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CORPORATE DIVISIONS UNDER SECTION 355

December 3, 1999

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I. INTRODUCTION

A. In General. Generally, corporate distributions of appreciated property are subject to tax on the amount by which the property's value exceeds the corporation's basis in the property. Under section 355 of the Internal Revenue Code of 1986, as amended (the "Code"), however, the distribution of stock of a subsidiary that is "controlled" by the distributing corporation may not be subject to tax either at the corporate level or to the recipient shareholders, provided a number of requirements are met.

B. Historic Focus

1. Traditionally, the focus under section 355 of the Code has been whether the transaction has been undertaken by the shareholders as a "device" in order to bail out earnings and profits at favorable capital gains rates.

2. Even in the absence of a rate disparity, the device issue remains relevant. A dividend distribution is taxed currently while a section 355 transaction is tax free. Moreover, a dividend is generally fully taxed (without recovery of any basis) while a transaction structured under section 355 followed by a sale permits the selling shareholder to recover basis. Furthermore, section 355 enables a distributing corporation to avoid the impact of the repeal of the General Utilities doctrine by the Tax Reform Act of 1986 (the "1986 Act").

C. Current Importance

1. The repeal of the General Utilities doctrine resulted in most distributions of appreciated property being subject to a corporate-level tax. Section 355 transactions are one of the few exceptions to this general rule. Accordingly, section 355 remains as one of the few valuable planning tools after the 1986 Act for avoiding the imposition of corporate-level tax on a distribution of stock of a subsidiary corporation.

2. However, this planning tool has been severely limited by several subsequently enacted provisions.

   a. Congress has given the Internal Revenue Service (the "Service") broad regulatory authority under section 337(d) of the Code to prevent the avoidance of the tax consequences of the General Utilities repeal, i.e., the imposition of a corporate-level tax upon the distribution of appreciated property. This regulatory authority may be used to thwart section 355 transactions structured to avoid the imposition of corporate-level tax.

   b. In addition, section 355(d) imposes a corporate-level tax on section 355 distributions if, immediately after the distribution, a shareholder holds a 50-percent or greater interest in the distributing

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

c. Moreover, the Taxpayer Relief Act of 1997 ("TRA 1997"), which added section 355(e) and (f), essentially eliminated tax-free "Morris Trust" transactions.

(1) Section 355(e) provides for a corporate-level tax on section 355 distributions that are part of a plan (or series of related transactions) pursuant to which one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.

(2) Section 355(f) provides that section 355 will not apply to the distribution of stock from one member of an affiliated group to another member if such distribution is part of a plan described in section 355(e).

d. TRA 1997 also granted the Service authority to provide adjustments (under section 358) to the adjusted basis of stock in the case of intragroup distributions to which section 355 applies, in order to appropriately reflect the proper treatment of such distributions.

3. Regulations

a. The current regulations, which were issued in 1989 and modified the original 1955 regulations, do not directly address the repeal of the General Utilities doctrine and its impact on section 355. However, many of the modifications that were made reflect the impact of General Utilities repeal.

b. These regulations appeared to shift the emphasis of section 355 from the device restriction to the business purpose requirement. Moreover, the regulations substantially tightened the business purpose requirement, clarified the continuity of interest test, and made certain changes in the device and active trade or business tests.

c. The regulations do not, however, reflect the amendments to section 355 made by the Revenue Act of 1987 (the "1987 Act") or the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Technical Corrections Act").

d. Proposed regulations have been issued under section 355(d) and 355(e). The proposed regulations under section 355(e) address the issue of what constitutes a plan or series of related transactions.

Additional regulations under section 355(e) and regulations under section 358 are expected in the future.

D. Future of Section 355 -- Subchapter C Study

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

1. If General Utilities repeal stands for the proposition that assets should not be taken out of corporate solution without the imposition of a corporate-level tax, then section 355 arguably is inconsistent with this policy. Under this view, stock of a subsidiary would be treated as an asset for General Utilities purposes.

2. However, several arguments can be made that section 355 should be retained, i.e., that stock of a subsidiary should not be treated as an asset.

   a. The first is that, in repealing the General Utilities doctrine, Congress only intended corporate income to be subject to two levels of tax.

      (1) The presence of sections 338(h)(10) and 336(e) both indicate that three levels of tax were not intended.

      (2) On the other hand, by disallowing losses arising from basis adjustments, Treas. Reg. § 1.1502-20 makes it clear that the taxpayer may not always avoid a third level of tax on the sale of the subsidiary's assets.

   b. If an exception for section 355 is not retained, three levels of tax can be imposed, i.e., one to the distributing corporation upon the distribution of stock, one to the shareholders upon receipt of subsidiary stock, and one to the subsidiary when it sells its assets. A repeal of section 355 would thus be inconsistent with sections 338(h)(10) and 336(e).

   c. In addition, the various restrictions contained in section 355 limit the potential for abuse. Abusive transactions falling within section 355 can be dealt with under section 337(d).

   d. Further, in repealing the General Utilities doctrine, Congress gave no indication that it intended to disturb the policy underlying the tax-free treatment of reorganizations (i.e., to allow tax-free movement of assets in modified corporate forms). Thus, it would be anomalous to allow section 355 treatment where a D reorganization is involved, but not otherwise.

3. The issue turns, in part, on timing, i.e., whether a corporate-level tax should be imposed at the time of the distribution rather than on the subsequent sale of assets.

   a. One can argue that section 355 allows an impermissible delay in taxation. Indeed, some view section 355 as a variation of the carryover basis scheme that was rejected by Congress in 1986.

   b. Importantly, if the distribution is to be taxed, an inside basis step-up would be necessary to prevent three levels of tax. In effect, section 355 would be replaced by section 336(e).

E. However, immediate taxation would stifle valid, non-tax motivated corporate restructurings. To borrow from the section 382 arena, immediate taxation would not be tax neutral -- tax results would affect business decisions.

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

1. First, the Service has initiated a significant examination and revision of the advance rulings process. Generally, this effort has concentrated on improving the transparency and candor of the rulings process. In particular, the Service has adopted a more flexible fact-based approach to the business purposes that it will entertain as valid reasons for a section 355 transaction. This additional flexibility has come at the cost of more onerous substantiation requirements.

