent qualifying ATB provided the rest of the assets were exclusively or largely nonqualifying business assets. See Prop. Treas. Reg. §1.355-2(d)(2)(iv)(C)(1).

[167] Schler, supra n.5, 56 SMU L. Rev. at 264-65. He further suggested that a lower threshold might be permitted, through advance rulings, for "non-abusive cases" that "would not violate the purposes of the active trade or business test." See also, Joint Tax Committee, "Options to Improve Tax Compliance and Reform Tax Expenditures," supra n. 146 at 2 [recommending at least 50 percent active business assets threshold for Distributing and Controlled].

Moreover, any substantial increase in the qualifying ATB threshold would relieve, though not necessarily totally eliminate, the pressure on the device restriction caused by the presence of substantial nonbusiness assets. To the extent that some level of such assets remains permitted for device purposes under the regulatory "nature and use of assets" concept, the removal of even those nonbusiness assets from Distributing arguably should not enjoy the nonrecognition treatment accorded by section 355.

In that regard, the value of the distributed Controlled shares attributable to any such assets might be treated as "other property," taxable (*i*) to the Distributing shareholders as "boot," similar to so-called "hot stock" (under section 355(a)(3)(B))[168] or "nonqualified preferred stock" (under sections 355(a)(3)(D) and 356(e));[169] and (*ii*) to Distributing to the extent of any gain inherent in such assets (under section 355(c)(2) or 361(c)(2)).

In all events, if the minimum ATB threshold were increased to a level beyond 33-1/3 percent, the existing 66-2/3 percent "investment assets" threshold under section 355(g) would have to be correspondingly reduced.[170]

**c.** **<u>Interface with COB/COBE</u>**. The statute requires that Distributing and Controlled each conduct a qualifying ATB "immediately after" the distribution of the Controlled stock. Read literally, this suggests that the ATB need only be continued for a nanosecond after the distribution -- <u>i.e.</u>, that all or a large chunk of the assets comprising the ATB could be sold to an outside party very soon after an otherwise qualifying section 355 distribution. The regulations,

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[168] Controlled stock acquired in an at least partially taxable transaction during the 5-year period preceding the distribution is considered "hot stock."

[169] "Nonqualified preferred stock" is defined by section 351(g) as preferred stock which is limited and preferred as to dividends, does not participate in corporate growth and (*i*) is callable, putable or mandatorily redeemable or (*ii*) carries a variable dividend rate tied to interest rates or other market indices.

[170] Presently, even with a 5 percent qualifying ATB, section 355(g) cannot come into play if the corporation has other nonqualifying "business" assets (as opposed to "investment assets") that represent at least 29 percent of total asset value. <u>See</u> discussion <u>infra</u> at 56 [suggesting possible repeal of section 355(g)].

however, have long provided that section 355 "contemplates the continued operation of the business existing prior to the separation."[171] Under this nonstatutory "continuity of business" ("COB") requirement, the ATBs of Distributing and Controlled must continue to be operated after the distribution for some indefinite period of time, i.e., for some period that extends beyond "immediately after." There is no published guidance that elaborates on the COB requirement or its relationship to the ATB requirement, including whether it is possible to satisfy the ATB requirement but fail the COB requirement (and therefore not qualify for section 355 nonrecognition treatment).[172]

The COB inquiry for section 355 transactions may also be informed by the nonstatutory "continuity of business enterprise" ("COBE") requirement that must be satisfied in connection with certain "reorganizations" accorded nonrecognition treatment under section 368. Under the COBE regulations, the acquiring or transferee corporation in an "acquisitive"-type reorganization (e.g., a two-party or triangular statutory merger, or a stock-for-assets type "C" reorganization) must continue to conduct a "significant historic business," or continue to use in a business "a significant portion" of the "historic business assets," of the target or transferor corporation.[173] While these rules clearly apply to "acquisitive"-type "D" reorganizations (described in section 368(a)(1)(D)),[174] they do not expressly apply to "divisive"-type "D" reorganizations (of which qualifying section 355 distributions are necessarily a part). It is unclear whether section 368 COBE principles (e.g., the "historic business/assets" or "significant portion" concepts) can be

[171] Treas. Reg. §1.355-1(b)(1955); id. (1989).

[172] For a hypothetical fact pattern along these lines, see Beller & Pauls, supra n. 82, 40 J. Corp. Tax (Part I) at 9-10 (Case 2).

[173] See Treas. Reg. §1.368-1(d), which permits post-reorganization transfers of acquired assets within the acquiring corporation's "qualified group" of affiliated corporations and partnerships.

[174] See Rev. Rul. 2002-85, 2002-2 C.B. 986 [post "D" reorganization transfer of target assets to controlled subsidiary of acquiring corporation does not foreclose reorganization treatment even though not expressly protected by section 368(a)(2)(C)]; Beller, "D" Reorganizations and Dropdowns: An Uneasy Match, 26 J. Corp. Tax 177 (1999), reprinted at 83 Tax Notes 1757 (1999).

appropriately imported (at either the taxpayer's or the Service's behest) for purposes of determining whether the section 355 COB requirement has been satisfied.[175]

In most instances, the ATB and COB rules operate in tandem -- that is, if you meet one, you meet the other because Distributing and Controlled typically continue to conduct their qualifying ATBs in substantially the same manner for at least several years. It is not clear, however, that a business that was in fact a qualifying ATB immediately after the spin, but is disposed of three days, weeks or months later, can be considered "continued" within the meaning of the COB requirement -- especially if the disposition was contemplated at the time of the spin.

One possible route to clarification in this area would be to amend section 355 to require that Distributing and Controlled each continue to conduct their qualifying ATBs (either directly or indirectly through SAG members) for some fixed period of time (e.g., at least 1-3 years following the distribution). Any perceived inflexibility with such a rule might be tempered by permitting taxpayers to obtain a private letter ruling where unforeseen post-distribution business circumstances dictate an earlier disposition or discontinuation of the qualifying ATB.[176] Short of requiring the protection of a ruling, another approach would be to issue administrative guidance to the effect that the impact, if any, of post-distribution dispositions of ATB assets upon the "immediately after" and COB requirements will be determined taking conventional step-transaction principles into account. Thus, the crucial inquiries would be whether, at the time of the

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[175] Given particularly that the section 355 regulations devote only a brief sentence to the COB requirement, such importation might be equally appropriate in the context of section 355 distributions which are not part of a "D" reorganization. In that regard, the COB analysis ought not yield different results depending on whether the distribution was or was not part of a divisive D reorganization. Although the required representations for a section 355 transactional ruling under Revenue Procedure 2017-52 include a COBE representation for D/355 transactions, there is no required business continuity representation for straight section 355 distributions. See Rev. Proc. 2017-52, supra n. 134, at §3.03. See also South Tulsa Pathology Laboratory, Inc. v. Commissioner, 118 T.C. 84, 91 (2002) [listing the requirements for section 355 qualification without any reference to a COB or COBE requirement].

[176] Cf. IRC §306(b)(4) [permitting avoidance of ordinary income consequences from certain transactions involving otherwise tainted "section 306 stock" "if established to satisfaction of the Secretary" that such transactions "not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."]

spin-off, Distributing or Controlled had any commitment, plan or intention to dispose of all or a substantial part of its qualifying ATB; or whether it could reasonably foresee that such a disposition might be necessary. In that regard, it would seem appropriate to borrow from the principles applied under the section 355(e) regulations to determine whether certain tainted acquisitions of Distributing or Controlled stock during a 4-year statutory period (running from two years before to two years after a qualifying section 355 distribution) can be linked to the spin-off as part of a proscribed "plan."[177]

Another framework for applying step-transaction principles in this context can be drawn from Revenue Ruling 2003-55,[178] involving a section 355 distribution to facilitate a planned public stock offering that was subsequently aborted due to adverse market conditions. The revenue ruling upheld section 355 qualification of the distribution, concluding that "[a]n unexpected change in market or business conditions following a distribution that prevents achievement of the business purpose will not prevent satisfaction of the business purpose requirement." This same rationale would seem equally applicable in connection with unanticipated business conditions that cause Distributing or Controlled to dispose or substantially reduce the size of a qualifying ATB soon after the distribution, thus protecting against violation of the "immediately after" and COB requirements.

