CHAPTER 11 - DIVISIVE REORGANIZATIONS

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11-1a. Note that the answers in each of the questions below assumes that any business purpose requirement is met. *Coady v. Commissioner*, 33 T.C. 771 (1960) involved a similar vertical division. As the text explains, the Tax Court in *Coady* invalidated the provision of former Regs. §1.355-1(a), which required that the corporation engage in two separate active trades or business before the transaction. Further, Regs. §1.355-3(c)(ex. 4) accepts the *Coady* result. The only wrinkles added by the facts of this problem are the pro rata form of the distribution and the anticipated liquidation of Y.

Is the pro rata form of the distribution important? Section 355(a)(2)(A) surely indicates that it is not, although Regs. § 1.355-2(d)(2)(ii) accurately observes that "[a] distribution which is pro rata or substantially pro rata among the shareholders of the distributing corporation presents the greatest potential for the avoidance of the dividend provision of the Code and ... is more likely to be used principally as a device." Is the potential for abuse realized here? No.

The effect of the divisive reorganization followed by the liquidation is that of a partial liquidation, both in form and in taxation. An astute student might observe that the Service's failing position in *Coady* is preserved in the partial liquidation provision of §302(e)(2) where there is an implicit requirement that the corporation conduct *two* distinct trades or business prior to the partial liquidation. Thus, one might argue that using the divisive reorganization in this problem improperly circumvents this aspect of §302(e)(2).

However, there is no two-business requirement in §302(e)(1) – that provision merely requires that there be a "genuine contraction" of the corporation. Surely the facts of this problem would constitute a legitimate contraction, and so the equivalent of partial liquidation treatment is appropriate.

If the business (or part of the business) being liquidated consists of loss property, the problem becomes more difficult. No loss can be recognized by a corporation on a partial liquidation taxed under §302(b)(4), see §31l(a), whereas the spin-off of loss assets followed by a complete liquidation of the new subsidiary arguably would permit the recognition of loss at the corporate level, see §336(a).

11-lb. There should be no difference between problems 11-1a and 11-1b.

11-2a. This transaction is a "split-up" qualifying under §355. At the corporate level, the transfers will be tax-free because they constitute D reorganizations. Thus, Y and Z will take transferred bases in the X Corp. assets under §362(b).

At the shareholder level, the exchanges by A and B of X stock for Y and Z stock will be tax-free under §355. Of course, if there is a pre-distribution plan to transfer the stock of Y or Z, the transaction will fail to qualify under §355 because of the "device" restriction in §355(a)(1)(B). Assuming that the transaction is not a "device," A and B will take bases in the Y and Z stock equal to their pre-reorganization bases in their X stock. §358(a). The allocation of that basis between the Y and Z stock should be based on relative fair market values. See Regs. § 1.358-2(a)(2).

11-2b. The transaction remains a D reorganization qualifying by reason of a §355 distribution. This form of the transaction is called a "split-off." Note that B is not a party to any exchange in this form of the transaction. Non pro rata divisive reorganizations are permitted. §355(a)(2).

11-2c. The transaction (now called a "spin-off") remains tax-free. Note that receipt of the Y stock by A and B is treated as an exchange for computing basis in the Y stock received. See §358(c).

11-2d. If the assets of Gameco do not include an active trade or business, the transaction will fail to qualify under §355 by reason of §355(a)(l)(C). Even if an active trade or business is present, the transaction should still fail to qualify under §355 if the liquid assets represent the reinvested profits from the business conducted by Denco and the transaction does not have an adequate business purpose. Cf. Rev. Rul. 59-400, 1959-2 C.B. 114. However, if the liquid assets represent reinvested profits from the operation of the business conducted by Gameco, the answer is less than clear.

Under Regs. §1.355-2(d)(2)(iv)(B), the presence of liquid assets not related to the reasonable needs of the business is considered evidence that the transaction is a "device" for the distribution of earnings and profits within the meaning of §355(a)(1)(B). However, in this case, the distribution of the Y stock is in exchange for all of A's stock in X Corp. In the absence of §355, this transaction would be taxed as an exchange to A under §302(a) (assuming that A and B are unrelated). Thus, the harm to which §355 speaks – possible conversion of dividend income into capital gain - is not present here. Accordingly, the transaction should not run afoul of the "device" restriction in §355(a)(l)(B), and, consistent with this analysis, Regs. §l.355-2(d)(5)(iv) provides that "a distribution is ordinarily considered not to have been used principally as a device if, in the absence of §355, with respect to each shareholder distributee, the distribution would be a redemption to which section 302(a) applied."

11-2e. For the most part, the statute makes easy work of this problem: the active business requirement of §355(a)(1)(C) will not be satisfied by reason of §355(b)(2)(C). However, what if X purchased the stock of Holding Co. three years before for cash and then liquidated Holding Co. in a tax-free subsidiary liquidation described in §332? If the assets of Holding Co. included the assets of Denco, arguably those assets were acquired by X in a tax-free transaction as allowed by §355(b)(2)(C). The transaction certainly should not qualify under §355 and it will not by virtue of §355(b)(2)(D).