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

II. SECTION 355 – OVERVIEW

A. Tax-Free Division

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

1. Types of tax-free divisions

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

a. Spin-off

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

b. Split-off

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

c. Split-up

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

2. "D" reorganization -- Division of one or more businesses

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

B. Tax Consequences of a Section 355 Transaction

1. No shareholder-level gain

A distribution qualifying under section 355 will not result in the imposition of tax at the shareholder level.

2. No corporate-level gain

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

3. Gain on the distribution of boot

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

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

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

(1) This differs from the treatment of boot in an acquisitive reorganization under Commissioner v. Clark, 109 S. Ct. 1455 (1989), where the hypothetical redemption is deemed to occur after the reorganization.

(2) The Service noted that the rationale of Clark is to compare the shareholder's percentage ownership in the assets of the corporation following the reorganization with the percentage ownership that would have resulted if no boot had been received in the transaction. In an acquisitive reorganization, this requires comparing the stock owned in the acquiring corporation with the stock that would have been owned had no boot been received; in a divisive reorganization, this requires comparing the total stock owned in both Distributing and Controlled after the transaction with the stock that would have been owned had no boot been received.

c. Whether the hypothetical redemption is equivalent to a dividend is determined under the principles of section 302.

d. Under TRA 1997, "nonqualified preferred stock" will be treated as boot for purposes of sections 351, 354, 355, 356, and 368. See, e.g., section 355(a)(3)(D).

(1) Nonqualified preferred stock is defined in section 351(g) as preferred stock for which (1) the holder has the right to require the issuer to redeem or purchase the stock, (2) the issuer is required to redeem or purchase the stock, (3) the issuer has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part with reference to interest rates, commodity prices, or other similar indices.

(2) The first three rules above do not apply if (1) the right cannot be exercised within 20 years of the date the right is issued and is subject to a contingency that makes the likelihood of redemption or purchase remote, (2) the right may be exercised only upon the death, disability, or mental incompetency of the holder, or (3) the right to redeem or purchase is in connection with the performance of services for the issuer and may be exercised only upon the holder's separation from service.

4. Basis of stock and securities

a. The basis of the stock and securities received in a section 355 transaction is determined with reference to the recipient's basis in the stock and securities of the distributing corporation. See section 358(b)(2); but see section 358(g) (authorizing the Service to provide adjustments to the stock basis of members in connection with intragroup distributions).

b. The recipient's aggregate basis in the stock and securities of the distributing corporation, before the distribution, is allocated based on relative fair market values between the stock and securities retained in the distributing corporation and the stock and securities received in the controlled corporation.

5. Tax attributes

a. Divisive "D" reorganization

(1) In a divisive "D" reorganization, the tax attributes of the distributing corporation, except for that corporation's earnings and profits, will remain with the distributing corporation. See section 381(a).

(2) The distributing corporation's earnings and profits will be allocated between the distributing corporation and the controlled corporation in proportion to the value of the retained and transferred assets. Treas. Reg. § 1.312-10(a).

b. Spin-off or split-off

(1) If a section 355 transaction is a spin-off or a split-off, the regulations provide that the earnings and profits of the distributing corporation are decreased by the lesser of (1) the amount of the adjustment that would have been made to the earnings and profits of the distributing corporation if it had transferred the stock of the controlled corporation to a new subsidiary in a divisive "D" reorganization, or (2) the net worth of the controlled corporation. Treas. Reg. § 1.312-10(b).

(2) The remaining tax attributes of the distributing corporation and the tax attributes of the controlled corporation are generally unaffected. However, in a non-pro rata split-off, section 382 may limit the carryover of the distributing or the controlled corporation's losses.

c. Split-up

If the section 355 transaction is a split-up, the tax attributes of the distributing corporation disappear. The tax attributes of the controlled corporations are not affected.

III. REQUIREMENTS UNDER SECTION 355

A. In General

1. Statutory requirements

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

a. Control

The distributing corporation must be in control of the controlled corporation immediately before the distribution.

b. Device restriction

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

c. Active trade or business requirement

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

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

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

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

e. Restrictions

Sections 355(b)(2)(D), 355(d), 355(e), and 355(f) impose further requirements as to the holding of stock in the distributing and controlled corporations, which must be met if the distribution is to be free of tax at the corporate level.

2. Non-statutory requirements

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

a. Business purpose

The transaction must have a corporate business purpose.

b. Continuity of interest

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

c. Continuity of business enterprise

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

3. Interrelationship between requirements

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

B. Control Requirement

1. In general

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

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

2. Definition of control

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

(1) Note that a nondivisive "D" reorganization must satisfy a different control requirement. Section 368(a)(2)(H) adopts the 50 percent vote or value test set forth in section 304(c). Moreover, other areas of the Code adopt other control definitions; e.g., sections 332, 338, 382, and 1504 use an 80-percent vote and 80-percent value requirement.

b. It is not necessary that the distributing corporation's control of the controlled corporation be "historic control." Steps may be

undertaken prior to the section 355 transaction in order to satisfy the control requirement.

(1) A recapitalization of the controlled corporation prior to its distribution by the distributing corporation, which results in the control requirement being satisfied, will be respected as long as the recapitalization results in a permanent realignment of control. Rev. Rul. 69-407, 1969-2 C.B. 50.

(2) The merger of two sister corporations that jointly own stock in a subsidiary resulting in the surviving corporation having control of the subsidiary will be respected. Rev. Rul. 70-18, 1970-1 C.B. 74.

(3) The transfer of assets for additional stock causing the transferor to be in control of the transferee will be respected. Rev. Rul. 71-593, 1971-2 C.B. 181. The Service, however, has declined to rule on whether the active business requirement has been satisfied if liquid or nonbusiness assets are transferred to obtain control. Rev. Proc. 96-3, § 4.01(31).

3. Control in a "D" reorganization

a. As mentioned above, if a spin-off involves a threshold "D" reorganization, either the distributing corporation or its shareholders must control the controlled corporation "immediately after the transfer." Section 368(a)(1)(D).

(1) Control is defined as ownership of stock possessing 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of each of the other classes of stock of that corporation. Section 368(c).