### 3. <u>Device</u>

The statutory "non-device" restriction is probably the murkiest of the section 355 qualification requirements and, along with the ATB requirement, probably most in need of reform. The term "device" was used by the Supreme Court in *Gregory* to characterize a series of

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[177] See Treas. Reg. §1.355-7. One concept under those regulations that might be particularly useful is whether an "agreement, arrangement, understanding or substantial negotiations" ("AUASN") regarding the acquisition or other potentially tainted transaction existed at the time of, or during specified period before or after, the spin-off. <u>Id</u>. at 7.

[178] <u>Supra</u> n. 129.

transactions found to be totally devoid of a legitimate business purpose and designed solely to achieve favorable tax consequences under the literal language of then-existing Revenue Act provisions. The dictionary meanings of "device" include "something devised or contrived" and "a scheme to deceive"[179] -- i.e., trying to get away with something, which is precisely what Mrs. Gregory (or at least her tax advisers) tried to do by creating a transitory entity to avoid dividend taxation. The focus of the statutory device requirement today is still upon the improper use of a purported section 355 transaction to achieve a nontaxable distribution of corporate earnings and profits that, absent section 355, would be taxed as a dividend. The circumstances, however, in which the Service might today assert a device problem are considerably broader and often far less blatant than those that understandably spawned the Court's ire in *Gregory*.

**a. Current Statutory and Regulatory Framework**. Section 355(a)(1)(B) permits nonrecognition treatment for the distribution of Controlled stock only if

> [t]he 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 (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by some or all of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device).

The precise import of the double parenthetical in this provision is difficult to discern. Read literally, it appears to say that post-distribution sales of Distributing or Controlled stock will trigger a device violation only where the sale was prearranged. The use of the term "shall not be construed" (instead of "may not be construed") seems to support this construction.[180]

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[179] Webster's International Dictionary (11th ed. 2003) at 342.

[180] See Shores, Reexamining Continuity of Shareholder Interest in Corporate Divisions, 18 Va. Tax Rev. 473, 505-510, 542 ["double parenthetical" of section 355(a)(1)(B) wrongly interpreted by regulations; "post-distribution sales of stock whether or not pre-planned… should not … automatically be viewed as circumventing the dividend rules."]

The regulations, however, tell a different story. They contemplate an overall "facts and circumstances" determination pursuant to a weighing process involving certain specified factors indicating evidence of "device" or "non-device", as well as certain "safe harbor" circumstances that "ordinarily" will prevent the finding of a "device."[181] The core concern addressed by these regulations is articulated as follows:

> Section 355 recognizes that 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.[182]

In light of this concern, any subsequent sale or exchange of Distributing or Controlled stock is considered "evidence" of device whether or not pre-arranged, and "substantial evidence" of device if "negotiated or agreed upon" before the spin.[183] In either context, the strength of such evidence generally depends on how much stock is sold and how soon after the distribution the sale occurs.[184]

Post-distribution stock sales have long been viewed suspiciously from a device perspective because they enable the selling shareholder to obtain capital gain treatment instead of dividend/ordinary income treatment that would result if the distribution of the Controlled stock were not accorded nonrecognition treatment under section 355.[185] This so-called "bailout" effect was generally worth far more to the selling shareholder when the tax rate differential between ordinary income and capital gain was substantial.[186] Since 2003, however, a uniform rate (currently 20 percent) has applied to both capital gains and "qualified dividends," so any "bailout" advantage

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181 Treas. Reg. §1.355-2(d)(1) (1989).
182 Id.
183 Treas. Regs. §§1.355-2(d)(2)(iii)(A)-(C).
184 Treas. Reg. §1.355-2(d)(2)(iii)(A).
185 The dividend amount would be the fair market value of the distributed stock, but only to the extent supported by current or accumulated earnings and profits. See IRC §301(d). In that regard, any gain inherent in the distributed stock would trigger corporate-level taxable gain under section 311(b) and correspondingly increase current earnings and profits.
186 Prior to 2003, the capital gain rate was always lower than the ordinary income rate, except for a few years following the 1986 Act (during which period the rates were the same).

is now limited to the ability to recover stock basis in calculating the amount of capital gain and to offset any existing capital losses.[187] Despite the uniform rate regime, Treasury continues to view these benefits as potentially significant indicators of device. As stated in the preamble to the 2016 Proposed Regulations:

> Although the device prohibition primarily targets the conversion of dividend income to capital gain, a device can still exist if there would be a recovery of stock basis in lieu of receipt of dividend income and even if the shareholder's federal income tax rates on dividend income and capital gain are the same.[188]

It also is possible to trip the device wire without an actual post-distribution stock sale. In that regard, the regulations identify a "nature and use of assets" device factor which treats as evidence of device the existence of assets not used in a qualifying ATB of Distributing or Controlled.[189] The strength of such evidence depends on the facts and circumstances, including the percentage of each corporation's assets represented by such non-ATB assets and whether such percentages are proportional to the values of the respective ATBs.[190]

The 2016 Proposed Regulations would significantly modify the nature and use of assets device factor by focusing on the composition of assets that are not connected with the qualifying ATB, including other "business" assets (e.g., those comprising a less than 5-year active business) and "non-business" assets (e.g., excess cash, portfolio securities or other investment-type assets not used in a business). In general, only "nonbusiness assets" of Distributing and Controlled would carry a device taint, the strength of which would depend on the percentage of the corporation's

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187 In many instances, the historic stock basis will be relatively low, so that the amounts of the capital gain and the "avoided" dividend may be quite close.

188 Preamble, Prop. Treas. Reg. §1.355-2 (July 15, 2016), at _____. The existing regulations already provide that "[a] device can include a transaction that effects a recovery of basis." [Treas. Reg. §1.355-2(d)(1).] This language was added in 1989, when a preferential capital gain rate did not exist; and as suggested by one group of commentators, "the focus on basis recovery seems to have been an effort to keep the device test relevant despite the (then-temporary) diminution of rate differentials." Azebu, Rizzi & Zarlenga, A New Role for the Device Test, 150 Tax Notes 1427, 1434 (Mar. 21, 2016).

189 Treas. Reg. §1.355-2(d)(2)(iv). Such assets include, for example, cash and other liquid assets not related to the reasonable needs of the qualifying ATB.

190 See Treas. Reg. §1.355-2(d)(4), Ex. (2).

total assets (in terms of value) represented by such nonbusiness assets and whether those nonbusiness asset percentages ("NBAP") for Distributing and Controlled differed substantially. In that regard, the existence of nonbusiness assets ordinarily would not constitute evidence of device if (*i*) Distributing's and Controlled's NBAPs are both less than 20 percent; (*ii*) the difference between the NBAPs is less than 10 percent; or (*iii*) in a split-off context, the NBAP difference is attributable to a need to equalize the value of Controlled with the redeemed Distributing stock.[191] On the other hand, "strong evidence" of device would exist if either Distributing's or Controlled's NBAP were 66-2/3 percent or more;[192] and under a proposed "per se" rule, such circumstances would be conclusive evidence of device if the NBAP differential fell within certain quantitative "bands."[193]

The existing device regulations also identify three "non-device" factors that may nullify clear evidence of device spawned by a pro rata spin-off transaction that, absent section 355, would normally be a taxable dividend distribution out of earnings and profits.[194] Two of these factors are relatively mechanical, including spin-off distributions (*i*) by publicly-traded corporations having no more than 5 percent shareholders; and (*ii*) to corporate shareholders that would otherwise be eligible for the 100 percent dividends-received deduction. The third non-device factor -- a strong corporate business purpose -- is far more subjective and described as follows:

> [T]he stronger the evidence of device…, the stronger the corporate business purpose required to determine that the transaction was used principally as a device. Evidence of device presented by the transfer or retention of assets not used in a [qualifying ATB] can be outweighed by the existence of a corporate business purpose for those transfers or retentions. The assessment of the strength of a

[191] Prop. Treas. Reg. §1.355-2(d)(2)(C).
[192] Prop. Treas. Reg. §1.355-2(d)(5)(iii).
[193] Id. For example, if one corporation's NBAP is between 66-2/3 percent and 80 percent, and the other corporation's NBAP were less than 30 percent, section 355 qualification would not be possible. Two other bands -- 80-90 percent / less than 40 percent; and more than 90 percent / less than 50 percent -- would yield the same result.
[194] Treas. Reg. §1.355-2(d)(2)(ii) [a pro rata or substantially pro rata distribution "presents the greatest potential for the avoidance of the dividend provisions of the Code and, in contrast to other types of distributions, is more likely to be used principally as a device"].

