The Aftermath of a Section 355 Transaction (Part I)

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This two-part article explores a wide variety of situations in which the tax-free treatment of corporate spin-offs and other separations under Section 355 can be jeopardized by transactions or other events that occur after the separation has been completed.

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Section 355 is one of the few bright spots remaining for corporate tax planners since repeal of the General Utilities doctrine in the mid-1980s. Under that provision, a parent corporation (“Distributing” or “D”) can distribute the stock of a subsidiary (“Controlled” or “C”) to some or all of its shareholders without tax at either the shareholder or corporate levels. However, satisfaction of one or more of the requirements for Section 355 treatment can often be affected by transactions or other events that occur after the separation has been completed. This article examines, through numerous hypothetical fact patterns, the principal issues that can arise in connection with post-spin developments.

I. Mechanics of Section 355

Section 355 transactions can take three basic forms:

- A “spin-off” (where none of the Distributing shareholders surrender any of their shares).
- A “split-off” (where one or more of the D shareholders redeem D shares for C shares).
- A “split-up” (where D completely liquidates and all D shareholders surrender all of their shares in exchange for shares of one or more Controlleds).

Consistent with common parlance, the term "spin-off" or "spin" will sometimes be used in this article with reference to Section 355 transactions generally, regardless of their particular form.

Absent Section 355, spin-off distributions would be subject to tax at the shareholder level as dividends under the Section 301 rules; split-off distributions would be taxed as dividends or as an "exchange" of the surrendered D stock under the Section 302 rules governing redemption transactions; and split-up distributions would be taxed as an exchange of the D shares under the complete liquidation rules of Sections 331 or 332 (the latter where D has a corporate shareholder that owns at least 80% of the D stock in terms of vote and value). At the corporate level, spin-off and split-off distributions of the C stock

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would trigger taxable Section 311(b) gain (but not loss); and split-up distributions would trigger gain and, subject to certain limitations, loss under Section 336.

Where Section 355 applies, (i) the transaction generally is tax-free to Distributing; 3 (ii) the D shareholders are not taxed on their receipt of the Controlled stock, but are subject to tax on any "boot" received; 4 and (iii) the D shareholders take an allocated or substituted basis in the Controlled stock received. 5 In some circumstances, however, a Section 355 distribution can qualify for tax-free treatment at the shareholder level, but not at the corporate level (by reason of the application of Section 355(d) or Section 355(e)).

A. Statutory requirements.

For a distribution to qualify under Section 355, all of the following statutory requirements must be satisfied:

- Stock of Controlled must be distributed to shareholders of Distributing with respect to their D stock; or stock or securities of Controlled must be distributed to security holders of Distributing in exchange for D securities. 6
- The distribution must not be used principally as a "device" for the distribution of the earnings and profits of Distributing or Controlled or both (the "Non-Device Requirement"). 7
- Both Distributing and Controlled must be engaged in the active conduct of a trade or business immediately after the distribution (the "ATB Requirement"). 8
- Distributing generally must distribute all of the Controlled stock that it holds immediately before the distribution, or at least an amount of shares constituting "control" of Controlled, as defined by Section 368(c) (the "Distribution of Control Requirement"). 9
- Immediately after the transaction, neither Distributing nor Controlled can be a "disqualified investment corporation" in which any person who holds a 50% or greater interest in such corporation held a less than 50% interest in such corporation immediately before the transaction. 10

B. Non-statutory requirements.

Additional Section 355 qualification requirements, provided in the underlying Treasury regulations, include the following:

- All Section 355 distributions must be motivated "in whole or substantial part" by one or more non-federal tax corporate business purposes that could not otherwise be feasibly accomplished on a non-taxable basis without separating Controlled as a stand-alone company (the "Business Purpose Requirement"). 11
• After a spin-off, "one or more persons who, directly or indirectly, were the owners of" Distributing before the spin-off must "own in the aggregate, an amount of stock establishing a continuity of interest in each of" Distributing and Controlled (the "355 COI Requirement").

• In addition to requiring continuing stock ownership, "[s]ection 355 contemplates the continued operation of the business or businesses existing prior to the separation" (the "355 COBE Requirement").

C. Divisive 'D' reorganizations.

Section 355 transactions are often structured as part of a "divisive" reorganization under Section 368(a)(1)(D), where, prior to the spin, Distributing transfers assets to an existing or a newly formed Controlled (a "D/355 transaction"). If the subsequent distribution of the Controlled stock qualifies under Section 355, and a separate "control" requirement is met (the "D Reorg Control Requirement"), Section 361(a) provides that no gain or loss will be recognized by Distributing in respect of its transfer of assets in exchange for Controlled stock. The D Reorg Control Requirement is met where one or more of the Distributing shareholders (including persons who were shareholders immediately before the asset transfer) hold at least 80% control of Controlled (within the meaning of Section 368(c)) "immediately after" the distribution. As relevant to D/355 transactions, the fact that the shareholders of Distributing dispose of part or all of the stock of Controlled following the distribution, or the fact that Controlled issues additional stock following the distribution, will not cause the D Reorg Control Requirement to be violated.

D/355 transactions are also subject to a separate set of nonstatutory requirements found in the Treasury regulations under Section 368. These include the following:

• Business purpose. The "business purpose" requirement of Reg. 1.368-1(b) applies to Distributing's contribution of assets to Controlled.

• Continuity of interest. Reg. 1.368-1(e) prescribes a separate COI requirement for acquisitive reorganizations (the "368 COI Requirement"). Although the 368 COI Requirement does not presently apply to either "acquisitive" or "divisive" type-D reorganizations, the interface, if any, between the 355 COI Requirement and the 368 COI Requirement is unsettled.

• Continuity of business. Reg. 1.368-1(d) describes in considerable detail a separate COBE requirement (the "368 COBE Requirement"); but it is unclear whether or how the 368 COBE Requirement informs application of the 355 COBE Requirement or interfaces with other Section 355 requirements (most notably, the ATB Requirement).

D. Corporate-level taxation.

Notwithstanding the qualification of a transaction under Section 355, Distributing may still be required under Section 355(e) to recognize gain on the distribution of the Controlled stock (i.e., on the excess of...
fair market value over basis). Section 355(e) is triggered where stock representing a 50% or greater interest in Distributing or Controlled (or any of their respective successors) is acquired (directly or indirectly) by one or more persons pursuant to a plan (or series of related transactions) that includes the Section 355 distribution (the "Proscribed Plan"). \(^\text{20}\) Stock dispositions during the four-year period beginning two years before and ending two years after the distribution carry a rebuttable presumption of being part of a Proscribed Plan. \(^\text{21}\) Because Section 355(e) comes into play only if the transaction meets all of the Section 355 qualification requirements, any post-spin stock disposition must first pass muster under the Non-Device and the 355 COI Requirements (as well as all other Section 355 qualification requirements).

### II. Framework for analysis

There are many ways in which compliance with the requirements of Section 355 may be affected by post-spin changes in the stock ownership and/or asset composition of Distributing or Controlled. Importantly, the fact that a favorable Section 355 private letter ruling was obtained from the IRS will not necessarily preclude a subsequent audit challenge based on post-spin developments. In that regard, since 2003 all private letter rulings issued under Section 355 have been caveat-ed (i.e., no ruling is given) with respect to the Business Purpose and the Non-Device Requirements and the determination of whether the spin is part of a Proscribed Plan under Section 355(e). \(^\text{22}\) Moreover, under its current ruling policy, the Service generally will not rule at all on Section 355 transactions, except in very limited circumstances. \(^\text{23}\)

As a general matter, the continuing viability of an otherwise qualifying Section 355 transaction can be jeopardized in the following basic scenarios:

- Transactions or steps necessary to effectuate the asserted corporate business purpose for the spin do not occur at all or occur in a different manner than originally contemplated.
- Distributing or Controlled transfers active business assets to another person or entity (whether related or unrelated).
- Shareholders of Distributing or Controlled sell or otherwise dispose of substantial amounts of Distributing or Controlled stock. \(^\text{24}\)

Analyzing the impact of these post-spin developments tends to focus on three critical factual inquiries:

- How soon after the spin did such developments occur?
- Were such developments planned, otherwise contemplated, or legally "wired" to occur at the time of the spin?
- What portion of Distributing or Controlled's assets or stock was disposed of after the spin in taxable and/or non-taxable transactions?
Acquisitions of all the assets or stock of Distributing or Controlled by unrelated parties will generally carry
the greatest risk, especially if the acquisition occurs soon or relatively soon after the spin. More limited
changes in the asset composition (or use) or stock ownership of Distributing or Controlled also can be
problematic, as can changes in business plans or operations that might be viewed as contradicting the
asserted corporate business purpose for the spin. In many instances, the risk of jeopardizing tax-free
treatment under Section 355 may be serious enough to dictate modifying or not proceeding with a
proposed post-spin transaction, or at least postponing it until a later date reasonably distant from the date
of the spin.

III. Deviation from asserted corporate business purpose

Certain post-spin transactions or events may jeopardize Section 355 qualification because the Service
views them as inconsistent with the asserted business purpose for the spin. The regulations, however,
require merely that the transaction be "motivated in whole or substantial part" by one or more corporate
business purposes, not that the asserted corporate business purpose actually come to fruition. Thus,
unless post-spin developments cast doubt upon the factual premises of the asserted motivating purpose
for the transaction, unforeseen deviations from that purpose generally ought not invalidate otherwise
available Section 355 treatment.

A. Unanticipated change in market/economic conditions.

Perhaps the most common scenario in which the Service tends to tolerate unachieved, modified, or
postponed business purposes is where the deviation is caused by unanticipated changes in market or
economic conditions.

Case 1

* Distributing is a publicly traded corporation that conducts Business A directly and
  Business C through Controlled, a wholly owned subsidiary of Distributing. Business C
  needs to raise a substantial amount of capital in the near future to invest in plant and
  equipment and to make acquisitions, and Distributing has been advised by its
  investment banker that the best way to raise this capital is through an initial public
  offering (IPO) of the stock of Controlled after Controlled has been separated from
  Distributing. In reliance on this advice, Distributing distributes the stock of Controlled to
  its shareholders in a transaction to which Section 355 otherwise applies, and Controlled
  prepares to offer its stock to the public as soon as practicable, but with a target date
  approximately six months after the spin. Following the spin and before the IPO can be
  undertaken, market conditions unexpectedly deteriorate to such an extent that, in the
  judgment of Controlled and its advisors, the IPO should be postponed. One year after
  the spin, conditions have not improved sufficiently to permit the IPO to go forward, and
  Controlled instead funds its capital needs through the sale of debentures.*
These were the facts of Rev. Rul. 2003-55, where the Service concluded that the Business Purpose Requirement was met notwithstanding that Controlled did not complete the contemplated stock offering because the deterioration of market conditions following the distribution was not reasonably foreseeable at the time of the spin. The core teaching of this important ruling is that the sufficiency of an asserted Section 355 business purpose is to be determined “at the time of the distribution,” even though that purpose ultimately cannot be achieved as the result of an unexpected change in circumstances following the distribution.