(2) Note: TRA 1997 initially lowered the control requirement for divisive "D" reorganizations from 80 percent to 50 percent of the vote and value of the controlled corporation.

a) However, the Internal Revenue Service Restructuring and Reform Act of 1998 (the "1998 IRS Restructuring Act") replaced the 50-percent control test enacted in TRA 1997 with a provision that states that if the requirements of section 355 are met, the fact that the shareholders of the distributing corporation dispose of part or all of their controlled corporation stock will not be taken into account for purposes of determining whether the transaction

qualifies under section 368(a)(1)(D). See Section 368(a)(2)(H)(ii).

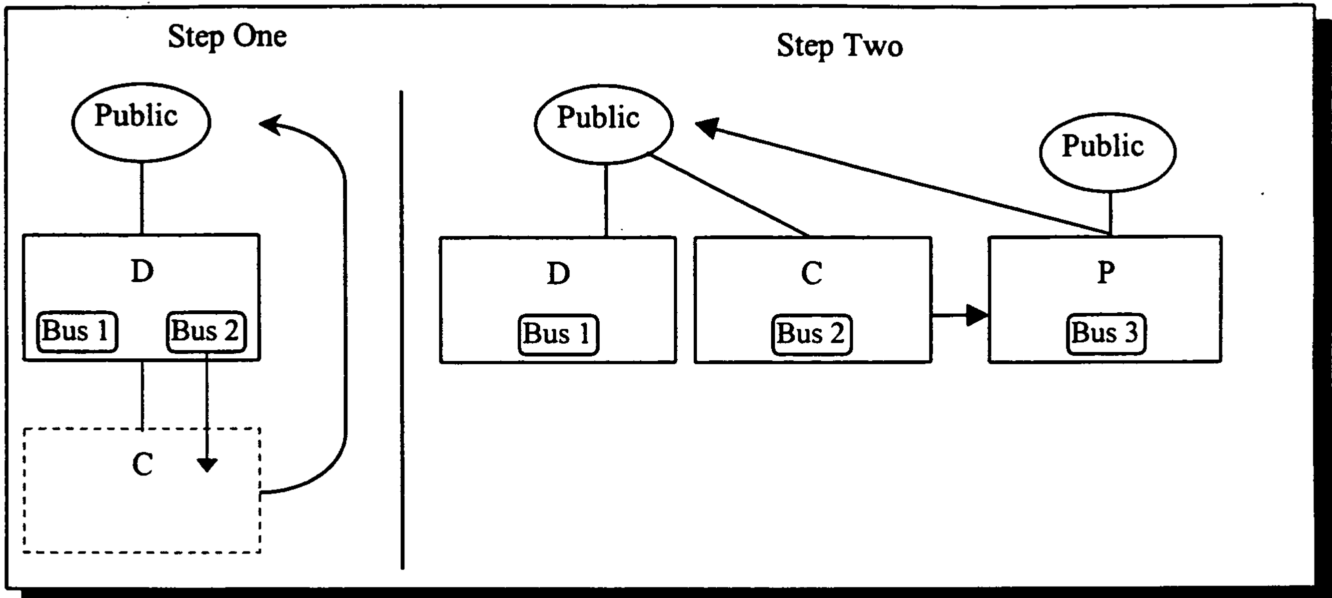
b) The Tax and Trade Relief Extension Act of 1998 (the "1998 Extension Act") contained a further technical correction of section 368(a)(2)(H)(ii), providing that the fact that the controlled corporation issues additional stock will not be taken into account for purposes of determining whether the transaction qualifies under section 368(a)(1)(D). See Section 368(a)(2)(H)(ii), as amended.

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

4. Control and application of the step-transaction doctrine

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

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



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

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

(2) Issues:

a) Arguably, the separation of the wanted and unwanted assets to facilitate a merger should be a valid business purpose. Cf. Mary Archer W. Morris Trust, 42 T.C. 779 (1964), aff'd 367 F.2d 794 (4th Cir. 1966), acq. Rev. Rul. 68-603, 1968-2 C.B. 148. But see Part III.J., infra, for an explanation of section 355(e), which imposes a

corporate-level tax on Morris Trust transactions. There may be legitimate business reasons why the shareholders wish to merge Controlled and permit Distributing to survive as a legal entity. For example, there may be agreements or licenses in Distributing's name that are impossible or unduly expensive to assign or transfer to Controlled under state law. Moreover, the acquirer may be reluctant to assume all of Distributing's hidden liabilities. Therefore, a traditional Morris Trust structure may require unduly expensive due diligence or unduly stringent warranties and indemnities.

b) Although, in substance, the transaction is virtually identical to a Morris Trust transaction, in Rev. Rul. 70-225, 1970-1 C.B. 80, the Service ruled that this transaction did not qualify as a tax-free distribution. The Service reasoned that a pre-arranged disposition of Controlled stock as part of the same plan as the distribution prevented the transaction from satisfying the requirement in section 368(a)(1)(D) that Distributing's shareholders be in "control" of Controlled "immediately after" the distribution. See Rev. Rul. 70-225, 1970-1 C.B. 80, obsoleted, Rev. Rul. 98-44, I.R.B. 1998-37. The Service recharacterized the transaction as (1) a direct taxable transfer of assets by Distributing to P in exchange for P stock, followed by (2) a distribution of the P stock.