> corporate business purpose will be based on all of the facts and circumstances, including, but not limited to the following factors: (A) the importance of achieving the purpose to the success of the business; (B) 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 (C) the immediacy of the conditions prompting the transaction.[195]

The 2016 Proposed Regulations eliminate the publicly-traded/widely-held non-device factor as a viable consideration in circumstances covered by the proposed per se device rule.[196] In addition, the "strong corporate business purpose" non-device factor would be revised to preclude consideration of that factor in the "nature and use of assets" context, "unless the business purpose involves an exigency that requires an investment or other use of the Nonbusiness Assets in one or more" businesses of Distributing and/or Controlled.[197]

The 2016 Proposed Regulations would not eliminate or revise the "device" safe harbors of the existing regulations. The 302 Safe Harbor is most important in this regard. Subject to the "cash-rich split-off" prohibition of section 355(g), it "ordinarily" protects any split-off/redemption distribution that absent section 355, would have qualified for exchange/capital gain treatment under the section 302 dividend equivalency rules (and thus not have facilitated avoidance of dividend taxation).[198] Another safe harbor can apply if neither Distributing nor Controlled has any current or accumulated earnings and profits; but the existence of any appreciated assets in Distributing immediately before the spin will generally preclude reliance on that exception.[199]

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195 Treas. Reg. §1.355-2(d)(3)(ii).

196 This factor apparently does continue to carry weight in device analyses with respect to situations that do not fall within the quantitative benchmarks of the per se rule.

197 Prop. Treas. Reg. §1.355-2(d)(3)(ii). Examples intended to illustrate this "exigency" principle seem to beg the question as to whether the assets were already being used or held for use in a qualifying ATB. See Prop. Treas. Reg. §1.355-2(d)(4), Exs. (2) and (4).

198 Treas. Reg. §1.355-2(d)(5)(iv). This safe harbor extends as well to section 303 redemptions, which call off the various tests for section 302(a) "exchange" treatment in the case of certain redemptions to fund death taxes and estate administration expenses.

199 Treas. Reg. §1.355-2(d)(5)(ii). The "absence of earnings and profits" safe harbor may also come into play where Distributing is an "S" corporation, which generally cannot have earnings and profits unless it was previously a "C" corporation or inherited earnings and profits from a C corporation in certain types of nonrecognition transactions (e.g., a statutory merger or section 332 subsidiary liquidation).

Although the existing and proposed regulations do provide much helpful guidance, application of the non-device requirement still presents a number of challenges -- particularly in connection with the "subsequent stock sale" and "nature and use of assets" device factors and the "strong business purpose" non-device factor. While the Service has now lifted its longstanding "no-rule" policy as to device issues,[200] its willingness to rule extends to an uncertain universe of issues that may or may not be considered "significant" or otherwise worthy of a ruling letter. It would be preferable to modify the device rules in ways that would make them clearer, simpler, and more predictable, thus eliminating in most instances the need to go through the expensive, and often lengthy and uncertain, private ruling process. Some suggestions for doing that follow below.

**b.** **Subsequent Stock Sales**. It is true that the uniform rate regime in place since 2003 may not totally obliterate the device potential of subsequent stock sales (because of basis recovery and offsetting capital loss implications). The occurrence of such sales, however, would seem to be far less important evidence of device than was the case when substantial capital gain v. dividend rate differentials existed. That, of course, could change if Congress were to do away with the preferential treatment of "qualified dividend" income. In any case, as noted earlier, the statute itself can be read as tainting only subsequent sales that were pre-arranged or negotiated. While the regulations nonetheless permit a finding of device evidence as a result of subsequent sales that were not pre-arranged (based on an overall "facts and circumstances" determination), they provide no guidance as to what would appear to be the most important inquiries in making such a determination, namely: (*i*) how much stock needs to be sold? and (*ii*) how soon after the spin-off must such sale occur?

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[200] Rev. Proc. 2016-45, supra n. 132.

The post-distribution sale of relatively small percentages of Distributing or Controlled stock -- even very soon after the spin -- generally should not raise a device concern. Sales at or above the 20 percent level (or perhaps lower double digit percentages) may be problematic, at least where pre-planned.[201] In one case, however, the Tax Court relied on a perceived strong overriding business purpose in upholding section 355 treatment for a spin-off distribution to Distributing's sole shareholder, notwithstanding the subsequent pre-arranged sale of a 49 percent stock interest in Controlled.[202]

A lower percentage threshold -- say, 10 percent -- may be appropriate as to pre-arranged sales, with sales above that threshold being considered substantial or possibly per se evidence of device if more than 20 percent (or some higher percentage) of the stock were sold. Sales below the 20 percent or other applicable threshold would avoid the device net no matter how soon they occur after the spin. But where subsequent sale(s) do exceed the applicable percentage threshold, only those sales that occur within some limited timeframe after the spin should be considered tainted for purposes of the device analysis. A period of 18-24 months would seem generally reasonable in that regard, with the taxpayer being given the opportunity to establish (via a PLR request) that the sale was not part of a plan including the purported section 355 distribution.[203]

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[201] The proposed version of the 1989 Regulations included a per se device rule for pre-negotiated sales of 20 percent or more of Distributing's or Controlled's stock, with sales under 20 percent considered "substantial evidence" of device. See 42 Fed. Reg. 3866 (Jan. 21, 1977). The proposed per se rule was dropped from the final regulations. A 20 percent ruling threshold has long existed, however, for purposes of an administrative safe harbor with respect to post-spin open market stock repurchases by public companies. See Rev. Proc. 96-30, supra n. 79 at §4.05(1)(b).

[202] Pulliam v. Commissioner, 73 T.C.M. 3052 (1997), nonacq. 1998-2 C.B. xix [sale to former employee of Distributing's funeral home business who posed a competitive threat; distribution necessary to comply with state law licensing requirements]. For further discussion of Pulliam, see infra, n. 223. Cf. South Tulsa Pathology Laboratory, Inc., v. Commissioner, 118 T.C. 84 (2002) [pre-arranged post-spin sale of all Controlled shares violated device and other section 355 qualification requirements; difficult to understand why this case was ever litigated].

[203] Similar to the above-suggested revision of the active business rules, section 355(e) "plan" principles could be utilized for purposes of the device determination or conventional step-transaction principles could be applied consistent with the rationale of Rev. Rul. 2003-55. See discussion supra, at 47.

Finally, in evaluating what if any changes might be made with respect to the "subsequent stock sale" device factor, the interface between that factor and the nonstatutory "continuity of interest" qualification requirement should be considered. Under the existing regulations, subsequent dispositions of Distributing or Controlled stock that do not trigger a continuity of interest violation (generally less than 50 percent) may nonetheless be sufficient to cause a fatal device problem. Again, given the uniform rate regime, and at least with respect to non-prearranged sales, consideration might be given to doing away with the subsequent stock sale device factor and relying solely on a more objective continuity of interest requirement or some other general stock ownership change restriction to prevent section 355 qualification where substantial stock sales occur too soon after the spin.[204]

**c.** **Nature and Use of Assets**. Under the current regulations, this device factor potentially threatens section 355 qualification whenever Distributing or Controlled has a substantial complement of assets that are not "used in" or "related to the reasonable needs of" a qualifying ATB of the corporation.[205] The existing regulations further suggest that, at least in pro rata distribution contexts (i.e., spin-offs), a difference in the Distributing and Controlled ratios of qualifying ATB assets to nonqualifying assets is a negative circumstance in evaluating the strength of device evidence that stems from the mere existence of non-qualifying ATB assets. In that regard, an example in the current regulations concludes that "relatively weak evidence of device" exists where, after the spin, Distributing and Controlled each hold nonqualifying ATB assets (cash and marketable securities) "in amounts proportional to the values of their businesses."[206]

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204 See discussion infra at 61-63 and 67-68.
205 Treas. Reg. §1.355-2(d)(2)(iv)(B).
206 Treas. Reg. §1.355-2(d)(4), Ex. (2).