Consistent with this rationale, the Service has issued favorable supplemental Section 355 rulings in a number of situations involving delays, reductions in size or cancellations of planned public offerings due to changes in market conditions, or other business circumstances. It also has ruled that a spin completed to facilitate increased debt financing for use in future acquisitions was not jeopardized by a change in plans to instead use part of the borrowed funds for working capital needs; or, where the principal purpose for a spin was to permit a public offering by Controlled, by subsequent open market repurchases of Controlled stock.

In short, an unanticipated change in market or economic conditions following a spin ought not preclude satisfaction of the Business Purpose Requirement. If the asserted business purpose is plausible and not contradicted by facts or circumstances known or reasonably apparent at the time of the distribution, post-spin developments that are inconsistent with the asserted purpose should not jeopardize the spin’s qualification under Section 355 on business purpose grounds.

B. Continuing post-spin relationships.

Another twist on the “business purpose deviation” theme can arise in connection with continuing post-spin relationships between Distributing and Controlled (or their respective subsidiaries). Such relationships are not uncommon (especially in public company spins) and may include (i) common directors or officers; (ii) shared administrative personnel, office space, or manufacturing or supply facilities; (iii) extension of credit; or (iv) other joint business or financial arrangements. Particularly where the asserted business purpose for the spin is “fit and focus,” the mere existence of continuing relationships might be viewed as contradicting such purpose; for the essence of “fit and focus” is that Distributing and Controlled can no longer comfortably co-exist under the same corporate umbrella and need to be completely divorced from one another. Nonetheless, where continuing relationships are intended to be effective after the spin for only a specified transitional period (as is often represented in Section 355 ruling requests), they normally will not prevent qualification under Section 355. That was the case, for example, in Rev. Rul. 2003-75, which accorded Section 355 treatment to a “fit and focus” spin involving the following described continuing relationships:

To facilitate the separation, Distributing and Controlled will enter into transitional agreements that relate to information technology, benefits administration, and accounting and tax matters. Other than the tax matters agreement, each agreement will terminate after two years absent extraordinary circumstances, in which case the
affected agreement may be extended on arm’s-length terms for a limited period. Following the separation, there will be no cross-guarantee or cross-collateralization of debt between Distributing and Controlled, and an arm’s-length loan from Distributing to Controlled for working capital will have a term of two years.

Such transitional relationships were found to be acceptable because they were “designed to facilitate, rather than impede, the separation of” the Distributing and Controlled businesses. While longer than two-year continuing relationships may also be acceptable in appropriate circumstances, they normally will be accorded closer scrutiny by the Service.

Where there is a significant lengthening of an asserted transitional period, or some other change in the nature of a particular type of continuing relationship, it may be necessary to persuade the Service that the revised relationship is compatible with the asserted business purpose, or that identifiable unanticipated circumstances have rendered that business purpose less compelling. That likely will be easier to do in cases not involving a “fit and focus” purpose, especially where the continuing relationship becomes permanent or of indefinite duration.

IV. Post-spin events involving Distributing or Controlled assets

Following a Section 355 distribution, Distributing or Controlled may sell or otherwise dispose or discontinue use of assets held at the time of the spin. Post-spin asset transfers may be made to unrelated or related parties via taxable or non-taxable transactions. In some instances, assets may be retained but become inactive (either on a temporary or permanent basis) or used in a different business. If the affected assets were relied upon for purposes of satisfying the ATB and/or 355 COBE Requirements, the post-spin developments could jeopardize Section 355 qualification. In some instances, moreover, asset transfers in connection with certain types of tax-free reorganizations can be treated as stock acquisitions and trigger corporate-level taxation under Section 355(e).

A. ATB and 355 COBE Requirements.

The ATB Requirement encompasses several elements set forth in Section 355(b). Both Distributing and Controlled must be engaged in a qualifying ATB “immediately after” the distribution of the Controlled stock—more specifically, in a business that (i) was actively conducted throughout the five-year pre-distribution period; (ii) was not acquired during such period in a transaction in which gain or loss was recognized in whole or in part; or (iii) was conducted by another corporation “control” of which (per Section 368(c)) was not acquired during such period other than via transactions in which no gain or loss was recognized in whole or in part (e.g., a Section 368 reorganization with no boot).

Under Section 355(b)(3), added to the Code in 2005, a qualifying ATB can be conducted directly by Distributing or Controlled or indirectly through a subsidiary that is a member of the Distributing or Controlled “separate affiliated group” (SAG). Under this regime, all SAG members (including the “top”
corporation, i.e., Distributing or Controlled) are treated as a single corporation for purposes of the ATB Requirement. 37

Notwithstanding a taxable acquisition of an active business during the five-year pre-distribution period, the ATB Requirement can nonetheless be met under the so-called "business expansion" doctrine, where the purchased business is in the same line of business as an existing qualified ATB of Distributing or Controlled—as opposed to being a new or different business. 38 The business expansion exception also may apply in contexts where Distributing or Controlled purchases the stock of a corporation engaged in the same line of business during the five-year pre-distribution period. 39 In such cases, the transaction may qualify as a mere expansion of an existing business and thereby satisfy the ATB Requirement notwithstanding the taxable stock acquisition transaction. 40

With respect to the 355 COBE Requirement, Reg. 1.355-2(b) requires the "continued operation" of the pre-spin businesses, seemingly suggesting an unspecified temporal requirement beyond whatever period needs to elapse to satisfy the statutory "immediately after" element of the ATB Requirement. Furthermore, in a D/355 transaction, the separate 368 COBE Requirement—along with the "historic business"/"historic business assets" criteria articulated in Reg. 1.368-1(d)—may come into play. Although practitioners often assume that satisfaction of the ATB Requirement will necessarily assure satisfaction of the 355 COBE Requirement, it is by no means clear that these requirements always operate in tandem.

B. Sale of ATB assets.

A sale of all or substantially all of the assets of a business relied upon by Distributing or Controlled to satisfy the ATB Requirement will almost certainly attract the Service’s attention, particularly if done relatively soon after the spin and the corporation does not continue a different business that also could have been relied upon to satisfy the ATB Requirement.

Case 2

Distributing, a public company, conducted three unrelated active businesses. Bus. 1 and Bus. 2 were directly operated through divisions and represented, respectively, 35% and 60% of Distributing’s total value; both had been operated by Distributing for more than five years. Bus. 3 was operated through a wholly owned subsidiary (“S1”), the stock of which was purchased by Distributing for cash on 6/30/09. Although Bus. 3 was worth only 5% of Distributing’s total value, it was viewed by Distributing’s management as having significant growth potential. On 9/30/12, Distributing transferred the Bus. 2 net assets to another wholly owned subsidiary (“S2”) and distributed the S2 stock pro rata to the Distributing shareholders in a qualifying Section 355 transaction. In November 2012, the CEO of Pubco, also a public company, approached Distributing’s CEO about a potential acquisition of Bus. 1. Pubco and Distributing had previously discussed a possible acquisition of Bus. 1 in 2007, and again in 2009, but Distributing had called off the discussions on both occasions. On 12/15/12, Distributing agreed to
sell the Bus. 1 assets to Pubco for cash, which it plans to earmark primarily for Bus. 3 capital expansion projects. The transaction closed on 1/31/13.

This fact pattern raises potential issues under both the ATB and 355 COBE Requirements. Distributing has to be engaged in a qualifying ATB "immediately after" the spin. Is it enough that a sale of Bus. 1 was not contemplated at the time of the spin? Or, even if not contemplated, is the agreement to dispose of Bus. 1 just 75 days after the spin nonetheless problematic—especially since Pubco was a prior suitor and Distributing management may have at least suspected that it would again express interest? If Distributing cannot continue to rely on Bus. 1 as its qualifying ATB, the original Section 355 qualification of the spin will be reversed unless it can instead rely on Bus. 3. In this case, Bus. 3 may not have been a qualifying ATB at the time of the spin, because the stock of S1 was stock acquired in a taxable transaction during the five-year pre-distribution period. 41

In analyzing Case 2-type situations for possible ATB violations, the most important factual inquiries are (i) how soon after the spin did the sale occur and (ii) were the circumstances or events motivating the sale known or reasonably foreseeable at the time of the spin? In general, absent a plainly "wired" transaction, the longer the "gap" period, the harder it will be for the Service to successfully assert a breach of the "immediately after" ATB Requirement via the application of conventional step-transaction principles. 42 Several private letter rulings provide some indication of the Service's tolerance in this regard. Consistent with the rationale of Rev. Rul. 2003-55 in "deviation from business purpose" scenarios, these rulings appear to focus primarily on whether the post-spin disposition was caused by circumstances or events that were unforeseen at the time of the spin. 43 While the Case 2 circumstances would likely raise an agent's eyebrow upon audit (especially the short timeframe separating the spin and the sale), they ought not be fatal if the taxpayer can convincingly demonstrate that, at the time of the spin, a sale of Bus. 1 was not under consideration or recognized as a possible transaction that Distributing or Controlled would be willing to entertain.

With respect to the 355 COBE Requirement, the threshold question is whether it is automatically satisfied so long as the ATB Requirement is satisfied. While that probably will be the case in most instances, 44 the Section 355 regulations do appear to identify "the continued operation of" the pre-spin businesses by Distributing and Controlled as a separate requirement that may contemplate a longer period of post-spin operation than whatever period may be contemplated by the "immediately after" element of the ATB Requirement. For example, on the Case 2 facts, Distributing's continued operation of Bus. 1 for 4 months before the sale to Pubco may well be enough to foreclose an "immediately after" challenge, but seems less clearly indicative of the post-spin business continuity required by the Section 355 regulations. 45

Whatever parameters may exist with respect to any temporal aspect of the Section 355 "business continuity" requirement, additional uncertainty may exist with respect to the extent to which pre-spin business activities must continue to be conducted, qualitatively or quantitatively, after the spin. The Section 355 regulations are silent in that regard. The COBE regulations under Section 368, however, require continuation of a "significant historic business" or the continued use of a "significant portion of the
historic business assets” of the acquired corporation; and an example in those regulations indicates that the continuation of only one of three equally valued pre-acquisition businesses will suffice. 46

The 368 COBE Requirement clearly applies to acquisitive type-“D” reorganizations. 47 If the principles of the 368 COBE Requirement were to be imported into the 355 COBE Requirement, and assuming that Bus. 3 satisfied the ATB Requirement, Distributing's continuation of only Bus. 3 (representing less than 10% of Distributing's aggregate pre-spin value) could be problematic from a COBE perspective. 48 While it is reasonable to conclude that the principles of the 368 COBE Requirement should not be imported into the 355 COBE Requirement, 49 this area remains quite murky and ripe for clarifying administrative guidance.