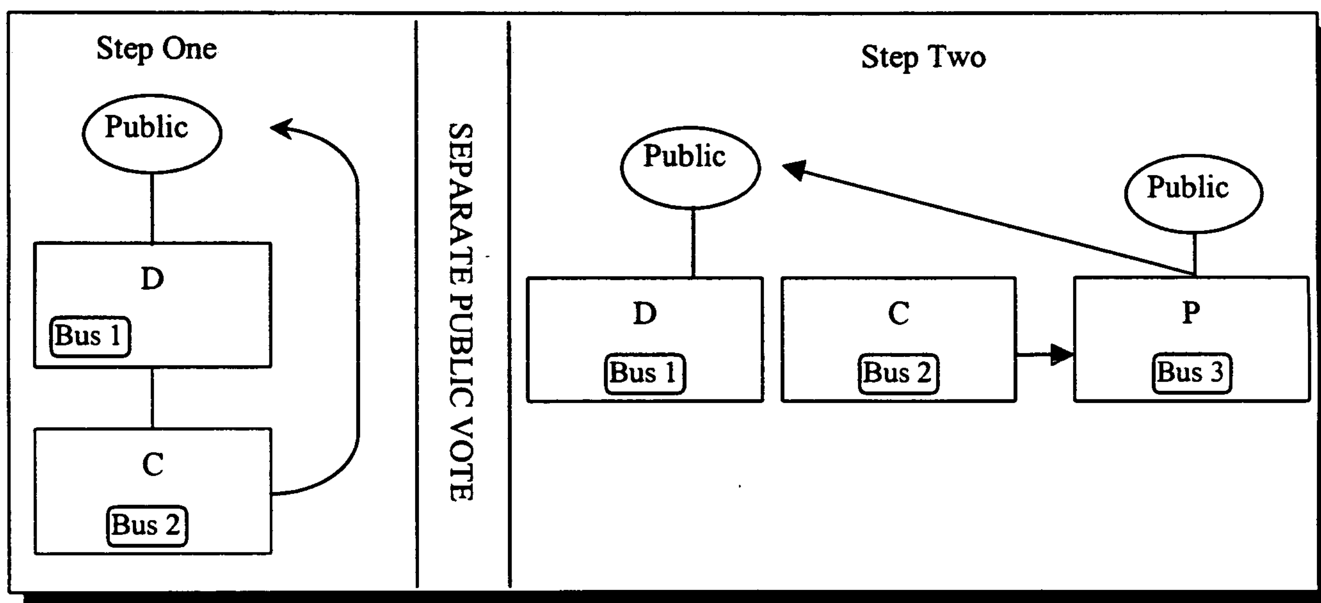
c) Note that section 355(e), discussed in Part III.J., infra, imposes a corporate-level tax only, whereas Rev. Rul. 70-225 would impose a tax at both the corporate and shareholder levels, due to the failure to satisfy the requirements of section 368(a)(1)(D).

d) In Rev. Rul. 98-27, I.R.B. 1998-22, the Service modified Rev. Rul. 70-225, stating that it would no longer apply the step-transaction doctrine to reorder the steps for purposes of the section 355(a)(1)(D) requirement (i.e., in determining whether Distributing distributes control of Controlled). However, Rev. Rul. 98-27 did not rule out the application of the step-transaction doctrine under the facts of Rev. Rul. 70-225 for purposes of

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

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

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



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

(2) Issues:

a) In Rev. Rul. 75-406, 1975-2 C.B. 125, the Service ruled that such a "non-D" transaction would qualify as a tax-free section 355 distribution followed by a merger. The Service reasoned that, in a non-D section 355 distribution, the shareholders of Distributing were not required to retain control of Controlled under section 355, provided there is a distribution of control as required under section 355(a)(1)(D).

i) The Service also held that (1) the transaction was not a device, and (2) continuity of interest was satisfied because the Distributing shareholders continued to have an indirect interest in Controlled.

ii) Importantly, in Rev. Rul. 75-406, there was a business purpose for the distribution separate and apart from the merger. In contrast, in Morris Trust, the business purpose for the distribution was to facilitate the merger. If the business purpose for the distribution in this case were the merger, it would be difficult to argue that the two steps should be viewed as independent as a result of the public vote.

b) On almost identical facts, the Service ruled that a spin-off of a subsidiary followed by a merger of that subsidiary into an unrelated corporation would qualify as tax free, provided that (1) there is a separate and independent shareholder vote after the distribution approving the merger, and (2) the distributing corporation has not entered into negotiations with the acquirer before the distribution. See Rev. Rul. 96-30, 1996-1 C.B. 36. (The merger in that ruling reduced the interest of the historic shareholders to 25 percent of the surviving entity.) But see Part III.J., infra, for an explanation of section 355(e), which imposes a corporate-level tax on Morris Trust transactions, and which creates a rebuttable presumption that any acquisition within two years of a section 355 distribution is part of a plan including such distribution.

i) In focusing on whether negotiations had been conducted by the distributing corporation, Rev. Rul. 96-30 appears to have relied heavily on Commissioner v. Court Holding Co., 324 U.S. 331 (1944). If Court Holding applied, the transaction would be recharacterized as a disposition by Distributing of the Controlled stock or assets to P, followed by a distribution of the P stock received in the exchange. Therefore, unless the Distributing shareholders received "control" of P in the transaction, Distributing would not be deemed to have distributed "control" of Controlled as required by section 355(a)(1)(D).

ii) Practitioners understood that the Service would not extend the "second separate vote" concept of these rulings to closely held corporations. Like Rev. Rul. 75-406, Rev. Rul. 96-30 involved a distributing corporation that was "widely held and actively traded."

iii) Similarly, the Service had previously been unwilling to extend the "second separate vote" concept of these rulings to "D" reorganizations (i.e., to situations involving the same facts as in Rev. Rul. 70-225, but with a separate shareholder vote). As a policy matter, this distinction between "D" and "non-D" section 355 transactions makes little sense.

c) In Rev. Proc. 96-39, 1996-2 C.B. 300, the Service announced that it would not issue advance rulings when there are "negotiations, plans or arrangements" to consummate a subsequent transaction that, if consummated before the distribution, would have resulted in a loss of control of the distributed corporation.

i) Unlike Rev. Rul. 96-30, which involved a post-distribution "disposition" of the distributed corporation, the Service's "no ruling" position appeared to apply even to