**2016 Proposed Regulations**. As described earlier, the 2016 Proposed Regulations would retain the "nature and use of assets" device factor, but only "nonbusiness" assets would be considered tainted. Thus, any "business assets" that are not part of a qualifying ATB of Distributing or Controlled are, in effect, considered "good assets" for purposes of determining the NBAP, i.e., the percentage of total assets represented by tainted nonbusiness assets. In addition, several new quantitative benchmarks would apply -- including (*i*) non-device factors where Distributing and Controlled each have a NBAP of less than 20 percent or the NBAP differential is less than 10 percentage points; (*ii*) a per se device rule where the NBAP is 66-2/3 percent or more and various levels of NBAP differential exist as between Distributing and Controlled; and (*iii*) a "strong evidence of device" rule where the NBAP of either Distributing or Controlled is at or above 66-2/3 percent but the NBAP differential is relatively small or the per se device does not otherwise apply.

On balance, the focus of the 2016 Proposed Regulations on business v. nonbusiness assets, as well as substantial disparities between the NBAPs of Distributing and Controlled, seem defensible as a policy matter. As other commentators have observed, however, because the proposed quantification criteria for applying the "nature and use of assets" device factor require fair market value determinations and comparisons, they may in practice be difficult to implement and could often lead to protracted and expensive valuation disputes with the Service in the event of an audit.[207] Additional layers of complexity in connection with the business v. nonbusiness asset valuation exercise stem from the proposed "look-thru" rules with respect to (*i*) members of the

[207] See Silverman & Gordon, Proposed Regs. Modify Device and Active Trade or Business Analysis, 153 Tax Notes 391, 399 (2016).

Distributing and Controlled SAGs; (*ii*) certain less than 80 percent owned corporations; and (*iii*) interests in partnerships that conduct qualifying ATBs.[208]

**Interface with ATB size**. The 2016 Proposed Regulations confirm that a business representing as little as 5 percent of total asset value can be a qualifying ATB for purposes of the "active business" requirement of section 355.[209] If, as suggested earlier, that minimum ATB threshold were raised to 50 percent, pressure on the "nature and use of assets" device factor would presumably diminish. For example, there would seem less need for a per se device rule along the lines of the proposed regulations. But the existence of nonbusiness assets in excess of the permitted NBAP could still be considered evidence of device which the taxpayer might or might not be able to neutralize depending on other facts and circumstances (including any planned or potential use of excess nonbusiness assets in or in connection with a business of Distributing or Controlled.)[210]

**Interface with section 355(g)**. Under either the existing or proposed regulations, the "nature and use of assets" device factor generally does not apply to "split-off" transactions where, as is often the case, Distributing needs to transfer cash or other liquid assets to Controlled to equalize the values of the Controlled stock to be received, and the Distributing stock to be redeemed, in the transaction.[211] Moreover, the redemption would qualify for "exchange" treatment absent the application of section 355 (again usually the case), the Section 302 Safe Harbor will

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208 Under these look-thru rules, at least some portion of the value of such stock or partnership interests would have to be allocated between the entity's business and nonbusiness assets for purposes of the NBAP calculations required by the proposed regulations. See Prop. Treas. Regs. §1.355-2(d)2(D)(6) and (7).

209 Prop. Treas. Reg. §1.355-9. Until recently, the Service was willing to bless even lower percentages for qualifying ATBs. See discussion supra at 41.

210 The 2016 Proposed Regulations would appear to apply a more stringent rule in this regard -- namely, that a corporate business purpose that purportedly relates to a separation of non-business assets from business assets could not be considered "evidence of non-device, unless the business purpose involves an exigency that requires an investment or other use of the Non-business Assets in a Business." Examples in the proposed regulations suggest that such use be relatively near-term and already decided upon or legally committed at the time of the spin-off. See Prop. Treas. Regs. §§1.355-2(d)(3)(ii) and (4), Exs. (2) and (4).

211 Treas. Reg. §1.355-2(d)(2)(iv)(B). To the extent such transfers include investment assets or other nonbusiness assets that have values in excess of their basis in Distributing's hands, no gain is triggered to Distributing or Controlled on such downstream transfers. See IRC §§361(a); 351(a); and 1032(a).

"ordinarily" preclude a proscribed device.[212] Such split-off transactions, however, may still fail to qualify for section 355 nonrecognition treatment by reason of section 355(g) if (*i*) Distributing or Controlled is a DIC (i.e., at least two-thirds "investment assets") and (*ii*) the transaction results in any DIC shareholder crossing the 50 percent stockownership threshold.

As noted earlier, if the minimum percentage threshold for ATB qualification were increased to more than 33-1/3 percent, the two thirds "investment assets" threshold of section 355(g) would have to be reduced. For example, if the qualifying ATB assets threshold is raised to 50 percent, the "investment assets" threshold of section 355(g) might be reduced to, say, 25 percent. It is not clear that section 355(g) would have been enacted to address split-off situations involving that relatively low level of tainted assets. But even assuming no increase in the minimum ATB threshold, section 355(g) might be repealed and, in its place, the 2016 Proposed Regulations strengthened to prevent reliance in cash-rich split-off situations on the "equalization of values" exception and/or the Section 302 Safe Harbor. Under that approach, the "nature and use of assets" device factor would apply with reference to the same "nonbusiness assets" percentage thresholds that apply to pro rata spin-offs (including any reduced tainted asset thresholds resulting from an ultimate increase in the qualifying ATB assets threshold).[213]

Moreover, in contrast to section 355(g), the regulatory approach would also not require that any shareholder cross the 50 percent stockownership line by reason of the split-off transaction. That feature would seem unnecessary from a policy perspective, because the main focus should be

212 Treas. Reg. §1.355-2(d)(5)(iv).

213 So to take the prior example, and assuming nonbusiness assets above the reduced 25 percent threshold, the device risk could not be avoided by reliance upon the equalization of values exception or the Section 302 Safe Harbor. The regulations also incorporate an "anti-stuffing" provision that treats business assets recently contributed to Controlled as nonbusiness assets for purposes of applying the applicable percentage thresholds.

on whether, or to what extent, any section 355 distribution (pro rata or non-pro rata) can be used to remove cash or other nonbusiness assets from Distributing on a tax-free basis.[214]

**d.** **Interface with Business Purpose**. Discerning the precise nature of the relationship between the non-device and corporate business purpose requirements of section 355 can be very difficult. Tax avoidance is a common element of both, but in somewhat different ways. An acceptable corporate business purpose must be a "real and substantial non-federal tax purpose,"[215] whereas the statutory device restriction focuses on whether a purported section 355 distribution was made "principally" to avoid dividend taxation. It is unclear whether or to what extent any tax-oriented motivation for the distribution can be disregarded or otherwise tolerated in either context. The regulations instruct that a pro rata distribution "presents the greatest potential for the avoidance of the dividend provisions… and is more likely to be used principally as a device," but is nonetheless labeled only "evidence" of device (as opposed to "substantial evidence.")[216] Moreover, a 2003 published ruling announces that the mere fact that, absent section 355, the distribution would trigger a corporate-level taxable gain (under section 311(b)) "does not present a potential for the avoidance of federal taxes" so as to cause violation of the section 355 business purpose requirement.[217] The 1989 Regulations (which post-dated *General Utilities* repeal) state, however, that "[t]he potential for the avoidance of Federal taxes by the distributing or controlled corporations (or a corporation controlled by both) is relevant in determining the

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[214] If, however, if the percentage of nonbusiness assets is low enough to avoid a device problem under the regulations, consideration might still be given to treating as "boot" the portion of the distributed Controlled stock attributable to permitted nonbusiness assets. See discussion infra, at 44.

[215] See Treas. Reg. §1.355-2(b)(2). See also, Treas. Reg. §1.355-2(b)(5), Ex. (7) [spin-off to facilitate S corporation election for federal and state tax purposes fails corporate business purpose requirement where resulting reduction in federal tax would exceed reduction in state tax].

[216] Treas. Reg. §1.355-2(d)(2)(ii).