C. Cessation/scale-down of ATB operations

Post-spin ATB or COBE issues may also arise if an ATB relied upon by Distributing or Controlled temporarily or permanently ceases or scales down operations.

Case 3

Unrelated individuals A and B each own 50% of the outstanding stock of Realco, Inc., which they formed in 1990. Realco owns and operates a large rental apartment building (the "Apartment Building") and a mid-rise office building with ground floor retail tenants (the "Office Building"). both through single-member limited liability companies that are treated as disregarded entities for federal income tax purposes. The Apartment Building was developed by Realco in 1990. The Office Building was purchased from a prior owner in 1995. A and B are the principal officers of Realco and actively manage the leasing and other activities of the Apartment Building and the Office Building. Realco employees perform all day-to-day maintenance and repair services for both properties. On 9/15/12, A and B part ways via a split-off transaction pursuant to which (i) the Office Building is contributed to a new, wholly owned subsidiary of Realco ("Newco"); and (ii) all of the Newco stock is distributed to B in redemption of all of B's Realco shares. Realco also contributes borrowed cash to Newco to equalize the post-split values of Realco and Newco. Because the Office Building had never been renovated, B plans to let the existing leases run out (within six months after the spin) and temporarily close down the Office Building for extensive refurbishing (to be financed with the borrowed cash). Shortly after beginning the refurbishment process (which is expected to take six months), a serious mold problem is discovered, causing B to decide to demolish the Office Building and consider other possibilities for developing the vacant property. In the meantime, Newco blacktops the property, begins to operate it as a public parking lot, and invests the remaining cash received from Realco in bank CDs and Treasury bonds. Three months later, before any alternative development plans have been formulated, B receives and accepts an unsolicited offer from an unrelated third party to
Even though contemplated at the time of the split-off, the temporary closure of the Office Building should not have caused Newco to violate the ATB Requirement. The ownership and operation of rental real estate constitutes a qualifying ATB provided "the owner performs significant services with respect to the operation and management of the property." Because Newco, through its officers and employees, did in fact actively operate the Office Building for several months prior to beginning the refurbishment process, the ATB "immediately after" requirement would seem safely met under a literal reading of the statute. Had the refurbishment gone forward and the Office Building re-opened as originally planned, the anticipated one-year hiatus presumably would not have been problematic. Particularly since the need to demolish the building was unforeseen at the time of the spin, it seems inappropriate to reach a harsher result with respect to the facts as they ultimately developed.

Moreover, even if the limited post-split continuation of the Office Building rental operations properly could be considered insufficient for purposes of the ATB or 355 COBE Requirements, the intended use of the vacant Office Building property as a pay parking lot might be viewed as a form of real estate leasing activity and, as such, a "continuation" of Realco's pre-split real estate leasing business. While the analysis is further complicated by the absence of alternative development plans and Newco's sale of the property only three months later, that too was unforeseen at the time of the split-off; and the fact that Newco quickly resumed leasing activities through its acquisition of the shopping centers would seem to weigh favorably against any challenge by the Service on either ATB or COBE grounds.

In short, Section 355 qualification of the Newco split-off ought not be jeopardized by any of these unexpected post-spin events. At the time of the split-off, Newco fully intended to continue its Office Building rental operations and did in fact do so for several months pending a planned temporary shut-down for refurbishment that, for unforeseen reasons, failed to materialize.

D. Shifting of ATB assets into investment assets.

The holding of stock, securities, land, or other property for investment purposes generally does not constitute the active conduct of a trade or business. Accordingly, Section 355 qualification may be jeopardized where assets that had been relied upon to satisfy the ATB Requirement are sold following the spin and the sale proceeds are invested in passive assets.

Case 4

The facts are the same as in Case 3, except that (i) the property that had been occupied by the demolished Office Building is left vacant and listed for sale by Newco (i.e., Newco does not construct a parking lot on the property); (ii) Newco sells the vacant lot to an unrelated third party; and (iii) Newco invests the sale proceeds in a
portfolio of stocks and bonds (i.e., it does not use the cash to purchase other rental real estate properties).

The Service might view this fact pattern more harshly than Case 3, because Newco took the initiative in seeking to sell the Office Building property (as opposed to acting in response to an unsolicited purchase offer) and deliberately chose to stop conducting any active business after the mold problem surfaced seems troublesome in that the "business continuity" reference in the Section 355 regulations appears to contemplate that both Distributing and Controlled continue their pre-distribution active businesses for some period of time. However, as noted above, the supplemental letter rulings in this area appear to turn mainly or exclusively on whether the post-spin dispositions of an active business were spurred by unanticipated developments that rendered retention of such business impractical or unreasonable. 54 Assuming that discovery of the mold problem in Cases 3 and 4 was in fact such a circumstance, how Newco decided to dispose of or replace the Office Building would seem irrelevant for purposes of the ATB and 355 COBE Requirements.

There may, however, be another potential Section 355 qualification issue raised by the Case 4 facts—namely, whether Newco's investment of the sale proceeds from the Office Building property in a securities portfolio would cause it to be considered a "disqualified investment corporation" (DIC) under Section 355(g). Added to the Code in 2006 to curb so-called "cash-rich split-off" transactions, that provision precludes Section 355 qualification if (i) "immediately after the transaction," at least two-thirds of the total value of the Distributing or Controlled assets are tainted "investment assets"; and (ii) no person who held a less than 50% stock interest in such DIC "immediately before the transaction" holds a 50% or greater stock interest "immediately after the transaction." 55 For purposes of applying these percentage tests, Section 355(g)(4) instructs that the term "transaction" includes "a series of transactions." Thus, while B held a 50% interest in Newco immediately before the split-off distribution, that distribution was part of a D/355 transaction that included the formation of Newco; so immediately before the formation, B held no stock (directly or indirectly) in Newco and thus went from less than 50% (i.e., zero) to 100% ownership of Newco. If that is how the Service would construe the "50% before/after" requirement of Section 355(g), that provision conceivably could be triggered if the sale of the Office Building property and the acquisition of the securities portfolio were considered part of the same "transaction" (or "series of transactions") that included the split-off distribution. The unforeseen nature of these post-spin events probably should prevent that unhappy result (as it should with respect to the ATB and 355 COBE Requirements). Treasury has broad "anti-avoidance" regulatory authority under Section 355(g)(5) (as yet unexercised), and at least some guidance on Case 4-type situations would be helpful.

E. Post-spin reliance on business expansion doctrine

If Distributing or Controlled has an existing active business and acquires another business, the acquisition may be treated as an expansion of the original business (whether or not gain or loss is recognized in the transaction), if the change is not sufficient to constitute the acquisition of a new or different business. 56 Thus, if the original business has been actively conducted for at least five years, the acquired business

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may be treated as having been actively and continuously conducted for the same period of years for purposes of applying the ATB Requirement.

1. Similar products/mode of operations.

A business that acquires another business that produces similar products or operates in a similar manner should constitute a mere expansion.

Case 5

Carco, Inc. ("Carco"), a domestic corporation, owned and operated two automobile dealerships-Dealership 1, which featured Brand 1 automobiles, and Dealership 2, which featured Brand 2 automobiles. Dealership 1 was started by Carco in 2000. The assets of Dealership 2 were purchased by Carco from an unrelated third party for cash on 6/30/09. On 3/31/11, Carco transferred Dealership 1 to Newco, a newly formed subsidiary of Carco. On 6/30/12, Carco distributes the Newco stock pro rata to the Carco shareholders in a transaction intended to qualify for tax-free treatment under Section 355. On 9/15/12, Carco sold Dealership 2 to an unrelated third party and acquired a car rental agency franchise with the sale proceeds.

The business activities associated with the operation of Dealership 1 (i.e., sales and service) are the same as the business activities associated with the operation of Dealership 2, Brand 1 and Brand 2 are similar products (i.e., automobiles), and the operation of Dealership 2 involves the use of the experience and know-how that Carco developed in the operation of Dealership 1. Accordingly, as confirmed by a 2003 published ruling, Carco’s acquisition of Dealership 2 constituted merely an expansion of Carco’s existing business (i.e., the ownership and operation of a car dealership); and Carco and Newco should each therefore be treated as satisfying the ATB Requirement immediately after the spin.

The fairly quick post-spin sale of Dealership 2 and its replacement with a car rental agency muddies the water. Is the ATB "immediately after" requirement met? Can Carco still rely on the "business expansion" exception with respect to the 2009 purchase of Dealership 2 (which otherwise would have caused an ATB problem under Section 355(b)(2)(C))? Has there been a sufficient "continuation" of the Dealership 2 business for purposes of the 355 COBE Requirement? Is it fatal that car rental was not an historic business of Carco or Newco, or is it enough that both businesses involved making cars available to the public? The answers to these questions are not that clear-cut. But assuming that the sale of Dealership 2 was motivated by circumstances not foreseen at the time of the spin, and based on the analysis offered with respect to Cases 3 and 4, the post-spin developments in Case 5 ought not jeopardize compliance with the ATB Requirement or, though perhaps less clearly, the 355 COBE Requirement.
2. Interface with SAG rules.

Under the SAG rules of Section 355(b)(3), a taxable acquisition of the stock of a corporation may be tested for ATB purposes as an asset acquisition (under Section 355(b)(2)(C)) rather than as a stock acquisition (under Section 355(b)(2)(D)); and, if the facts otherwise warrant application of the business expansion doctrine, both Sections 355(b)(2)(C) and (b)(2)(D) are disabled, and the taxable acquisition within the five-year pre-distribution period will not prevent compliance with the ATB Requirement. 58

Case 6

The facts are the same as in Case 5, except that on 6/30/09, Carco purchased the stock of a corporation that had operated Dealership 2 ("Dealerco") from an unrelated party. On 6/30/12, Carco organized Newco and contributed Dealership 1 to Newco. Thereafter, Carco distributed the stock of Newco pro rata to the Carco shareholders in a transaction intended to qualify for tax-free treatment under Section 355. On 9/15/12, Dealerco sold Dealership 2 and acquired a car rental agency franchise with the proceeds of that sale.

Under the SAG rules, the stock acquisition resulted in Dealerco becoming a member of the Carco SAG group. 59 Because Dealerco and Carco were in the same business, the business expansion doctrine should apply to treat Carco and Dealerco as satisfying the ATB Requirement (and, correspondingly, the 355 COBE Requirement) immediately after the spin. Again, assuming that the post-spin events were unforeseen at the time of the spin, the same analysis advanced with respect to Cases 3, 4, and 5 should likewise protect Section 355 qualification on the Case 6 facts (including preservation of the business expansion exception for the Dealerco acquisition).

3. Discontinuance/conversion of historic business.

Rev. Rul. 2003-18 confirms that the "business expansion" doctrine can appropriately apply where the acquired and existing businesses (i) have the same subject matter or product; (ii) conduct essentially the same operational activities; and (iii) draw on the same fundamental know-how and experience. These "sameness" factors were clearly present in Cases 5 and 6. The following fact pattern presents some additional twists, relating to the nature of the expansion business and the post-spin developments.