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

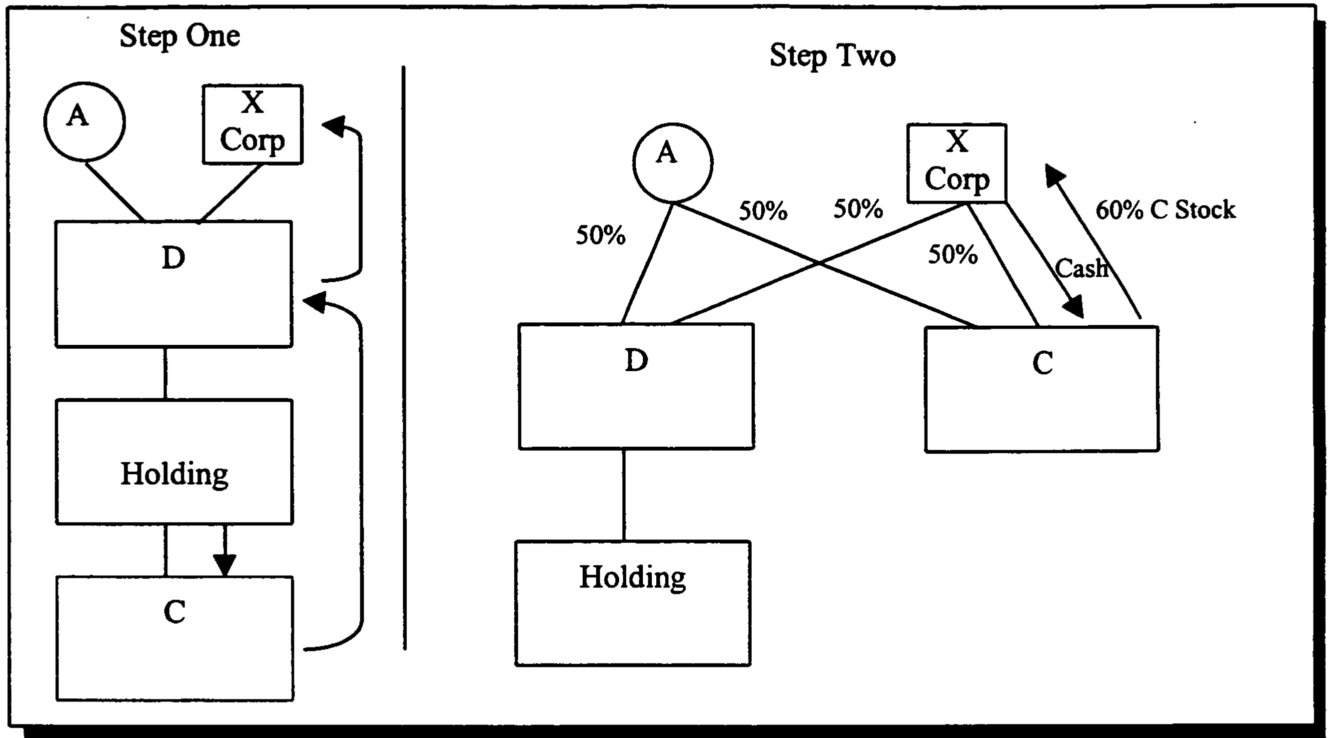
ii) The most dramatic departure of Rev. Proc. 96-39 is that it suggests the government may reorder steps in a transaction to deny the transaction tax-free treatment. However, such an expansive approach to the step-transaction doctrine has seldom been accepted by courts. See, e.g., Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988).

iii) As authority for this approach, it is possible that the announcement relies on Court Holding. One might infer this from the announcement's emphasis on "negotiations" and the approach adopted in Rev. Rul. 96-30. If so, it is not clear that such reliance is either apposite or sensible. Court Holding reached its result by treating the selling shareholder as a mere "conduit."

iv) However, the no-rule position taken by the Service in Rev. Proc. 96-39 was revoked in Rev. Proc. 97-53, 1997-2 C.B. 528. It is unclear whether this revocation meant that the Service would no longer apply step-transaction principles to these types of transactions or whether it would look to the facts of each case.

d) In response to section 355(e) and the legislative history thereunder, the Service stated in Rev. Rul. 98-27, that it would no longer apply the step-transaction doctrine for purposes of determining whether Distributing had "control" of Controlled immediately before the spin-off. Thus, Rev. Rul. 98-27 obsoletes Rev. Rul. 75-406 and Rev. Rul. 96-30.

d. Example 3 -- Sale to historic shareholders



(1) Facts: Individual A and X Corp own the stock of Distributing. Distributing owns the stock of Holding, and Holding owns the stock of Controlled. The following transaction is proposed: (1) Holding transfers assets to Controlled in a "D" reorganization; (2) Holding spins-off Controlled to Distributing; (3) Distributing spins-off Controlled to its shareholders, A and X Corp; and (4) X Corp, now a shareholder of Controlled, purchases new stock from Controlled representing 60 percent of Controlled's outstanding stock.

(2) Issues: This transaction raises issues regarding both the control requirement of section 368(a)(1)(D) and the control requirement of section 355(a)(1)(A).

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

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

i) If the Service were to seek to recharacterize the transaction as if the sale to historic shareholders took place before the spin-offs, then the section 355 control requirement could not be satisfied.

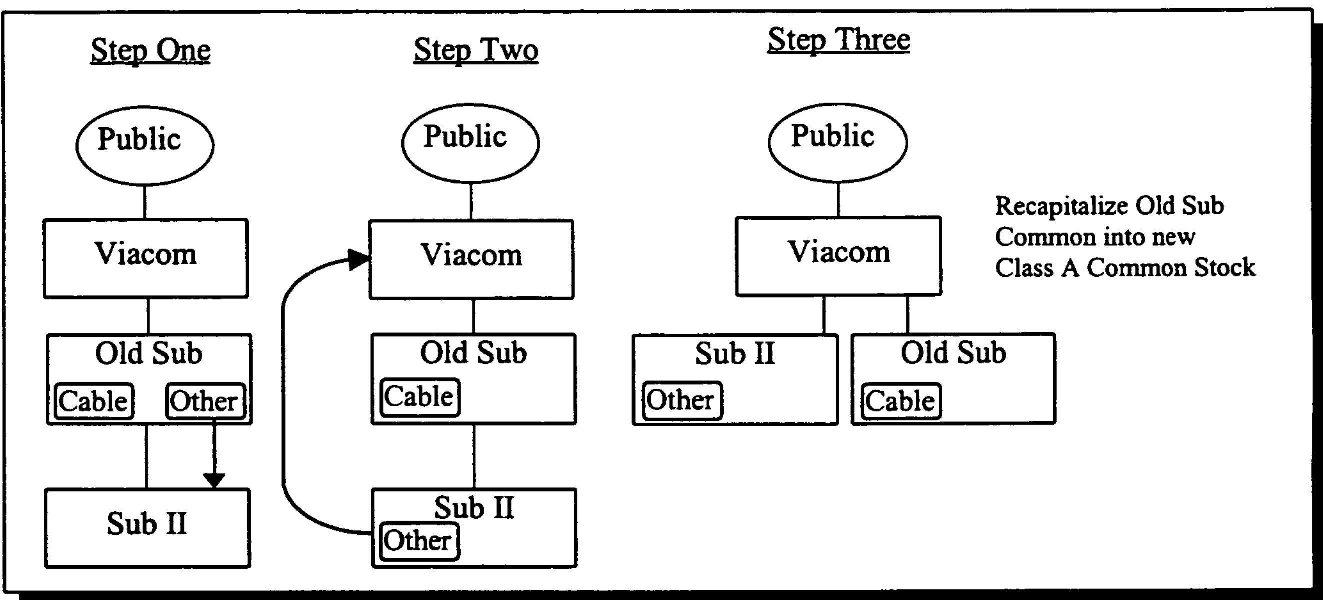
ii) Prior to Rev. Proc. 96-39, it appeared from Rev. Rul. 73-246, 1973-1 C.B. 181 that the Service would not recharacterize the transaction. Under Rev. Proc. 96-39, however, the Service presumably would not rule, because if consummated before the distribution, X Corp's purchase of controlled stock would prevent Distributing from distributing a "controlled" corporation.