[217] Rev. Rul. 2003-110, supra, n. 126 [corporate-level nonrecognition treatment expressly provided by sections 355(c) and 361(c) "is part of the statutory scheme of §355 and implicit on all such distributions"]. Similarly, the mere fact that shareholder-level nonrecognition treatment statutorily results from a qualifying section 355 distribution should not preclude satisfaction of the business purpose requirement. See Murray, supra n. 5 at 37 and note 112 (Mr. Murray was the principal author of Revenue Ruling 2003-110.)

extent to which an existing corporate business purpose motivated the distribution."[218] This warning is echoed in the preamble to the 2016 Proposed Regulations.[219] It thus seems clear that satisfaction of the non-device and business purpose qualification requirements of section 355 can be derailed by circumstances that facilitate either shareholder or corporate-level federal income tax avoidance, i.e., that potential abuse of the section 355 exemption from *General Utilities* repeal is very much part of the analysis from the Service's perspective.[220]

The existence of a "strong" corporate business purpose is identified in the regulations as a non-device evidentiary factor[221] and is often asserted as a basis for avoiding a potential device problem, particularly in spin-off transactions where the pro rata distribution of the Controlled stock is clear evidence of device and the Distributing stock is not publicly-traded and widely-held. Implicit in this factor is the questionable notion that a corporate business purpose for the separation that passes muster for purposes of the nonstatutory business purpose requirement may not be "strong enough" to neutralize a potential section 355 qualification issue under the statutory non-device requirement.[222] Attempting to assign relative degrees of strength to one or more legitimate

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[218] Treas. Reg. §1.355-2(b)(1).

[219] Although the existing device regulations focus on "facilitating the avoidance of the dividend provisions of the Code" by enabling post-spin stock sales at capital gain rates [see §1.355-2(d)(1)], the Preamble to the 2016 Proposed Regulations warns that "[t]he Treasury Department and the IRS continue to study whether permitting tax-free separations of large amounts of nonbusiness assets from business assets, especially when the gain in the non-business assets is expected to be eliminated, is consistent with General Utilities repeal in all circumstances." Preamble, REG-134016-15 (7/15/16), at §4.

[220] Circumstances in which section 355 transactions might properly be viewed as contravening the spirit of General Utilities repeal – notwithstanding the explicit statutory exceptions provided by sections 355(c) and 361(c) – are by no means clear. The principal doubts in this regard stem from the fact that distributions of Controlled stock do not remove Controlled's underlying appreciated (or depreciated) assets from the corporate tax base; rather, they simply shift the underlying beneficial ownership of such assets among the existing shareholders. Moreover, unlike taxable distributions of appreciated assets that generate a fair market value basis in the hands of the shareholder, the basis of the Controlled stock received in a section 355 distribution is either an allocated portion of the shareholder's historic basis in her Distributing stock (in a spin-off) or the "substituted" basis of the redeemed Distributing stock (in a split-off). IRC §§358(b) and (c). See generally, Alexander & Wood, supra n. 140, 96 Taxes at 37 et seq.

[221] Treas. Reg. §1.355-2(d)(3).

[222] The existing regulations set forth three "assessment of strength" factors: (*i*) importance to success of business; (*ii*) transaction prompted by outsiders (i.e., non-shareholders) or noncontrollable external circumstances; and (*iii*) immediacy of conditions prompting transaction. At least the first and third of these are fact-intensive and often not readily discernible. Treas. Regs. §§1.355-2(d)(3)(ii)(A)-(C). The 2016 Proposed Regulations retain the "strong

business purposes is a highly subjective exercise that can lead to questionable and inconsistent results.[223]

The inter-relationship between the independent corporate business purpose and non-device qualification requirements of section 355 should be better delineated.[224] This could be done, at least in part, by strengthening the device regulations to make clear that the corporate business purpose for a purported section 355 distribution -- no matter how "strong" it may be -- will not constitute evidence of non-device in cases involving (*i*) pre-arranged sales of more than 20 percent of the Distributing or Controlled stock; (*ii*) substantial and disproportionate amounts of nonbusiness assets held by Distributing and/or Controlled (consistent with the more stringent "nature and use of assets" criteria of the 2016 Proposed Regulations); or (*iii*) any other circumstances in which "substantial evidence" of device may exist. With these changes, qualification for section 355 treatment would become more rigorous, and the business purpose and non-device requirements would hopefully operate more cohesively.

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business purpose" non-device factor, but not for purposes of counterbalancing the "nature and use of assets" device factor if the excess or disproportionate non-ATB assets are not reasonably related to use in a business of Distributing or Controlled. That approach seems to beg the question, since if they are so related, they should be considered "business assets" to begin with and, as such, the nature and use of assets factor should not come into play at all. See Prop. Treas. Regs. §§1.355-2(d)(3)(ii) and (d)(4), Exs. (2) and (4).

223 See and compare: Pulliam v. Commissioner, supra n. 202, with Treas. Reg. §1.355-2(d)(4), Ex. (1). In Pulliam, Distributing, which owned and operated funeral homes, transferred one of the homes to a newly-formed subsidiary and distributed the Controlled stock to its sole shareholder, who then sold 49 percent of the Controlled stock to a former key employee who was a competitive threat to Distributing. The Tax Court held that section 355 applied, concluding that the business purpose for the distribution (the validity of which was not entirely clear) outweighed the pro rata nature of the distribution and any other evidence of device. In Example (1), Distributing (which conducted Business 1) spun off an existing subsidiary (which conducted Business 2) to its sole shareholder (Mr. A) so that a key employee of Business 1 (who had threatened to quit) could purchase a "significant amount" of Distributing stock from A. The distribution was found to constitute a device on the ground that, instead of A selling Distributing stock to the employee, Distributing could have issued the stock -- but either way the spin-off had to occur to provide Distributing stock to the key employee, i.e., there was certainly a valid corporate business purpose for separating the two businesses. It is unclear why Example (1) did not compel a device finding in Pulliam (where the Controlled stock could similarly have been issued directly by the corporation).

224 See Schler, supra n. 5, 56 SMU L. Rev. at 254-55 [device test should not be eliminated as a separate section 355 qualification requirement and "replaced with more precise prohibitions."]

**4. Continuity of Interest.**

**a. Current Landscape.** Under the section 355 "continuity of interest" requirement (the "355 COI Requirement"), after the spin the pre-spin historic shareholders of Distributing must "own, in the aggregate, an amount of stock establishing a continuity of interest in each of" Distributing and Controlled.[225] Examples in the Treasury regulations indicate that 50 percent continuing ownership is sufficient, whereas 20 percent is not.[226]

The regulations appear to contemplate that, to satisfy the 355 COI Requirement, the requisite level of stock ownership be maintained in both Distributing and Controlled for some indefinite period of time following the spin (as opposed to being held simply "immediately after" the spin, as under the ATB Requirement). By contrast, the regulations describing the continuity of interest requirement for section 368 reorganizations (the "368 COI Requirement") were amended in 1998 to eliminate the need for any post-acquisition holding period with respect to acquiring corporation stock received in an acquisitive reorganization, requiring only that such stock represent "a substantial part" of the total value of the acquired corporation's outstanding stock immediately before the reorganization.[227] The amended section 368 COI regulations also eliminate the former requirement that only acquiring corporation stock received by "historic" shareholders of the target corporation "counts" towards establishing the requisite level of continuity.[228] The preamble to those regulations, however, states that, pending further study by Treasury and the Service as to the role of the 368 COI Requirement in reorganizations under section 368(a)(1)(D) and section 355

225 Treas. Reg. §1.355-2(c)(1).

226 See Treas. Reg. §1.355-2(c)(2), Exs. (2) and (4). In these examples, the stock sales occurred prior to (but in contemplation of) the spin. As a result, the purchaser of the shares was not considered an "historic shareholder" of Distributing whose shares were taken into account for purposes of measuring continuity of interest. See Rev. Rul. 79-223, 1979-2 C.B. 125. There are no examples involving post-spin stock sales.