Case 7

Stepco, Inc. has owned and operated a men’s shoe store since 1990. In 2009 Stepco began to sell shoes on-line as well. The website is named "Stepco.com" to take advantage of the name recognition, customer loyalty, and other elements of goodwill associated with the Stepco name. On 6/30/11, Stepco transferred its on-line business assets to Clickco, a newly formed subsidiary. A year later, Stepco distributed the Clickco stock pro rata to the Stepco shareholders in a transaction intended to qualify for...
tax-free treatment under Section 355. In December 2012 Stepco sold its existing shoe store inventory and, over the next three months, converted the store premises into an outdoor recreational apparel and equipment store. Approximately 10% of the inventory in the new store is represented by hiking boots, running shoes, and other types of outdoor footwear (some lines of which also had been carried by Stepco in the shoe store). Plans regarding the shoe store conversion were under consideration at the time of the Clickco spin.

The products sold by Stepco's retail shoe store business and the products sold on Stepco.com are the same (i.e., shoes); and the core business activities of Stepco's retail outlet are the same as those of Stepco.com (i.e., purchasing shoes at wholesale and reselling them to the public at retail). Although selling shoes on a website does require know-how not normally associated with operating a retail shoe store (e.g., familiarity with different marketing approaches, distribution chains, and advanced computer technologies), the website's operation nevertheless draws on Stepco's existing experience and know-how to a significant extent, and the success of the on-line business depends in large measure on the goodwill associated with the Stepco name. Accordingly, as confirmed by another 2003 published ruling, Stepco's creation of the website in June 2008 likely constituted an expansion of Stepco's retail shoe store business, so that each of Stepco and Clickco should be treated as satisfying the ATB Requirement (and, correspondingly, the 355 COBE Requirement) immediately after the spin.

The post-spin conversion of the shoe store premises into the outdoors store could raise ATB or COBE problems for both Stepco and Clickco. Is it enough that 10% of the inventory in the new store continues to be represented by footwear (some lines of which had been carried in the shoe store)? Can it be plausibly argued that the products carried in the new store are merely an expansion of those offered at the old store in that both, broadly speaking, are types of clothing? Is Clickco's reliance on the business expansion doctrine for Stepco.com jeopardized by the effective disappearance of the shoe store business?

The answers to these questions presumably are significantly influenced by the fact that the shoe store conversion was already under consideration at the time of the spin. In particular, the application of conventional step-transaction principles for purposes of the ATB and 355 COBE Requirements could result in a violation of the ATB "immediately after" requirement, as well as any temporal requirement that may be contemplated by the 355 COBE Requirement. Further questions could arise as to which iteration of the step-transaction doctrine should apply. For example, would it matter that the shoe store conversion was merely a contemplated possibility at the time of the spin (as opposed to a "done deal")? Even though the conversion was already in the planning stage, is the ATB Requirement still met by Stepco since its shoe store operations in fact continued to operate for a full year after the spin? Again, the answers are not totally clear, so proceeding to complete the shoe store conversion in such circumstances could prove problematic.

F. Post-spin reorganization transactions.
Not uncommonly, a spin-off may be followed by a Section 368 tax-free reorganization involving Distributing or Controlled. In such situations, the sole or primary business purpose for the spin often is to shed an unwanted business and thereby facilitate the planned acquisition of the "wanted" business. That was what happened in *Morris Trust*, a 1966 decision in which Distributing, a state bank, incorporated and distributed an unwanted insurance department to enable Distributing to merge directly into a national bank, with the Distributing shareholders receiving 54% of the acquiring bank's stock in the merger. Upholding tax-free treatment for both the spin-off (under Section 355) and the reorganization (under Section 368(a)(1)(A)), the Fourth Circuit held that facilitating the subsequent merger constituted a valid Section 355 business purpose for the spin-off, and that the ATB and other Section 355 qualification requirements also were satisfied notwithstanding that Distributing had ceased to exist as a stand-alone corporation and the Distributing shareholders had disposed of all their Distributing stock in the merger.

The Service acquiesced in *Morris Trust* and the decision remains good law today. The double "tax-free" benefit of such transactions, however, was greatly restricted by the 1997 enactment of Section 355(e). If applicable, that provision triggers a corporate-level taxable gain to Distributing in respect of the distributed Controlled stock. Section 355(e) can apply only if (i) the transaction otherwise qualifies under Section 355; and (ii) a Proscribed Plan can be found linking the spin-off to the acquisition(s) of a 50% or greater interest in the stock of Distributing or Controlled during a four-year statutory period beginning two years before and ending two years after the Section 355 distribution. Tainted stock ownership changes can occur via either taxable stock acquisitions or tax-free reorganization transactions (including certain asset reorganization transfers, which are treated as stock acquisitions for Section 355(e) purposes).

1. Asset reorganizations involving Distributing.

To avoid the normally fatal bite of Section 355(e), *Morris Trust* transactions must now be structured so that the Distributing shareholders receive 50% or more of the acquiring corporation's stock or a Proscribed Plan cannot be found in light of (i) the particular asserted business purposes(s) for the spin, (ii) the timing of the spin and the post-spin reorganization and/or (iii) other factors and safe harbors articulated in Reg. 1.355-7 (the so-called "plan" regulations).

**Case 8**

*Foodco*, a publicly traded corporation, directly owns and operates a chain of supermarkets in several East Coast states and, through a wholly owned subsidiary formed in 2008 (*Healthco*), a separate chain of organic and specialty food stores in Massachusetts and Vermont. Substantial outside financing is needed for the construction of new Healthco stores and the renovation of several existing Foodco stores. Foodco's principal bank lender indicated a willingness to make substantial commitments to both companies if Healthco were spun off as a stand-alone public company. A pro rata distribution of the stock of Healthco, approved by the Foodco board and shareholders, occurred on 3/31/12 (the "Healthco Spin"). In December 2010, Foodco had commenced discussions with Natco, another publicly traded grocery
company, regarding a possible tax-free merger transaction. The Natco discussions terminated in February 2011 and were never resumed. On 7/31/12, i.e., four months after the Healthco Spin, Safeco, another publicly traded grocery company, announced a proposed acquisition of Foodco pursuant to a statutory merger of Foodco with and into Safeco (the "Foodco Merger"), with the Foodco shareholders receiving solely Safeco voting stock representing 60% of the total outstanding Safeco shares. Although Foodco was not then "on the market," Safeco's offer was considered too good to pass up and the Foodco Merger was consummated on 11/30/12. Neither Foodco nor Healthco had yet obtained any outside financing after the Healthco Spin and prior to the Foodco Merger.

As would have been true had *Morris Trust* been decided today, the Case 8 transactions avoid the reach of Section 355(e) in the first instance because the Foodco shareholders retained a greater than 50% indirect interest in the Foodco business assets and operations through their collective 60% ownership of Safeco stock received in the merger. Moreover, consistent with the *Morris Trust* rationale, the Foodco Merger should not preclude Section 355 qualification of the Healthco Spin on ATB or COBE grounds. If anything, the Case 8 facts present an even stronger case in that regard; for unlike *Morris Trust*, where the spin and merger were pre-ordained to occur in tandem, an acquisition of Foodco by Safeco or any other company was not planned or intended by Foodco at the time of the Healthco Spin, and Foodco in fact continued to operate its pre-spin ATB for eight months prior to the Foodco Merger. That presumably was sufficient to satisfy the "immediately after" element of the ATB Requirement, especially given the literal interpretation accorded that term by the court in *Morris Trust* and the fact that, at the time of the Healthco Spin, Foodco intended to continue its supermarket business indefinitely.

**Case 9**

*The facts are the same as in Case 8, except that the Foodco shareholders instead receive 40% of the Safeco shares as merger consideration.*

In contrast to *Morris Trust* and Case 8, the Foodco shareholders in Case 9 do not retain a greater than 50% indirect interest in Foodco's supermarket business following the Foodco Merger. Is the quantum of acquiring corporation stock received by the Foodco shareholders relevant at all to whether the merger might jeopardize compliance with the ATB Requirement? Nothing in the *Morris Trust* opinion or any other case or pronouncement from the Service since suggests that it is. Indeed, the 1996 revenue procedure describing acceptable Section 355 business purposes would appear to suggest otherwise; for it specifically blesses the *Morris Trust* transactional format without any reference to the percentage of the acquiring corporation's stock received in the reorganization by the Distributing shareholders. Thus, a good business purpose for the spin will be found to exist even if the reorganization is a "whale swallows a minnow" transaction, i.e., where the acquiring corporation is much larger than Distributing. If that scenario could nonetheless trigger an ATB problem, the revenue procedure presumably would have contained an explicit warning to that effect.
Assuming no adverse impact on Section 355 qualification, Safeco’s acquisition of Foodco in Case 9 would, however, bring Section 355(e) into play because 60% of the Foodco stock would be treated as acquired by the Safeco shareholders. It thus becomes necessary to determine whether a Proscribed Plan exists. This in turn requires consulting the provisions of Reg. 1.355-7 to determine whether any of several Section 355(e) “plan” safe harbors applies or, if not, whether a Proscribed Plan exists based on an overall facts and circumstances determination made with reference to various “plan” and “non-plan” factors described in the regulations.

In all cases involving a post-spin acquisition of or by Distributing or Controlled, the threshold inquiry under the Section 355(e) plan regulations is whether-

there was an agreement, understanding, arrangement, or substantial negotiations [an "AUASN"] regarding the acquisition or a similar acquisition at some time during the two-year period ending on the date of the distribution.

Absent an AUASN during the two-year pre-distribution period, the Section 355 distribution and the acquisition cannot be part of a Proscribed Plan and, therefore, Section 355(e) cannot be triggered no matter how soon after the distribution the tainted stock acquisition(s) occurred. This absolute dispensation, sometimes referred to as the “Super Safe Harbor,” would apply to eliminate any Section 355(e) risk on the Case 9 facts; for even if Foodco’s terminated discussions with Natco had risen to the level of an AUASN, the plan regulations indicate that the discussions should not be considered as having occurred with respect to a “similar acquisition.” Moreover, even if the Super Safe Harbor did not apply, the presence of certain important “non-plan” factors would most probably lead to the same favorable result.

Case 10

The facts are the same as in Case 8, except that Foodco merges into a newly formed Safeco subsidiary, with the Foodco shareholders still receiving solely Safeco stock in the merger.

This structuring of the post-spin reorganization would be designed to qualify as a forward triangular merger under Section 368(a)(2)(D) and, as such, would require that Foodco transfer “substantially all” of its assets to the Safeco subsidiary. Under the rationale of another Fourth Circuit decision, Elkhorn Coal Co., if the prior Healthco Spin were considered part of the Foodco-Safeco “plan of reorganization,” the value of the distributed Healthco stock (i.e., a significant Foodco asset) would have to be counted as part of Foodco’s total assets for purposes of the “substantially all” determination and, most probably, would cause that requirement to be flunked.