11-3. Because each subsidiary corporation has actively engaged in a trade or business for more than 5 years, §355(b) is satisfied, assuming Parent has no other assets. See §355(b)(1)(B). However, each of the shareholders purchased his stock of Parent within 5 years of the distribution. Does §355(d) apply to the transaction? Section 355(d) should apply to the distributions, because each shareholder will hold disqualified stock in Parent and will receive more than 50% of stock of a controlled corporation in the distribution. See §355(d)(2)(B). Section 355(d) does not cause the distributee shareholder to lose the benefit of §355 but rather taxes the distributing corporation (here, Parent) on appreciation in the stock distributed. The facts of the problem do not provide the necessary information to compute Parent's tax consequences, assuming that the stock distributed to the shareholders is not treated as qualified property. *See* §355(c)(2)(A) and (d)(1).

If the distribution is pro rata, however, no single shareholder will own 50% or more of stock of Parent or any controlled corporation. Thus, unless the stock ownership of X, Y, and Z are aggregated, §355(d) apparently does not apply. Under §355(d)(7), however, the stock ownership of multiple persons may be aggregated to satisfy then 50% test. If X, Y or Z are related, §355(d)(7)(A) will apply. In any event, §355(d)(7)(B) could apply if X, Y or Z acted in concert to acquire the stock of Parent of the controlled corporations.

11-4. Assuming Y and Z have actively conducted trades or businesses for more than 5 years, the transaction appears to qualify under §355. However, the stock of Y has been acquired twice within the 5 years preceding the distribution, first by X in a purchase and second by P in a B reorganization. Although the second acquisition was tax-free, and therefore not a purchase for purposes of §355(d)(5), the second acquisition is also a carryover-basis acquisition. Under §355(d)(5)(C), P is treated as acquiring the Y stock by purchase at the same time that X acquired it by purchase. Because P will be deemed to acquire all the Y Corp. stock by purchase within five years of the distribution, the distribution is a disqualified distribution under §355(d)(2). Thus, Y recognizes any appreciation in the Z stock on the distribution.

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11-5. If the transaction is respected as intended, it is not a §355 transaction. Therefore, when B transfers X Corp. stock in exchange for Y corporation stock, the exchange is potentially taxable (§304 doesn't apply because B does not receive property under §317(a)). Section 351 does not apply because B only has 50% control after the transaction. Therefore, it is a taxable exchange, but because B's basis and the fair market value of the Y Corp. stock each is $50,000 in the aggregate, there is no gain on the exchange. On a subsequent attempted complete redemption, the constructive ownership rules will force B to treat the distribution under §301. §§302(c) and 318. However, if Y Corp. has no earnings and profits, then the distribution will reduce B's basis by $50,000 and B will have no income. §301(c)(2).

However, if the Service uses the step transaction doctrine to recharacterize the transaction, it might view X Corp. as distributing the Y Corp. stock to B in exchange for

half of B's X Corp. stock. Viewed in this manner, the transaction would not satisfy the §355 active trade or business or device tests. Accordingly, the distribution of Y Corp. stock by X Corp. would be a distribution taxable to B under §301 since it doesn't qualify as an exchange under §302. The distribution would be fully taxable under §301 since X Corp. has ample earnings and profits. The subsequent redemption by Y Corp. would not produce any further tax to B.

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11-6a. This transaction satisfies all the requirements of §355. Accordingly, Y will not be taxable on the receipt of the S Corp. stock and the basis of Y's X Corp. stock will be prorated according to the fair market value of the X Corp. stock and the S Corp. stock. Note, however, that because Y purchased half of the X stock within five years of the distribution, §355(d) applies to X's distribution.

If §355(e)(2)(B) applies, then Y Corp. must recognize gain on the distribution of the S Corp. stock to Y. Notice here that the purchase of stock was 3 years ago which is outside the presumptive 2 year period before the date of distribution. But that is just a presumption. If §355(e) applies, then because the S Corp. stock will have a basis equal to the basis of the assets transferred to S Corp. under §358, it would be better to transfer the business 1 assets to S Corp. because they are less appreciated.

11-6b. Now there has been no triggering acquisition before the §355 transaction, but at the end of the day, Y will not control whichever corporation (X or S) merges into the publicly-traded corporation. Does this subsequent disposition affect the application of §355? Does it matter that the subsequent disposition is a tax-free merger? The answers are yes to the first and no to the second. Section 355(e)(2)(B) applies to both pre- and post-acquisitions and those acquisitions can be tax-free or taxable. Consequently, X Corp. will have to recognize gain on the distribution of the S Corp. stock. It would be smarter for X Corp. to spin off the business 1 assets and have that corporation merge into the publicly-held corporation. The asymmetry in the operation of §355(e) can put a premium on good planning.