iii) However, the no-rule position taken by the Service in Rev. Proc. 96-39 was revoked in Rev. Proc. 97-53. As noted above, it is unclear whether this revocation meant that the Service would no longer apply step-transaction principles to these types of transactions or whether it would look to the facts of each case.

iv) The transaction should, however, qualify under section 355.

e. Example 4 -- Viacom

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



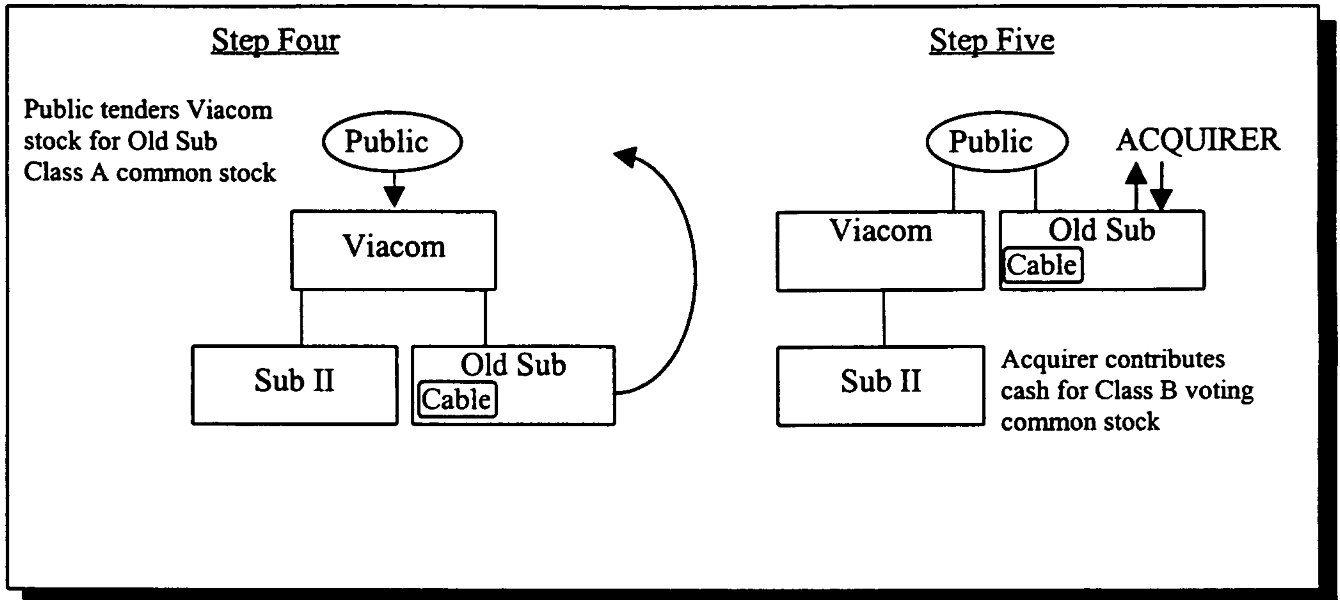
(1) Facts: Through its wholly owned subsidiary, Old Sub, Viacom conducts a cable business and other businesses. Old Sub owns all of the stock of Sub II, which is engaged in the other businesses. Viacom wishes to dispose of the cable business (but not its other businesses) to Acquirer on a tax-free basis.

a) Old Sub contributes its other businesses to Sub II. Sub II assumes substantially all of Old Sub's debt. Old Sub distributes Sub II to Viacom in a section 355 spin-off.

b) Old Sub is recapitalized. Viacom exchanges its common stock for new Class A common stock that will automatically convert to nonvoting preferred stock upon Acquirer's investment in Old Sub (described below). The Old Sub preferred stock will be convertible by either the holder or the issuer into stock of Acquirer after five years.

c) Viacom offers to exchange not less than all of its Old Sub stock upon tender of Viacom stock by the

Viacom public shareholders. When sufficient shareholders accept the tender offer, Viacom distributes its Old Sub stock to the public in a section 355 distribution.



d) Acquirer contributes a substantial amount of cash to Old Sub in exchange for newly issued Class B voting common stock. This causes the Class A common stock held by the public to convert to nonvoting preferred stock.

e) On substantially these facts, the Service held that both the distribution of Sub II and the distribution of Old Sub qualified as tax free under section 355. See P.L.R. 9637043 (June 17, 1996). But see Part III.J., infra, for an explanation of section 355(e) and (f), which effectively eliminates tax-free Morris Trust transactions and intragroup spins related to such transactions.

(2) Issues:

a) If the form is respected, Acquirer effectively receives control and substantially all of the upside potential of Viacom's cable business in a tax-free transaction.

b) In Rev. Rul. 75-406, the Service respected a section 355 distribution followed by a merger of the distributed corporation when the merger was approved by a separate vote of the public shareholders.