While Elkhorn Coal may not be a problem on the Case 9 facts (because the acquisition was not contemplated at the time of the spin), cautious tax planers typically shy away from using "substantially all" type reorganizations in Morris Trust contexts whether or not the sole or a substantial purpose for...
undertaking the spin is to set the stage for the acquisition. As a practical matter, and absent compelling non-tax impediments, the safest course is to structure any reorganization involving Distributing that occurs within two years of a spin as either a two-party statutory merger or a type-“B” stock-for-stock exchange.

2. Asset reorganizations involving Controlled.

In what are sometimes referred to as "reverse Morris Trust" transactions, it is Controlled rather than Distributing that is acquired in a post-spin reorganization. These transactions usually arise in contexts where at least a substantial purpose for the spin is to facilitate the subsequent reorganization.

Case 11

The facts are the same as in Case 8, except that (i) Foodco had no discussions with Natco; (ii) Foodco spins off Healthco to facilitate Healthco’s immediate acquisition by a Safeco subsidiary via a forward triangular merger; and (iii) pursuant to the merger, the Healthco shareholders receive 52% of the Safeco stock in cancellation of their Healthco shares. At the time of the Healthco Spin, the Healthco acquisition had been approved by the shareholders of both Healthco and Safeco.

This format avoids a Section 355(e) trigger even though the post-spin acquisition is legally "wired" to occur, because the former Healthco shareholders retain a greater than 50% indirect ownership in the Healthco assets and operations through their stock ownership interest in Safeco. Nor should the acquisition jeopardize tax-free treatment of the spin-off at the shareholder level. In a 2003 published revenue ruling involving a spin followed by an acquisition of Controlled via a purported "C" reorganization, the Service concluded that step-transaction principles should not apply to treat the Controlled assets transferred in the merger as only part of the combined pre-spin assets of Distributing and Controlled; consequently, Controlled was treated as transferring all of its assets and the "substantially all" requirement of Section 368(a)(1)(C) was considered satisfied. Moreover, as in the Morris Trust case itself, the post-spin merger of Healthco into the acquiring corporation, even though pre-arranged, should not jeopardize compliance with either the ATB or 355 COBE Requirements. Rather, it should suffice that the Healthco business continues to be conducted by the Safeco subsidiary and that the Healthco shareholders will become Safeco shareholders.

3. 'Born To Die' transactions.

Because Rev. Rul. 2003-79 involved a newly organized Controlled that ceased to exist soon after the spin, that revenue ruling has been referred to as blessing a "born to die" transaction. Notably, the Service has issued a number of favorable Section 355 letter rulings in D/355 transactions followed by (i) an upstream reorganization of a newly organized Controlled with its corporate shareholder and (ii) a sideways merger of a newly organized Controlled into a sister corporation owned by its corporate
Analogously, the same result has been reached in situations involving Section 332 liquidations, downstream mergers, and sideways mergers of an "old and cold" Controlled into parent, subsidiary, and sister corporations. As in Rev. Rul. 2003-79 and Morris Trust contexts generally, the disappearance of Controlled in these transactions, and the shifting of its business assets and operations to another related or affiliated corporation, does not jeopardize compliance with the ATB or 355 COBE Requirements—and that presumably will be so whether or not the post-spin non-recognition transaction is part of an overall D/355 transaction.

G. Post-spin asset drop-downs.

Following an otherwise qualified Section 355 distribution, Distributing or Controlled may for valid business reasons wish to transfer all or a substantial part of the assets of the ATB relied upon for Section 355 qualification to a corporate subsidiary, partnership, or an LLC. If the drop-down is viewed as a separate transaction from the spin (e.g., if not planned or intended at the time of the spin), it normally will qualify for non-recognition treatment under Section 351 (corporate transferee) or Section 721 (partnership/multi-member LLC transferee) and no jeopardy to Section 355 qualification should result. Where the transfer is pre-planned, or occurs soon after the spin so as to give that appearance, closer attention needs to be given to the timing and other circumstances surrounding the dropdown; but in most instances, the dropdown ought not be problematic.

Case 12

The facts are the same as in Case 8, except that (i) there is no post-spin transaction between Foodco (Distributing) and Safeco; and (ii) on the day before the Healthco Spin, Foodco contributed cash and certain intellectual property assets to Healthco. Soon after the spin, Healthco (Controlled) forms two wholly owned subsidiaries (S1 and S2) and transfers the net assets associated with its Massachusetts stores to S1 and its Vermont stores to S2.

Foodco’s pre-spin transfer of cash and intellectual property to Healthco would most probably be considered part of a D/355 transaction (particularly if explicitly referenced in a written “plan of reorganization”). A determination must therefore be made as to whether the post-spin dropdown of the Healthco net assets into S1 and S2 jeopardizes not only Section 355 qualification for the spin, but also qualification as a "D" reorganization. The spin can be a good Section 355 distribution whether or not the dropdown or some other circumstance precludes "D" reorganization treatment; but if the dropdown causes the spin to flunk Section 355, qualification under Section 368(a)(1)(D) will also be foreclosed.

At least in the context of an "acquisitive" type-"D" reorganization, a 2002 published ruling concludes that the transferee or acquiring corporation (P) can safely drop down some or all of the assets received from the transferor or acquired corporation (T) to a wholly owned subsidiary (S), where "S will continue T's historic business after the transfer and P will retain the S stock." In those circumstances, the Service found that the Section 368 COBE Requirement (as articulated in Reg. 1.368-1(d)) was satisfied because...
S was directly controlled by P (per the 80% stock ownership tests of Section 368(c)) and, therefore, was a member of P's "qualified group."

The post-spin dropdowns to S1 and S2 will shift Healthco's active business assets and operations into two other wholly owned corporations, each of which will conduct a geographic segment of the same overall business. That ought not be problematic for purposes of either the ATB or 355 COBE Requirements, particularly since S1 and S2 are members of the Healthco SAG (any member of which can, under Section 355(b)(3), house the ATB relied upon for Section 355 qualification). This result is perhaps less clear if Controlled drops assets into a subsidiary that is controlled under Section 368(c) but is not a SAG member because it is not controlled under Section 1504(a)(2). That could occur, for example, where (i) the transferee subsidiary has Class A voting common and Class B non-voting common shares; (ii) Controlled owns 80% of the Class A stock and 80% of the Class B stock; but (iii) another shareholder owns Class A and B shares representing more than 20% of the subsidiary's total value. It would seem odd to conclude that the ATB Requirement is violated in such circumstances, especially since the same dropdown would satisfy the "qualified group" rule for purposes of the 368 COBE Requirement. Nevertheless, administrative guidance on this point would be helpful.

Suppose that Controlled instead drops its ATB into a joint venture corporation (Newco) in exchange for a 60% stock interest, with an unrelated investor (X) contributing cash for the remaining 40% of the stock. In that scenario, Newco is not a member of the Controlled SAG, but Controlled and X collectively hold Section 368 control of the Newco stock (so that Controlled can qualify for Section 351 non-recognition treatment on the dropdown). Despite Healthco's lack of control over Newco, this dropdown may also be harmless from the standpoint of the ATB and 355 COBE Requirements, by analogy to (i) Morris Trust transactions in which the post-spin reorganization is of the "whale swallows minnow" variety or (ii) dropdowns into partnerships in which, as discussed below, corporate partners with as low as a 20% interest may be able to rely upon the partnership's ATB as if it were directly conducted by such partner. In both of these scenarios a substantial group of new owners enters the picture, yet that circumstance does not jeopardize Section 355 qualification. While the rationale for attributing a partnership business to a partner may be rooted in the "aggregate v. equity" concept, policy differences between the corporate joint venture dropdown scenario and the Morris Trust scenario seem more difficult to identify. In any event, the safest course from a planning perspective may be to postpone the dropdown for a significant period (e.g., at least 12 months), so as to remove it from the plan of reorganization and thereby better support compliance with the ATB and 355 COBE Requirements.

Case 13

The facts are the same as in Case 12, except that all of the Healthco stores are transferred to a limited partnership (LP) in which Healthco receives a 20% general partner interest and an unrelated cash investor receives an 80% limited partner interest. The LP business operations are managed and conducted by Healthco and LP employees.
The post-spin dropdown of Controlled or Distributing assets into a partnership or multi-member LLC can be problematic if the corporate transferor retains no other qualifying ATB, depending on the nature and extent of the corporation's ownership and active involvement in the partnership's business. Accordingly, both the ATB and 355 COBE Requirements need to be revisited in these situations.

**ATB analysis.** Published rulings address various situations in which a corporate partner may be viewed as directly engaged in the partnership's ATB for Section 355 purposes. In the earliest of these rulings, the ATB Requirement was deemed satisfied where Distributing owned a 20% general partnership interest in a limited partnership (LP) that conducted a real estate leasing business; and Distributing's officers performed "active and substantial management functions" with respect to LP, including "significant business decision-making" and regular participation in the "overall supervision direction and control of LP's employees."  

In later rulings, the Service reached the same result where (i) Distributing and an unrelated corporation, each owning a 20% member interest in an LLC, jointly managed the LLC's business;  and (ii) Distributing owned a 33 1/3% member interest in an LLC (considered a "significant interest"), but all "management and operational functions" were performed by LLC employees. The opposite result was reached, however, where Distributing owned only a 20% LLC member interest, and all management and operational functions with respect to the LLC business were performed by LLC employees. The 20% and 33 1/3% administrative benchmarks are also incorporated in the proposed ATB regulations under Section 355. The bottom line for planning purposes is that a one-third partnership interest will suffice even without any active management or operational involvement by Distributing or Controlled, as will a 20% partnership interest coupled with significant active involvement in the business. The Case 13 facts should clearly meet the 20% test given Healthco's substantial active involvement in the LP business. However, uncertainties remain as to the sufficiency of percentage interests that fall outside the 20% and 33 1/3% parameters, as well as the particular types and level of services that must be performed by the corporate partner. Moreover, in what is somewhat a trap for the unwary, where the partnership has no employees and another partner or LLC member performs all managerial functions and activities with respect to the partnership business, the proposed ATB regulations provide that even a one-third or more ownership interest by Distributing or Controlled may not suffice for ATB purposes.

In all events, the partnership business must have the requisite five-year history in order to be attributed to the corporate partner for ATB purposes. Further, although the determination regarding partnership ATB attribution is normally made immediately after the spin, a reduction soon thereafter in the corporate partner's percentage interest, or a change in the nature or level of such partner's participation in the partnership business, could adversely affect application of the 20% and one-third tests and thus jeopardize compliance with the ATB Requirement on step-transaction grounds.