227 See Treas. Reg. §1.368-1(e)(1)(i).

228 Id. [pre-reorganization dispositions of acquired corporation stock to unrelated parties disregarded for COI purposes]. See Murray, supra n. 5, at 781 and note 3314.

transactions, the amended continuity of interest rules for acquisitive reorganizations will not apply to reorganizations under section 368(a)(1)(D) or section 355 transactions.[229]

Similar to the analysis with respect to the subsequent sale of stock device factor, the risk associated with the 355 COI Requirement presumably dissipates as the post-spin "holding period" lengthens. In light of the fact pattern presented in a 1974 published ruling (since obsoleted on other grounds), most practitioners probably believe that a 2-year holding period is quite "safe" and that shorter periods may also suffice.[230] Thus, if post-spin stock sales were precipitated by identifiable unforeseen circumstances but clearly not otherwise contemplated at the time of the spin, those sales should not count against the continuity of interest threshold under conventional "step-transaction" principles no matter how soon after the spin they might occur.[231] The rationale of Revenue Ruling 2003-55 is again instructive. Just as the intention, at the time of the spin, to accomplish an ultimately aborted corporate business purpose is sufficient to satisfy the business purpose requirement of section 355, so should an intention to continue substantial stock ownership in both Distributing and Controlled where unforeseen post-spin circumstances cause a complete or substantial near-term disposition of such stock.

It is disappointing that almost two decades have passed without action since Treasury's promise of "further study" regarding what, if any, role the COI requirement plays in connection with type "D" reorganizations or section 355 transactions. The question is complicated by the different COI principles reflected in the section 355 and 368 regulations, and the fact that section

229 See T.D. 8760, *Continuity of Interest and Continuity of Business Enterprise*, 63 Fed. Reg. 4174, 4176 (Jan. 28, 1998).

230 See Rev. Rul. 74-5, supra n. 59. The stock ownership period in this ruling ran from "in 1969" to "in 1971," so it could have been more or less than exactly two years.

231 This analytic approach was endorsed in cases involving the post-acquisition continuity of interest requirement that previously existed in connection with section 368 corporate reorganizations. See, e.g., Penrod v. Commissioner, 88 T.C. 1415 (1987) [stock sale 9 months after reorganization did not break continuity of interest; no intent to sell at time of reorganization]; Est. of Christian v. Commissioner, 57 T.C.M. (CCH) 1231 (1989) [stock sale seven months after reorganization did not break continuity of interest; no intent to sell at time of reorganization].

355 distributions are often part of a divisive "D" reorganization. Further complications stem from the fact that (*i*) the "control immediately after" requirement of section 368(a)(1)(D) for D/355 reorganizations is effectively nullified by section 368(a)(2)(H)(ii);[232] (*ii*) substantial post-spin sales or other taxable dispositions of less than 50 percent of the Distributing or Controlled stock may separately cause a "device" problem even though they would not cause a COI problem; and (*iii*) notwithstanding satisfaction of the non-device and COI requirements, acquisitions of a 50 percent or greater interest in Distributing or Controlled stock during the 2-year post-spin period may trigger a corporate-level tax to Distributing under section 355(e). The time for reconciling these various possible outcomes has surely arrived.

**b. Possible Reshaping or Repeal**. Conformity with the 368 COI Requirement is probably the most significant change that might be made to the 355 COI Requirement -- in particular, recognizing a lower 40 percent continuity threshold as acceptable[233] and doing away with the post-spin continuity and historic shareholder requirements.[234] A 40 percent threshold does not seem objectionable, since the COI concept has historically focused on whether stock or other proprietary interests represents a "substantial portion" or "part" of the total

[232] In both "acquisitive" and "divisive" type-"D" reorganizations, one corporation transfers all or part of its assets to another corporation and immediately after such transfers, the transferor or its shareholder must hold section 368(c) "control" (i.e., 80 percent of voting proxy and non-voting stock) of the transferee corporation. In a divisive "D", the transferor corporation (Distributing) distributes the transferee corporation ("Controlled") stock to the Distributing shareholders under section 355 and, under section 368(a)(2)(H)(ii), the Distributing shareholders can dispose of the Controlled stock all or part (i.e., more than 20 percent) without violating the "control" requirements of section 368(a)(1)(D). Such dispositions, however, could be substantial enough (i.e., more than 50 percent) to cause a COI violation.

[233] See Treas. Reg. §1.368-1(e)(i)(v), Ex. (1).

[234] In the acquisitive reorganization context, it only is necessary that the target company shareholders reserve a substantial portion of the acquisition consideration in the form of acquiring company stock (which they are generally free to dispose of immediately, except by way of a planned redemption resulting in the receipt of cash or other non-stock consideration from the acquiring company). See Treas. Regs. §§1.368-1(e)(1)(i) and (e)(8), Exs. (1) and (4).

consideration received in a nonrecognition transaction;[235] and the 50 percent example in the section 355 COI regulations pre-dated the 1998 changes to the COI rules for reorganizations.

Given the liberalization of the 368 COI Requirement and the "control" requirement for D/355 transactions, as well as the existing device and section 355(e) policing mechanisms with respect to at least certain pre- and post-spin dispositions of Distributing or Controlled stock, a reasonable case can be made for disregarding pre- or post-spin stock dispositions in determining compliance with the 355 COI Requirement. As expressed by one commentator in advocating such treatment for both COI and device purposes:

> [G]eneral principles of corporate taxation provide no sound reason for assuming that pre- or post-distribution sales of stock, whether or not pre-planned, should automatically be collapsed into the distribution for purposes of the continuity of interest requirement on the device test. Such sales are fully taxed at the shareholder level, and do not inherently involve the extraction of assets from corporate solution. Thus, the should not automatically trigger a corporate level tax, or be viewed as circumventing the dividend rules. As with acquisitive reorganizations, when the continuity of interest doctrine is applied to divisive transactions, it ought to focus on what the corporation furnished to the shareholders in the transaction [normally all of the controlled stock, i.e., a "substantial proprietary interest"] and not on what the shareholders did with their stock prior to or following the distribution.[236]

If there is to be a post-spin COI requirement under section 355, the question of how long the requisite stock ownership must last could be resolved by requiring a fixed minimum "holding period" of the requisite stock ownership (e.g., at least 40 or 50 percent for one or two years). An alternative approach would be to permit earlier post-spin stock dispositions, provided the taxpayer can demonstrate that such dispositions are not factually linked to the spin-off.[237]

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[235] See John A. Nelson v. Commissioner, 296 U.S. 374 [38 percent continuity found acceptable]; and Treas. Reg. §1.368-1(e)(1)(i) ["substantial part of the value of the proprietary interests in the target corporation"]. The section 355 COI regulations, however, merely contain examples indicating that 50 percent continuity is acceptable (and 20 percent is not), without any reference to "substantial proprietary interest" or other definition of COI.

[236] Shores, supra n. 180, 18 Va. Tax Rev. at 542-43.

[237] The absence of such linkage could be determined with reference to conventional step-transaction principles, the Revenue Ruling 2003-55 rationale and/or the AUASN or other factors under the section 355(e) "plan" regulations.

Professor George Yin has expressed the view that the section 368 and section 355 continuity of interest requirements serve different purposes, stating as follows:

> In an acquisitive reorganization, a former target shareholder who subsequently sells stock of the acquiring corporation obtains no tax advantage that did not exist prior to the reorganization. The same tax results -- a potential capital gains tax to the shareholder and the absence of any corporate-level tax -- could have been obtained through a sale of the target corporation stock prior to the reorganization. In contrast, … a disposition of distributing or controlled corporation stock in connection with a divisive reorganization can result in tax advantages at both the shareholder [avoidance of section 301, 302, or 336 taxation] and corporate [avoidance of *General Utilities* repeal via section 355(c) or 361(c)] levels. It is appropriate, therefore, to monitor closely dispositions in the latter case but not the former.[238]

Professor Yin goes on to suggest, however, that it may be possible to eliminate the section 355 COI Requirement altogether in conjunction with a broader section 355 reform proposal that would condition section 355 qualification upon there not being an aggregate change of Distributing or Controlled stock ownership above a prescribed percentage level (*i*) during a fixed period of years surrounding the spin-off or (*ii*) pursuant to a plan including the spin-off transaction.[239] As discussed in part IV.C below, this approach might also facilitate repeal of section 355(d), section 355(e) and possibly a good part of the device requirement as well.