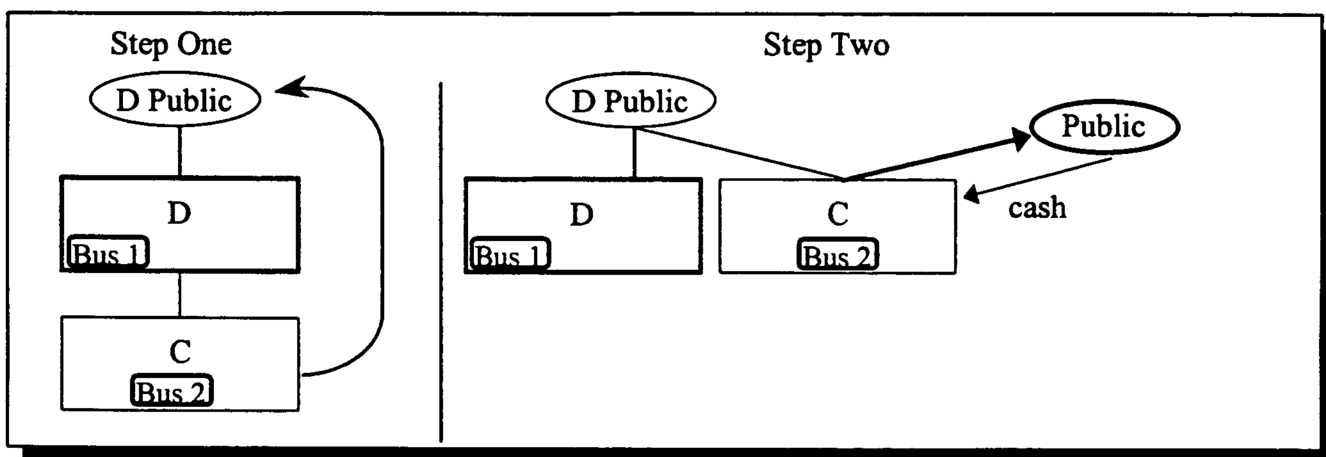
i) However, the Service clarified Rev. Rul. 75-406 in Rev. Rul. 96-30, stating that the result in Rev. Rul. 75-406 turned on the fact that the subsequent merger had not been prearranged by the distributing corporation; i.e., the result was not based merely on the separate shareholder vote. Assuming Acquirer's investment in Old Sub is prearranged, it appears that the transactions must be viewed as part of a plan under Rev. Rul. 96-30.

ii) The Viacom ruling was arguably distinguishable from Rev. Rul. 96-30, because it involved a stock offering rather than a merger. However, under the Service's current position, the same results are obtained without the need to distinguish Rev. Rul. 96-30. See Rev. Rul. 98-27 (obsoleting Rev. Rul. 96-30).

iii) Note, however, that any such post-disposition acquisition or restructuring could result in a corporate-level tax under section 355(e).

c) Because Old Sub is a preexisting subsidiary, the transaction is not a "D" reorganization. Therefore, Viacom must distribute control of Old Sub, but the public shareholders are not required to retain control. See section 355(a)(1)(D). Thus, the disposition of control as a result of Acquirer's investment does not necessarily preclude tax-free treatment.

f. Example 5 -- IPO by Controlled without a "D" reorganization



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

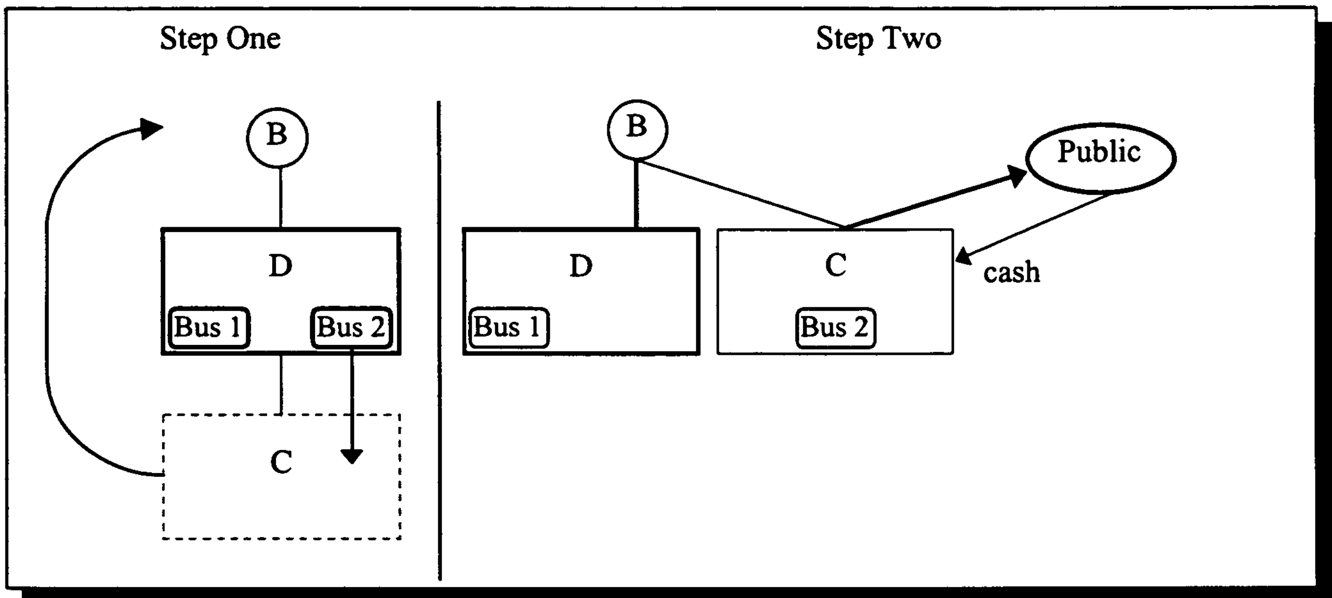
(2) Issues:

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

b) Although more recent Service announcements threw substantial doubt on this conclusion, the Service conceded this conclusion in Rev. Rul. 98-27, in which it stated that it would not apply the step-transaction doctrine for purposes of determining whether Distributing owns and distributes "control," solely because of post-distribution acquisitions or restructurings of Controlled.

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

g. Example 6 -- "D" reorganization followed by IPO



(1) Facts: Assume the same facts as in Example 5, except that Business 2 is not already conducted in a separate subsidiary. Therefore, Distributing forms Controlled as part of the transaction (i.e., a "D" reorganization is necessary).