**COBE analysis.** Because it was part of an overall D reorganization, it may be best to analyze the Healthco spin and dropdown into LP for COBE purposes under the "qualified group" concept of Reg. 1.368-1(d). Those regulations embrace the same 20% and 33 1/3% tests that apply for purposes of the
ATB Requirement, thus permitting the 368 COBE Requirement to be satisfied via a partnership business where (i) members of the qualified group own, in the aggregate, a "significant interest" in the partnership business; 96 or (ii) one or more group members exercise "active and substantial management functions as a partner" with respect to such business. 97 Examples in the regulations indicate that (i) a one-third partnership interest is a "significant interest" without need for any management participation; (ii) substantial management participation by a 20% corporate partner will suffice; and (iii) substantial management participation by a 1% corporate partner will not suffice. 98

Under these regulations, Healthco's 20% partnership interest plus its substantial involvement in the LP business should suffice to permit its reliance on such business for purposes of both the 368 COBE Requirement and the 355 COBE Requirement. The result presumably would be the same if the Healthco spin were not part of a "D" reorganization; for if the LP business is relied on as Healthco's ATB, the 20% and one-third tests would still have to be applied under the published rulings referenced above. Thus, at least in the partnership attribution context, the ATB and 355 COBE Requirements clearly operate in tandem.

To come

Part 2 of this article, to be published in the January/February 2014 issue, will cover (i) post-spin transactions involving dispositions or new issuances of the stock of Distributing or Controlled; (ii) important recent changes in IRS ruling policy with respect to Section 355 transactions; and (iii) common analytic themes for assessing, and suggestions for minimizing, the potentially adverse tax implications of post-spin developments.

1 Under the rationale of General Utilities & Operating Co., 16 AFTR 1126, 296 US 200, 80 L Ed 154, 35-2 USTC ¶9658, 1936-1 CB 214, 36-1 USTC ¶9012 (1935), a corporation could make a liquidating or non-liquidating distribution of appreciated property to shareholders without incurring a corporate-level tax. The Code generally embraced such treatment for non-liquidating distributions until 1984, and for liquidating distributions until 1986. The statutory reversal of the General Utilities doctrine in those years (through amendments to Sections 311, 336, and 337) spared only complete liquidations of controlled subsidiaries (under Section 332) and qualifying distributions of the stock of a controlled subsidiary (under Section 355).


3 Sections 355(c) and 361(c).

4 Sections 355(a) (flush language), 356(a) and (b).
5 Section 358(a)-(c); Reg. 1.358-1(a) and -2(a).

6 Section 355(a)(1)(A); see also Reg. 1.355-2(a). Under Section 355(a)(1)(A)(ii), holders of D securities may receive either C stock or C securities tax-free under Section 355 only if they surrender D securities in the exchange. Furthermore, holders of D securities may receive C securities tax-free only to the extent that the principal amount of the D securities surrendered equals or exceeds the principal amount of the C securities received. Sections 355(a)(3)(A) and 356(d)(2)(C). Exchanged D or C debt instruments that have sufficiently lengthy maturities (typically at least five to ten years) generally will constitute "securities" for Section 355 and other subchapter C purposes.

7 Section 355(a)(1)(B); see also Reg. 1.355-2(d)(1).

8 Section 355(a)(1)(C) and (b)(1)(A); see also Reg. 1.355-2(h). In the context of a split-up, Section 355(b)(1)(B) requires that, immediately before the transaction, the distributing corporation have no assets other than stock or securities in Controlled(s) and that, immediately after the transaction, each of the distributed Controlleds be engaged in a qualifying active business.

9 Section 355(a)(1)(D); see also Reg. 1.355-2(e). Section 368(c) "control" means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. Only direct (actual) ownership is taken into account; and 80% of each class of non-voting stock must be held. See Rev. Rul. 59-259, 1959-2 CB 115; Rev. Rul. 56-613, 1956-2 CB 212. In limited circumstances, Distributing may be able to retain a relatively minor portion of the Controlled stock for good business reasons, but not indefinitely. See Section 355(a)(1)(D)(ii) (D must demonstrate that retention of C stock not in pursuance of a plan having avoidance of federal income tax as one of its principal purposes); Rev. Proc. 96-30, App. B, §1.01, 1996-1 CB 696 (advance ruling requirements where D retains C stock; retained stock generally must be disposed of by D not later than five years after spin); see also Rev. Rul. 75-321, 1975-2 CB 123 (D’s distribution of 95% of C stock to comply with federal banking laws and retention of 5% of C stock to meet collateral requirements for short-term financing did not jeopardize Section 355 qualification); Ltr. Rul. 200534006 (5/24/05) (post-spin retention of C stock by "rabbi trust" established by D prior to spin to hold D stock and other assets did not constitute a proscribed tax avoidance retention by D), supplementing Ltr. Rul. 200403060 (9/30/03).

10 Section 355(g)(1) and (4). A corporation will constitute a "disqualified investment corporation" if the fair market value of its "investment assets" is equal to two-thirds or more of the fair market value of all of its assets. Section 355(g)(2)(A)(i). For this purpose, the term "investment assets" generally means (i) cash, (ii) any stock or securities in a corporation, (iii) any interest in a partnership, (iv) any debt instrument or other evidence of indebtedness, (v) any option, forward contract, futures contract, notional principal contract, or derivative, (vi) foreign currency, or (vii) any "similar asset." Section 355(g)(2)(B)(i). For purposes of Section 355(g), the term "50% or greater interest" means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock. Section 355(g)(3)(A) (cross-referencing Section 355(d)(4)).

Reg. 1.355-2(c)(1). Examples in the regulations indicate that 50% continuing stock ownership is an acceptable COI threshold for Section 355 purposes, but that 20% is too low. Reg. 1.355-2(c)(2), Examples 2 and 4. Indirect COI can exist, for example, where an internal spin of a lower-tier subsidiary is followed by another spin of that subsidiary to the distributee corporation's shareholders. See, e.g., Rev. Rul. 62-138, 1962-2 CB 95.


In contrast to an "acquisitive" type "D" reorganization, there is no requirement that Distributing transfer "substantially all" of its assets to Controlled. See Section 354(b)(1)(A).

See Section 368(a)(2)(H)(ii). A similar relaxation of the "control immediately after" requirement applies where the pre-distribution asset transfer by Distributing to Controlled is governed by Section 351 (as opposed to being part of a "D" reorganization). See Section 351(c)(1) and (2).

See Reg. 1.355-2(b)(3) ("For rules with respect to the requirement of a business purpose for a transfer of assets to a controlled corporation in connection with a reorganization described in section 368(a)(1)(D), see §1.368-1(b).") In many instances, the corporate business purpose(s) for the reorganization and the spin-off will coincide.

See Reg. 1.368-1(b) ("Requisite to a reorganization under the Internal Revenue Code are a continuity of the business enterprise . . . and (except as provided in section 368(a)(1)(D)) a continuity of interest as described in paragraph (e) of this section. (For rules regarding the continuity of interest requirement under section 355, see §1.355-2(c).") (Emphasis added)); TD 8760, Continuity of Interest and Continuity of Business Enterprise, 63 Fed. Reg. 4174, 4176 (1/28/98) ("The IRS and Treasury Department continue to study the role of the COI requirement in section 368(a)(1)(D) reorganizations and section 355 transactions. Therefore, these final COI regulations do not apply to section 368(a)(1)(D) reorganizations and section 355 transactions. See §1.355-2(c).") (Emphasis added)).

Important amendments to the Section 368 COI regulations in 1998 eliminated the requirement of "post-acquisition continuity," i.e., the target company shareholders are generally free to dispose of their acquiring company shares at any time. See Reg. 1.368-1(e)(1)(i). As will be seen, however, post-spin...
stock dispositions can jeopardize satisfaction of the Non-Device Requirement and, even absent device or COI concerns, may risk corporate-level taxation under Section 355(e).

19 The preamble to the 1998 amendments to the Section 368 COBE regulations states that the 368 COBE Requirement applies to any reorganization "for which COBE is relevant," and is not necessarily limited to type-A, B, C, or G reorganizations under Section 368. TD 8760, Continuity of Interest and Continuity of Business Enterprise, 63 Fed. Reg. 4174, 4178 (1/28/98). Reg. 1.355-1(b) literally requires the "continued operation of the business(es)" (not "continuity of business enterprise"), and pre-dates the "historic business"/"historic business assets" concept that was added to the Section 368 COBE regulations in 1980. See TD 7745, Continuity of Business Enterprise Requirement for Corporate Reorganizations, 1981-1 CB 134. For a discussion of earlier COBE case law and the events leading to this then controversial regulatory change, see Beller and Brown, "IRS Mounts Double-Barreled Attack on 'Cash Reorganizations' with Mutual Funds," 53 J. Tax'n 76 (1980).

20 Section 355(e)(1) and (2)(A); Reg. 1.355-7(a). For purposes of Section 355(e), the term "50% or greater interest" means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock. Section 355(e)(4)(A). Gain is recognized by Distributing on the distribution because the stock of Controlled is not treated as "qualified property" for purposes of Section 355(c)(2) or Section 361(c)(2).

21 Section 355(e)(2)(B). Corporate-level gain can also be triggered under Section 355(d) in connection with qualifying Section 355 distributions, where substantial purchases of Distributing or Controlled stock occur during the five-year pre-distribution period (whether or not linked to the distribution by any plan). Where both Section 355(d) and (e) could apply (i.e., in cases involving stock purchases during the two-year period preceding the distribution), Section 355(d) trumps. Section 355(e)(2)(D).

22 See Rev. Proc. 2003-48, supra note 11, at §2; see also Rev. Proc. 2013-3, 2013-1 IRB 113, §3.01(43). Although audit challenges to Section 355 transactions are apparently quite rare, the authors understand that IRS attorneys sometimes do receive inquiries from the field regarding Section 355 ruling letters on which they had worked.


24 Post-spin reductions in the voting power attached to the Controlled shares also may be problematic where the spin was preceded by a recapitalization designed to give Distributing the requisite 80% "control" (within the meaning of Section 368(c)) of Controlled at the time of the spin. See infra, note 199.

25 Reg. 1.355-2(b).

26 2003-1 CB 961.
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27 See, e.g., Ltr. Rul. 200129032 (4/24/01) (cancellation of planned public offering of Controlled following spin-off undertaken to allow Controlled to raise more capital), supplementing Ltr. Rul. 200017019 (1/27/00); Ltr. Rul. 200103054 (10/23/00) (due to unexpected business difficulties and unfavorable market conditions, public offering of Controlled could not be completed within one year of spin-off transaction; later date set), supplementing Ltr. Rul. 199950032 (9/13/99).