**c.** **Minimal Administrative Fixes**. Assuming retention of the existing 355 COI Requirement, examples should be added to the regulations illustrating application of the requirement in one or more situations involving post-spin stock dispositions. Such examples should reflect specific facts as to the timing and extent of such dispositions and whether they were

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[238] Yin, supra n. 5, 56 SMU L. Rev at 298. As Professor Yin further points out, adopting the 368 COI model for section 355 purposes (i.e., requiring only that a substantial portion of the consideration received by Distributing shareholders consist of Controlled stock) would essentially render the requirement a dead letter, since at least 80 percent of the Controlled stock must be distributed as a threshold requirement of section 355 qualification. Id., at n. 43.

[239] Id. at 297-301. He also suggests that it should "be possible to repeal most or all of the device clause." Id. at 288. As made clear at the outset and conclusion of his article, Professor Yin questions whether any significant reform of section 355 should await more fundamental reform of subchapter C -- in particular, reform measures which address "the disparate tax treatment of stock and asset acquisitions." Id. at 289-90, 303. That concern has since been at least partially addressed via the section 336(e) regulations finalized in 2013. See discussion supra, at 23-24.

planned or anticipated at the time of the spin. They also should indicate whether COI is to be measured with reference to voting power and/or stock value or simply the percentage of total shares collectively held by historic shareholders of Distributing.[240]

The Service also should issue guidance clarifying that the 355 COI Requirement contemplates both direct and indirect continuity,[241] and exactly how the quantum of indirect COI should be measured. For example, assume that Distributing spins off an unwanted business to facilitate a merger into P, an unrelated corporation, with the Distributing shareholders receiving an aggregate 54 percent P stock interest in the merger. That was the fact pattern in the *Morris Trust* case, where the court held that the pre-planned merger did not jeopardize compliance with the COI or any of the other section 355 qualification requirements. Although Distributing ceased to exist, it sufficed for COI purposes that its former shareholders directly held 100 percent of the Controlled stock and thereby collectively maintained a more than 50 percent indirect equity position in the Distributing assets through their stock ownership in P.[242] More specifically, the aggregate value of the P stock received represented 100 percent of the aggregate value of the Distributing shares exchanged in the merger; and that would have been true as well had P been much larger than Distributing, with the result that the Distributing shareholders received P stock representing a

240 See Murray, supra n. 5 at 782 ["The Service view for ruling purposes has been (and we believe continues to be) that the percentage of continuing stock ownership controls, regardless (or nearly so) of the extent to which the continuing ownership reflects the corporation's (Distributing's or Controlled's) underlying value before the distribution."] The "vote or value" construct (used for section 355(d) and (e) purposes) would seem well-suited to deal with situations involving multiple classes of stock.

241 See Rev Rul. 62-138, 1962-2 C.B. 95. Distributing distributed Controlled stock to its parent company shareholder, P, which then distributed Controlled stock to its sole shareholder. The Service ruled that both distributions qualified under section 355, stating that the Distributing shareholders "held the same enterprises in modified corporate form as before the transaction and the corporate enterprises were continued as such." (There was no separate COI provision in the then existing section 355 regulations (1955 version).)

242 In those circumstances, the court concluded that "[t]here was clearly the requisite continuity of stockholder interest." Morris Trust v. Commissioner, supra n. 71, 367 F.2d at 799-800.

much lower percentage of the total outstanding P stock (i.e., a "whale swallows minnow" situation).[243]

## C. Possible Repeal of Sections 355(d) and (e)

Taken together, the above-suggested surgical procedures would go a long way toward clarifying, tightening and better objectifying the section 355 qualification requirements, thereby limiting nonrecognition treatment to corporate separations that involve substantial active businesses and modified corporate structures that truly embody the continuity of ownership, continuity of business and corporate business purpose underpinnings of both acquisitive and divisive reorganizations. Qualifying under section 355 would likely become more difficult, but at the same time more predictable. With these changes in place, the need for sections 355(d) and (e) would seem less pressing. Consequently, thought could be given to sending both to the morgue and replacing them with a new provision that embodies the principal requirements of sections 355(d) and (e).

These post-'86 Act provisions were each designed to address concerns about the use of section 355 as a vehicle for avoiding *General Utilities* repeal. They commonly focus on stock ownership changes in Distributing or Controlled, but do so in an inconsistent and overreaching manner. Moreover, both substantially replicate specific qualification requirements of section 355,

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243 In that situation, however, a corporate-level tax would be triggered under section 355(e) if the merger was part of a "plan" including the spin-off. Section 355(e) did not exist at the time of the Morris Trust decision, but would not have applied anyway because the Distributing shareholders retained a more than 50 percent indirect stock interest in the former Distributing enterprise -- i.e., new shareholders did not acquire 50 percent or more stock interest as required by section 355(e). See IRC §355(e)(3)(B) [in a section 368(a)(1)(A) statutory merger, for section 355(e) purposes the acquisition of Distributing or Controlled assets by the acquiring corporation is treated as if the shareholders of the acquiring corporation acquired stock of the acquired corporation.] See Reinhold, supra n. 59, 82 Tax Notes at 1491, n. 38 ["[P]ost-Morris Trust authorities routinely applied the holding of the case without regard to the degree of ownership of the acquiring company by former Distributing shareholders… and… Morris Trust plainly remains good law in the interpretation of section 355, even for cases that run afoul of the ownership change restriction in the new measure and thereby trigger liability for tax under section 355(e)."] See also Beller & Pauls, supra n. 82, 41 J. Corp. Tax (Part II) at 24-26 (Cases 18-21).

yet neither comes into play to impose a corporate-level tax absent satisfaction of all statutory and nonstatutory qualification requirements.

The 50 percent tainted stock "purchase" threshold of section 355(d) effectively expands the reach of section 355(b)(2)(D), which precludes meeting the "active business" requirement where an 80 percent or more controlling stock interest (per section 368(c)) is acquired during the 5-year pre-distribution period (the same relevant period for section 355(d) purposes) in a wholly or partially taxable transaction. Section 355(e) also has a 50 percent stock ownership change threshold, but looks to a 4-year "taint" period (extending from 2 years before to 2 years after the distribution); counts both taxable and non-taxable stock acquisitions; triggers corporate-level tax only where the proscribed stock acquisitions can be linked to the spin-off as part of a "plan"; and is not limited in its coverage to leveraged Morris Trust transactions (i.e., the originally intended target of the provision).[244]

The logic of these discontinuities is not easily explained. Further, the central "plan" requirement of section 355(e) often requires analysis that is essentially similar to that which must be undertaken to determine whether the device or continuity of interest requirements have been or would be breached by reason of post-spin stock dispositions. In situations involving planned stock

[244] See discussion supra, at 17. Apart from Morris Trust scenarios, leveraging is a fairly common feature of section 355 transactions, especially in public company spins. For example, Controlled may borrow from an outside lender, distribute the loan proceeds to Distributing, and Distributing may then use such funds to pay off its own liabilities. Alternatively, Distributing may borrow with Controlled assuming the debt as part of the D/355 transaction; or Controlled may issue its debt securities to Distributing, which then exchanges the securities (or some of the Controlled stock) for recently incurred outside debt. These techniques are typically designed to avoid tax to Distributing under favorable exceptions to the section 361 "boot" rules that apply to D/355 reorganizations. See IRC §§361(b) and (c) [generally permitting Distributing to avoid boot taxation on cash or other property distributed to shareholders or creditors pursuant to the plan of reorganization]. In 2013 the Service suspended issuing private rulings with respect to certain forms of leveraging structures "pending further study," but recently announced that it will resume ruling in such situations as it continues to study the area. See Rev. Proc. 2017-38, 2017-22 I.R.B. 1258 [will again rule on "whether §355 or §361 applies to a distributing corporation's distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if such … debt is issued in anticipation of the distribution…"] and Willens, IRS Will Rule Again on "Leveraged" Spinoffs, Bloomberg BNA Daily Tax Report (May 12, 2017). See generally, Sheffield, Spinoffs, Corporate Capital Structure and Disguised Sales, 91 Taxes 119 (2013).

ownership changes of 50 percent or more via taxable transactions occurring within two years after the spin, serious device and/or continuity of interest problems may well exist and render the section 355(e) inquiry moot. But even if the taxpayer is able to obtain favorable "significant issue" rulings on device and continuity of interest, the ruling letter would still be caveated as to any section 355(e) "plan" issue. Moreover, as a practical matter, if any real risk of triggering a heavy corporate-level tax under section 355(e) appears to exist (e.g., by reason of pre-spin discussions with the acquiring party),[245] the appetite for going forward with a substantial proposed post-spin acquisition transaction would presumably evaporate or diminish greatly.[246]

The repeal of sections 355(d) and (e) would certainly result in significant tax simplification and probably simplify as well the overall tax planning analysis in connection with many proposed section 355 transactions.[247] Such action warrants consideration because the tax impact of stock ownership changes that can trigger section 355(d) or (e) should more appropriately focus on whether such changes cause the transaction to lack one or more of the core elements of nonrecognition treatment for acquisitive and divisive reorganizations. If they do, then the transaction should not qualify under section 355 and, consequently, should result in taxable treatment at both the shareholder (under sections 302 or 331) and corporate (under sections 311 or 336) levels. If they do not, then section 355 nonrecognition treatment should apply at both the shareholder and corporate levels. There really is no need for the hybrid result of taxation at only

245 While any section 355(e) tax would now be considerably less with the new 21 percent corporate tax rate, the exposure would still be quite substantial in most cases.