28 See, e.g., Ltr. Rul. 200104025 (10/26/00), supplementing Ltr. Rul. 200011017 (12/14/99).

29 See, e.g., Ltr. Rul. 200036023 (6/7/00), supplementing Ltr. Rul. 9821052 (2/24/98).

30 The "fit and focus" purpose contemplates a spin undertaken to resolve management, systemic or other problems that arise (or are exacerbated) by the taxpayer's operation of different businesses within a single corporation or affiliated group. See Rev. Proc. 96-30, supra note 9, at §4.04(4) and App. A, §2.05(1). In such situations, the spin is expected to eliminate internal competition or conflict between the separated businesses. See, e.g., Ltr. Rul. 200944026 (6/29/09) (the separation will (i) reduce the competition for capital that currently exists between Business A and Business B and (ii) improve management "fit and focus," including sharpening management focus and strategic vision, providing the flexibility needed to respond more effectively to customer needs and a changing economic environment and enhancing the success of the businesses by enabling them to resolve management, systemic or other problems that arise or are exacerbated by Distributing's operation of Business A and Business B within a single affiliated group); Ltr. Rul. 200932018 (4/14/09) (corporate business purposes include (i) resolving concerns regarding allocation of scarce resources; (ii) allowing Distributing's management to focus solely on the performance and profitability of Business A; and (iii) allowing Controlled's management to focus solely on the performance and profitability of Business B).

31 2003-2 CB 79.

32 See, e.g., Ltr. Rul. 200420015 (2/2/04) (extension of Controlled's lease of building from Distributing due to unexpected circumstances), supplementing Ltr. Rul. 200107008 (11/9/00); Ltr. Rul. 200130003 (4/3/01) (Section 355 ruling still valid where, shortly after "fit and focus" spin, chairman of Controlled's board of directors (i) resigned as chairman but remained a Controlled director; (ii) was appointed chairman and CEO of Distributing on a temporary basis; and (iii) was likely to remain on Distributing's board of directors after replacement found), supplementing Ltr. Rul. 200044019 (8/3/00).

33 See, e.g., Ltr. Rul. 200823004 (3/3/08) (in exchange for arm's-length consideration, Distributing 1, Distributing 2, and Controlled will continue certain business relationships, including sharing of employees, accounting functions, continuance of the currently existing benefits plan for Controlled's employees, and Controlled's receipt of services from Distributing 1 with respect to Business B; regulatory, risk, and acquisition business purposes); Ltr. Rul. 200704018 (10/12/06) (third-party lenders required cross-guarantees by D and C of each other's indebtedness; most of the loans were to mature in "a year or two" following spin, but three loans had longer terms; key employee business purpose (among others)), supplementing Ltr. Rul. 200603016 (10/14/05); Ltr. Rul. 200214025 (1/4/02) (post-spin administrative
management services provided by Distributing to subsidiaries of Controlled without time limitation; regulatory business purpose).

34. Cf. Atlas Tool Co., 70 TC 86, 103-104 (1978) (“It is well established that the same business need not be conducted by the transferee as was conducted by the transferor. In several cases in which reorganizations were found, the transferor's assets have been taken by a newly formed, related corporation and employed in a different business.”), aff'd 45 AFTR 2d 80-645, 614 F2d 860, 80-1 USTC ¶9177 (CA-3, 1980).

35. Section 355(b)(1)(A) and (2)(A). In the context of a split-up, where Distributing goes out of existence, each Controlled must conduct a qualifying ATB immediately after the distribution.

36. Section 355(b)(2)(B), (C), and (D).

37. See Prop. Reg. 1.355-3(b)(1)(ii) (2007). The composition of a SAG is determined under the Section 1504(a) “affiliation” rules (i.e., chain of corporations linked by 80% or more direct/indirect stock ownership), but including corporations normally excluded under Section 1504(b) (e.g., foreign corporations and life insurance companies).

38. See Reg. 1.355-3(b)(3)(ii) (“[I]f a corporation engaged in the active conduct of one trade or business during . . . [the 5-year pre-distribution period] purchased, created or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business.”); Reg. 1.355-3(c), Example 8 (expansion of existing hardware store business via purchase of assets of hardware store in another state).

39. See Notice of Proposed Rulemaking, Guidance Regarding the Active Trade or Business Requirement Under Section 355(b), 72 Fed. Reg. 26012, 26022 (5/8/07) (noting that no authorities have limited the application of the business expansion exception to asset acquisitions).


41. Accordingly, if the business expansion exception does not apply to the acquisition of the stock of S1, Bus. 3 may run afoul of Section 355(b)(2)(D), or, if the acquisition were instead tested as an asset acquisition under the SAG rules, Section 355(b)(2)(C). While the relatively minor size of Bus. 3 (12.5% of Distributing's post-spin value) might also be problematic from an ATB perspective, the Service has historically been comfortable with otherwise active businesses representing 5% of total asset value. For example, in Rev. Proc. 96-43, 1996-2 CB 330, the Service announced that it generally would not rule on whether a distribution of stock or securities is described in Section 355(a)(1) when the gross assets of the
trade or business relied on to satisfy the ATB Requirement have a fair market value that is less than 5% of the total fair market value of the gross assets of the corporation conducting the trade or business. This position was incorporated into the annual "no-rule" list beginning with Rev. Proc. 97-3, 1997-1 CB 507, but ultimately was deleted from that list. See Rev. Proc. 2003-48, supra note 11, at §4.07.

42 Cf. Intermountain Lumber Co., 65 TC 1025 (1976) (Section 351 "control immediately after" requirement breached by pre-existing legal obligation to sell to unrelated party 50% of stock received in exchange for incorporation transfer).

43 See, e.g., Ltr. Rul. 199922036 (3/3/99) (sale of active business due to industry consolidation), supplementing Ltr. Rul. 9651045 (9/23/96); see also Ltr. Rul. 200109045 (12/6/00) (transfer of Distributing's active business to new subsidiary more than three years after spin, preparatory to sale in response to changed market conditions), supplementing Ltr. Rul. 9649040 (9/10/96); Ltr. Rul. 200019013 (2/10/00) (despite dedicating additional resources to growth of active business's employees, offices, and assets, unforeseen circumstances caused significant decline in rate of return resulting in discontinuance of business), supplementing Ltr. Rul. 9821052 (2/24/98).

44 See, e.g., Murray, The Gregory Rules of Section 355-Business Purpose, Active Trade or Business, Device (With Additional Thoughts on Control, Continuity, and Other Section 355 Miscellany) 568-569 (Practising Law Institute 2012); Wessel et al., Corporate Distributions Under Section 355 at 31-32 (Practising Law Institute 2009); Ridgway, Tax Management Portfolio 772-4th: Corporate Acquisitions-D Reorganizations, at pt. VII.B.

45 The representation that had been required in Section 355 letter ruling requests did not include a temporal or quantitative benchmark, stating merely that "each of Distributing and Controlled will continue the conduct of its active trade or business." Rev. Proc. 96-30, supra note 9, at §4.03(8).

46 See Reg. 1.368-1(d)(2)(ii) ("significant line of business"), (d)(3)(i) ("significant portion of T's historic business assets") and (d)(5), Example 1 (Target conducts three businesses of roughly equal value; six months before being acquired, Target sells two of the three businesses; 368 COBE Requirement satisfied).


48 The appropriate percentage comparison presumably should not include Bus. 2, which was spun-off with and continued by Controlled. As to the remaining post-spin businesses of Distributing (Bus. 1 and Bus. 3), Bus. 3 represents approximately 12.5% on a relative value basis, still well below the one-third "significance" benchmark blessed in the Section 368 COBE regulations.

49 See commentary cited supra note 44.

Reg. 1.355-3(b)(2)(iii) instructs that "the determination whether a trade or business is actively conducted will be made from all of the facts and circumstances." In Rev. Rul. 82-219, 1982-2 CB 82 a one-year pre-spin interruption due to loss of the business's only customer did not prevent that business from satisfying the ATB Requirement because the loss was unforeseen, outside of the taxpayer's control, and all reasonable steps were taken to restore income flow by redesigning products and looking for new customers in that year. See also Rev. Rul. 57-126, 1957-1 CB 723 (pre-spin dormancy of a citrus business for five years due to series of disastrous freezes did not prevent satisfaction of the ATB Requirement; separate identity of citrus division maintained and full operations resumed); Ltr. Rul. 201102046 (9/28/10) (pre-spin business activity temporarily suspended due to increase in raw material price; history of slowdowns and accelerations in the business); Ltr. Rul. 9809051 (12/2/97) (four months of reduced activity pre-spin during relocation and size reduction not inconsistent with active business). But see Spheeris, 29 AFTR 2d 72-1057, 461 F2d 271, 72-1 USTC ¶9395 (CA-7, 1972) (pre-spin four-year interruption of business on account of fire violated ATB Requirement).

Cf. Ltr. Rul. 200323041 (3/11/03) (due to business differences between son and daughter, Distributing leased farm property on cash rent basis to third party for crop year, pending (i) probate of father's estate, (ii) distribution of father's Distributing shares equally to son and daughter, and (iii) separation of Distributing's assets equally between son and daughter; viewed as temporary cessation of business activities that did not violate ATB Requirement).


Section 355(g)(1), (2)(A), and (2)(B)(i)(II).

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

58 As explained in the preamble to the proposed ATB regulations with respect to the SAG rules: "The SAG rule alters the application of section 355(b)(2)(C) and (D) with respect to the acquisition of stock of a corporation that is or becomes a subsidiary SAG member. Section 355(b)(3) treats SAG members as one corporation for purposes of . . . section 355(b). Consequently, a transaction that results in a corporation-including controlled-becoming a subsidiary SAG member is treated as a direct acquisition of all the assets (and activities) owned (and performed) by the acquired corporation at the time of the acquisition. . . . In addition, an acquisition that results in a corporation becoming a subsidiary SAG member in a transaction in which gain or loss is recognized might . . . [qualify] as an expansion of one of the acquiring SAG's existing businesses, as discussed in section E. of this preamble." Notice of Proposed Rulemaking, Guidance Regarding the Active Trade or Business Requirement Under Section 355(b), 72 Fed. Reg. 26012, 26015-26016 (5/8/07) (citations omitted).

59 Dealerco became a SAG member because Carco acquired Section 1504(a)(2) "affiliation" ownership of Dealerco, i.e., stock representing at least 80% of vote and value. See, e.g., Ltr. Rul. 201133003 (5/18/11) (Distributing acquired Controlled stock via taxable inversion transaction and distributed such stock to Parent; Distributing and Controlled in same business, so business expansion doctrine applied.)


61 Note that, because the expansion occurred through internal growth, as opposed to via an acquisition of an existing on-line business from unrelated owners, Section 355(b)(2)(C) should not apply. Furthermore, because Clickco acquired its assets from Stepco in a wholly non-taxable Section 351 transaction, Clickco will have the requisite five-year ATB history for purposes of Section 355(b)(2)(B).

62 If the shoe store conversion was not planned or contemplated at the time of the spin, any risk of violating the ATB and 355 COBE Requirements would appear substantially lower (as in Cases 4, 5, and 6).