246 If the post-spin acquisition of Distributing or Controlled is effectuated via a section 368 reorganization with little or no boot, device is normally not a concern. See Treas. Reg. §1.355-2(d)(2)(iii)(E). Further, indirect section 355 continuity of interest should exist so long as the target company (i.e., Distributing or Controlled) shareholders receive acquiring corporation stock representing at least 50 percent of the value of their exchanged target company stock (regardless of how small a percentage that stock represents of the acquiring corporation's total outstanding stock). See Morris Trust, supra n. 71 at 800-02; and discussion supra at 17.

247 Section 355(f), which turns on the application of section 355(e) to external spins following an internal spin, could also be repealed, as could the Treasury regulations permitting a section 336(e) election with respect to section 355 transactions in which a section 355(d) or (e) corporate-level tax is triggered.

the corporate level, an outcome that sophisticated tax advisers are normally able to easily avoid in structuring *Morris Trust*-type transactions. If situations arise involving otherwise qualifying section 355 transactions that truly smack of *General Utilities* avoidance, the hole in the dike can be plugged through regulatory action under section 337(d).

In his 2003 article, Professor Yin similarly suggested that sections 355(d) and (e) are dispensable, and that the "triggering events" of section 355(e) can instead be used as a qualification tool for limiting nonrecognition treatment under section 355 to "corporate divisions (that) do not result in any significant change in the ownership of any of the components of the corporate structure."[248] More specifically, he proposed a single "ownership change condition" to the effect that "a divisive transaction (that) results in a change in interest greater than X percent in any of the corporate components of the transaction. . . is not a mere reorganization of continuing interest and is not entitled to tax-free treatment."[249]

Like most tax reform proposals, the devil is usually in the details, so Professor Yin further addresses important questions as to how the ownership change condition (whatever percentage it may be) would be implemented -- in particular: (*i*) would occurrence of the requisite change in ownership within a fixed period of years automatically prevent section 355 qualification, whether or not linked to the spin-off as part of a "plan"? (*ii*) Should the presence of a plan automatically foreclose section 355 qualification no matter how soon or long after the spin-off the requisite change in ownership occurs? (*iii*) Should tainted ownership changes include both taxable and nontaxable stock acquisitions (as under section 355(e)) or only taxable stock acquisitions (as under section 355(d))? He appears to answer all of these queries in the affirmative,[250] and further suggests

[248] Yin, supra n. 5, 56 SMU L. Rev. at 296.
[249] Id.
[250] Id. at 296-301.

that the "taint" period should run from some point in time preceding the spin-off to a point in time after the spin.

While Professor Yin does not propose a specific percentage threshold or taint period at or during which a proscribed change in stock ownership would need to occur, the 50 percent / 4-year benchmarks now applicable under section 355(e) would seem reasonable.[251] It is less clear whether a new change in ownership qualification provision should taint both taxable and nontaxable stock acquisitions or apply to stock acquisitions that are not part of a "plan" including the spin-off. A reasonable compromise position would be to taint both taxable and nontaxable stock acquisitions (as does section 355(e)), but only if linked to a plan including the spin-off.

Under that approach, the new condition for section 355 qualification would be violated by nontaxable post-spin acquisitions of Distributing or Controlled stock in Morris Trust transactions in which the Distributing or Controlled shareholders collectively received less than 50 percent of the acquiring corporation stock.[252] Retention of the "plan" feature would accommodate the business world reality that changed or unforeseen circumstances frequently occur, as Treasury was generously willing to recognize in crafting the "non-plan" factors and safe harbors of the section 355(e) "plan" regulations. The replacement of sections 355(d) and (e) with a new "plan"-based ownership change qualification condition should not be viewed as a pro-taxpayer "end around" *General Utilities* repeal, especially since a failure to meet that condition would result in taxation

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[251] This would include the 2-year periods before and after the spin. A 6-year window (3 and 3) might instead be considered. The existing 5-year pre-spin taint period under section 355(d) could continue to apply to taxable stock and asset acquisitions for purposes of the active business restrictions under sections 355(b)(2)(C) and (b)(2)(D) (e.g., 2 or 3 years), although it is arguable that some shorter period would be more appropriate for such purposes.

[252] Such transactions would continue to be disfavored notwithstanding that (*i*) they were commonplace prior to General Utilities repeal and the 1997 enactment of section 355(e); (*ii*) the Section 355 COI Requirement is considered indirectly met in such circumstances (because the acquiring corporation stock received represents at least 50 percent of the value of the Distributing or Controlled stock surrendered in the post-spin transaction); and (*iii*) spin-offs done to facilitate a subsequent acquisition have historically been viewed as satisfying the section 355 corporate business purpose requirement.

at both the shareholder and corporate levels (as opposed to only a corporate-level tax if section 355(e) were to remain in the Code).

An alternative approach would be to combine sections 355(d) and (e) into a single new "corporate-level tax only" provision which is triggered by 50 percent or more stockownership changes that arise from taxable or nontaxable transactions (including public and private offerings) in the same circumstances that now trigger section 355(e) -- i.e., during a 4-year period surrounding a qualifying section 355 distribution, provided that such transactions are linked to the spin-off under a proscribed "plan". Thus, *Morris Trust* transactions that currently trigger section 355(e) would continue to do so under the new provision; but both taxable and nontaxable stock acquisitions (not just "purchases") during the pre-spin taint period (reduced from 5 to 2 years) would result in corporate-level taxation unless the absence of a "plan" could be demonstrated (applying the same factors and safe harbors articulated in the existing section 355(e) "plan" regulations). As is now the case, the spin would still have to pass muster under all of the section 355 qualification requirements that remain in effect before the new provision could come into play.

## V. Conclusion

The main goal of any section 355 overhaul should be to bring its qualification requirements into better sync with the core continuity of ownership and continuity of business concepts that support nonrecognition treatment for acquisitive and divisive reorganizations. This calls for limiting the application of section 355 to corporate separation transactions in which primarily active business assets of Distributing are shifted into stand-alone corporations that continue to be owned primarily by the Distributing shareholders; and denying nonrecognition treatment where substantial amounts of nonbusiness assets change hands and a substantial complement of new shareholders enters the picture.

If the reform measures proffered in this article were to find daylight, section 355 would in my view become a simpler and more rational component of subchapter C. To be sure, the suggested changes are by no means exhaustive and not likely to curry complete favor among tax academics or practitioners who specialize in section 355 matters. While some may argue that the section 355 mousetrap does not need further fixing beyond occasional tinkering, I would respectfully disagree. Hopefully, a consensus can be reached that significant changes are indeed necessary in this important area of the tax law, so that the challenging task of crafting and implementing such changes –- through some mix of statutory amendments, revised or new regulations or other administrative pronouncements -- can proceed expeditiously. Whatever the contours and specific requirements of a revised section 355 might turn out to be, corporations contemplating tax-free separations should avail themselves of the more expansive section 355 ruling policies that are now evolving; and they should exercise due caution in utilizing transactional structures, or engaging in near-term dispositions of Distributing or Controlled stock or assets, that are likely to awaken the ghost of Mrs. Gregory or be perceived as damaging the integrity of *General Utilities* repeal.