65 The term "50% or greater interest" means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock. See Sections 355(e)(4)(A) and 355(d)(4). For purposes of determining whether a 50% or greater interest has been acquired:

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• A person and all persons related to such person (within the meaning of Section 267(b) or Section 707(b)(1)) are treated as one person. See Sections 355(e)(4)(C)(i) and 355(d)(7)(A).

• The attribution rules of Section 318(a)(2) are applied when determining whether a person holds stock of a corporation, but Section 318(a)(2)(C) (concerning attribution from corporations) generally is applied without regard to the "50% or more in value" threshold. See Section 355(e)(4)(C)(ii).

• All acquisitions of the stock of Distributing or Controlled that are considered to be part of a Proscribed Plan must be aggregated. See Reg. 1.355-7(c)(5).

• Any reference to Distributing or Controlled includes a reference to any predecessor or successor of such corporation. Section 355(e)(4)(D). Proposed Treasury regulations issued in 2004 define the terms "predecessor" and "successor" primarily by reference to transactions described in Section 381. See Prop.Regs. 1.355-8(b) and (c) (2004).

66 See Section 355(e)(3)(B) (specifying reorganizations under Section 368(a)(1)(A), (C), or (D) or any other transaction specified in regulations). Morris Trust transactions may also involve type "B" reorganizations (stock for solely voting stock) under Section 368(a)(1)(B), where the acquired corporation survives as a controlled subsidiary of the acquiring corporation. See Rev. Rul. 78-251, 1978-1 CB 89 (acquisition of Distributing stock by unrelated corporation).

67 Mechanically, the Safeco shareholders are treated under Section 355(e)(3)(B) as having acquired 40% of the Foodco stock. While that alone is not enough to trigger Section 355(e), additional tainted acquisitions of at least 10% of the Foodco stock during the four-year statutory period (i.e., two years before and after the spin) could bring Section 355(e) into play.

68 Nor should satisfaction of the Non-Device or 355 COI Requirements be jeopardized. See discussion of Case 19 infra.

69 The Fourth Circuit essentially concluded that Distributing had met the "immediately after" requirement simply by completing the spin, no matter how quickly its ATB was taken over by the acquiring bank in the merger. The court reasoned as follows:

   Section 355(b)(1)(A) requires that both the distributing corporation and the controlled corporation be "engaged immediately after the distribution in the active conduct of a trade or business." There was literal compliance with that requirement, for the spin-off, including the distribution of Agency's stock to American's stockholders, preceded the merger. . . . It is in marked contrast to § 355(b)'s highly particularized requirements respecting the duration of the active business prior to the reorganization and the methods by which it was acquired. These contrasts suggest a literal reading of the post-reorganization requirement and a holding that the Congress intended to restrict it to the situation existing "immediately after the distribution."

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Such a reading is quite consistent with the prior history. . . . It sufficiently serves the requirements of permanence and of continuity, for as long as an active business is being conducted immediately after the distribution, there is no substantial opportunity for the stockholders to sever their interest in the business except through a separable, taxable transaction. If the corporation proceeds to withdraw assets from the conduct of the active business and to abandon it, the Commissioner has recourse to the back-up provisions of § 355(a)(1)(B) and to the limitations of the underlying principles. At the same time, the limitation, so construed, will not inhibit continued stockholder conduct of the active business through altered corporate form and with further changes in corporate structure, the very thing the reorganization sections were intended to facilitate.

Morris Trust, supra note 63, at 796, 798-799.


71 No matter what percentage of the acquiring corporation's stock is owned by the Distributing shareholders, the Distributing ATB will be "inherited" in the merger by the acquiring corporation; and the value of the Distributing shareholders' shares in the acquiring corporation will be the same regardless of what percentage of the acquiring corporation's total shares they represent.

72 See Regs. 1.355-7(d) (safe harbors), 1.355-7(b)(3) (plan factors) and 1.355-7(b)(4) (non-plan factors). The Section 355(e) plan regulations evolved out of various earlier proposed versions that generally were less "taxpayer friendly" and generated substantial comment and other input from the tax community. For a comprehensive review of the history of these proposals and the provisions of the final version, see Silverman, "Final Section 355(e) Plan Regulations-The Final Chapter in the Saga," (Practising Law Institute 2012).

73 Reg. 1.355-7(b)(2).

74 The potential Natco acquisition and the actual Safeco acquisition likely are not "similar acquisitions" for Section 355(e) purposes because the "ultimate owners" of the combined business operations in these alternative scenarios would be "substantially different." See Regs. 1.355-7(h)(12) and 1.355-7(j), Example 6.

75 These include, for example, the facts that (i) the Healthco Spin was motivated by a corporate business purpose other than to facilitate an acquisition of Foodco (i.e., to make Foodco more attractive to lenders); and (ii) the Healthco Spin would have occurred at the same time and in the same form notwithstanding the acquisition (which was not contemplated or expected at the time of the spin). See Reg. 1.355-7(b)(4)(ii), (v), and (vi). Consistent with Rev. Rul. 2003-55, the fact that no new debt financing had yet been obtained by Foodco prior to the Safeco acquisition ought not be considered a fatal deviation...
from the asserted business purpose for the spin, so long as the seeking of such borrowings was in fact intended at the time of the spin.

76 20 AFTR 1301, 95 F2d 732, 37-2 USTC ¶9501, 1939-1 CB 248, 38-1 USTC ¶9238 (CA-4, 1937).

77 For ruling purposes, "substantially all" is defined to mean assets representing at least 90% of total net asset value and 70% of total gross asset value. See Rev. Proc. 77-37, 1977-2 CB 568, §3.01, as amplified by Rev. Proc. 86-42, 1986-2 CB 722, §§7.05-7.06. Published rulings and case law, however, embrace a more flexible "facts and circumstances" approach, considering, for example, the types of assets involved (i.e., cash v. non-cash; operating v. non-operating). See, e.g., Rev. Rul. 70-240, 1970-1 CB 81 (involving a "D" reorganization); Rev. Rul. 57-518, 1957-2 CB 253 (involving a "C" reorganization); see also Moffatt, 42 TC 558, 578 (1964) ("[The] term 'substantially all' is a relative term, dependent on the facts of any given situation."). aff'd 17 AFTR 2d 1290, 363 F2d 262, 66-2 USTC ¶9498 (CA-9, 1966).

78 In addition to Section 368(a)(2)(D) mergers, these include reorganizations described in Sections 368(a)(1)(C) (stock for assets), (a)(1)(D) (acquisitive variety), (a)(2)(E) (reverse triangular mergers), and (a)(1)(G) (bankruptcy reorganizations).

79 Rev. Rul. 2003-79, supra note 64. This ruling indicates that the Service will continue to apply the Elkhorn Coal rationale to post-spin acquisitions of Distributing via reorganizations involving a "substantially all" requirement. Respecting post-spin acquisitions of Controlled as separate transactions is consistent with Rev. Rul. 98-27, 1998-1 CB 1159, where the Service announced that, in light of (i) the legislative policy behind the enactment of Section 355(e), and (ii) the effective elimination of the "control immediately after" requirement for "D" reorganization and Section 351 transfers followed by Section 355 distributions (see Sections 368(a)(2)(H)(ii) and 351(c)(2)), it would no longer apply step transaction principles to treat pre-arranged post-spin acquisitions or restructurings of Controlled as violating the "distribution of control" requirement under Section 355. Prior to Rev. Rul. 98-27, the Service was willing to bless such transactions only where the post-spin acquisition was subject to shareholder approval or otherwise not a foregone conclusion at the time of the spin. See Rev. Rul. 75-406, 1975-2 CB 125, modified by Rev. Rul. 96-30, 1996-1 CB 36. (Rev. Ruls. 75-406 and 96-30 were both obsoleted by Rev. Rul. 98-27.)


81 See, e.g., Ltr. Rul. 201032017 (2/5/10) (upstream reorganization of newly organized Controlled following D/355 transaction).

82 See, e.g., Ltr. Rul. 200812017 (12/14/07) (lateral merger of newly organized Controlled into sister corporation following D/355 transaction); Ltr. Rul. 200113019 (12/27/00) (same); Ltr. Rul. 200104001 (3/16/00) (same).
See, e.g., Ltr. Rul. 201312020 (12/20/12) (Section 332 liquidation of “old and cold” Controlled following spin); Ltr. Rul. 200912008 (12/10/08) (lateral merger of “old and cold” Controlled into sister corporation following D/355 transaction); Ltr. Rul. 200811012 (11/30/07) (Section 332 liquidation of “old and cold” Controlled following D/355 transaction); Ltr. Rul. 9445015 (8/11/94) (downstream merger of Controlled).

Transfers to a single-member LLC that is treated as a “disregarded entity” for tax purposes will be treated as if the transferor entity transferred the assets to itself and, as such, will likewise have no impact on the Section 355 qualification (whether or not pre-planned). See generally Reg. 301.7701-2(c)(2) (describing business entities disregarded as separate from their owners for federal tax purposes).

Section 351 treatment requires that the transferor(s) hold transferee corporation stock representing Section 368(c) "control" immediately after the transfer, i.e., at least 80% of voting power and at least 80% of the number of shares of any class of non-voting stock. Section 721 treatment applies for any type or class of partnership/LLC interest received, without regard to any "control" or percentage requirement.

As such, any unrealized gain inherent in the transferred intangible assets would not be recognized by reason of Section 361(a). The actual issuance of additional Healthco stock to Foodco in exchange for the transferred property would be a meaningless gesture and therefore unnecessary given Foodco’s 100% ownership of Healthco.

In that event, the pre-spin dropdown into Healthco should still be protected by Section 351(a) (instead of Section 361(a)); and under Section 351(c), the immediate distribution of the Healthco stock by Foodco to its shareholders should not violate the Section 351 “control” requirement. That distribution, however, would be taxable to the shareholders as a dividend and will also trigger Section 311 gain to Distributing.

Rev. Rul. 2002-85, supra note 47. This ruling was motivated by the fact that Section 368(a)(2)(C), which protects asset or stock transfers to 80% or more controlled subsidiaries following type-“A”, “B”, “C”, or “G” reorganizations, does not explicitly protect such transfers following "D" reorganizations (whether of the acquisitive or divisive variety). See generally Beller, ”‘D’ Reorganizations and Dropdowns: An Uneasy Match,” 26 J. Corp. Tax'n 177 (1999).

See discussion of Case 18 infra.


See Rev. Rul. 2007-42, 2007-28 IRB 44 (Situation 1). Neither Distributing nor any other LLC member performed services with respect to the LLC business.

See id. (Situation 2).
94 See Prop. Regs. 1.355-3(b)(2)(v) (2007), 1.355-3(d)(2), *Examples* 22 and 23 (2007); see also Section 355(g)(2)(B)(v) (providing a similar partnership "look-thru" rule for purposes of determining whether Distributing or Controlled is a "disqualified investment corporation").


98 See Reg. 1.368-1(d)(5), *Examples* 7, 8, 10, and 11.