(2) Issues:

a) The contribution of Business 2 to Controlled is a "D" reorganization, which requires the Distributing shareholders to be in control of Controlled "immediately after" the transaction.

b) Note that in this situation, up to 20 percent of the Controlled stock could be offered in the IPO. Under prior law, the sale of more than 20 percent would cause the transaction to fail the control requirement of a "D" reorganization. The control limitation imposed by a "D" reorganization would apply even if Controlled were a pre-existing

subsidiary, as long as any property were transferred to Controlled as part of the transaction.

c) There is an issue, however, as to whether aggregating the contribution of cash in the IPO with the contribution of property by Distributing would cause the Service to treat the transaction as if the public offering had occurred prior to the spin-off, in which case the distribution would fail, because Distributing would not have distributed stock constituting control of Controlled. Compare Rev. Rul. 73-246, 1973-1 C.B. 181 (spin-off of Controlled followed by contribution to capital of Controlled in exchange for 25 percent of Controlled stock was not recharacterized as contribution to capital followed by spin-off; accordingly stock constituting control of Controlled was distributed, and the spin-off qualified under section 355) with Rev. Rul. 70-225, 1970-1 C.B. 80, obsoleted, Rev. Rul. 98-44, I.R.B. 1998-37 ("D" reorganization followed by exchange of Controlled stock for stock in X, an unrelated corporation, recharacterized as contribution of assets by Distributing to X for X stock, followed by distribution of the X stock by Distributing).

    i) This transaction, however, could have qualified as a transaction under sections 351 and 355 rather than a failed "D" reorganization and section 355 transaction. See Treas. Reg. § 1.351-1(a)(3) (stating that if a person acquires stock of a corporation from an underwriter in exchange for cash in a qualified underwriting transaction, for section 351 purposes, the person acquiring the stock from the underwriter is treated as transferring cash directly to the corporation in exchange for stock, and the underwriter is disregarded). See also Rev. Rul. 78-294, 1978-2 C.B. 141 (treating public who purchased shares from an underwriter as transferors for purposes of the section 351 control test), obsoleted by T.D. 8665, I.R.B. 1996-21 (promulgating Treas. Reg. § 1.351-1(a)(3)).

ii) In Rev. Rul. 62-138, the Service treated the dropdown of assets and subsequent distributions as a section 351 transaction (not a "D" reorganization) followed by successive section 355 transactions (presumably to avoid the "D" reorganization control issue); see also section 351(c).

iii) Moreover, in P.L.R. 9236007 (Feb. 14, 1992), and P.L.R. 9141029 (July 11, 1991), "D" reorganizations followed by multiple spin-offs were approved.

d) The Service appears to have adopted a contrary position on these issues within the space of a few months, which caused considerable confusion. First, in the private ruling issued to Viacom (described above), the Service, in effect, ruled that an issuance of stock following a section 355 distribution should not disqualify the distribution, even though the distributing corporation's shareholders were no longer in control of the controlled corporation following the stock issuance. Almost immediately thereafter, however, the Service issued Rev. Proc. 96-39, 1996-2 C.B. 300.

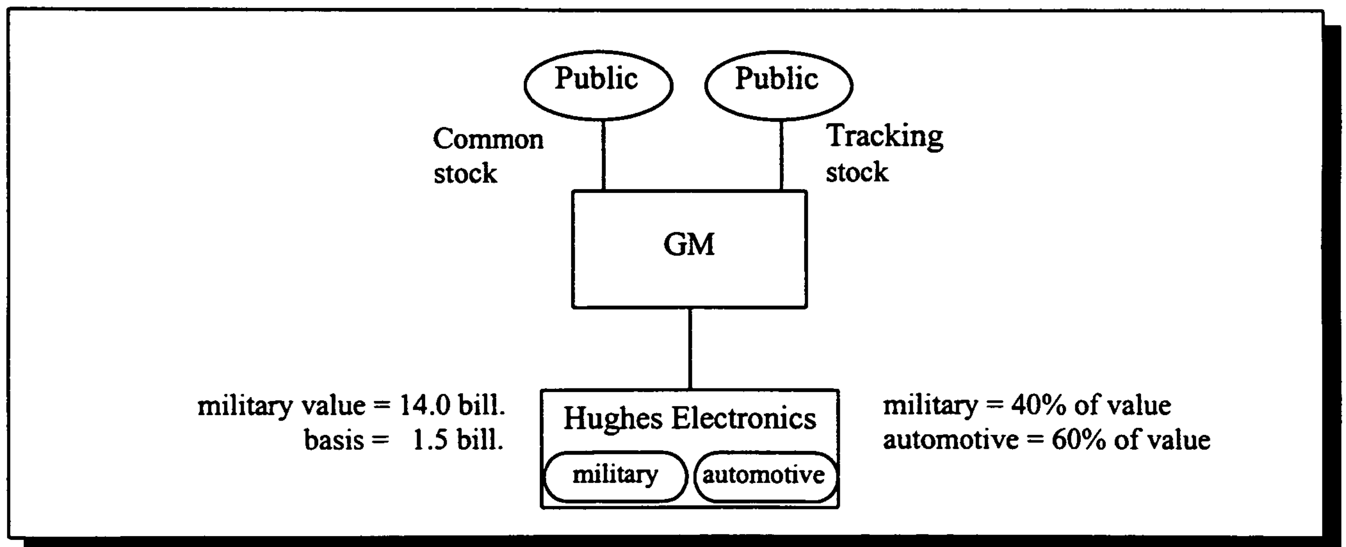
i) In Rev. Proc. 96-39, the Service announced that it would not issue advance rulings when there are "negotiations, plans or arrangements" to consummate a subsequent transaction that, if consummated before the distribution, would have precluded a distribution of control of the distributed corporation. The Revenue Procedure stated that the issue of post-distribution transactions was under extensive study.

ii) However, the no-rule position taken by the Service in Rev. Proc. 96-39 was revoked in Rev. Proc. 97-53, 1997-2 C.B. 528. It is unclear whether this revocation meant that the Service would no longer apply step-transaction principles to these types of transactions or whether it would look to the facts of each case.

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

e) Thus, the fact that Controlled issues 55 percent of its stock in an IPO will not affect whether the control requirement of section 368(a)(1)(D) is satisfied.

h. <u>Example 7 -- GM-Raytheon transaction (simplified)</u>



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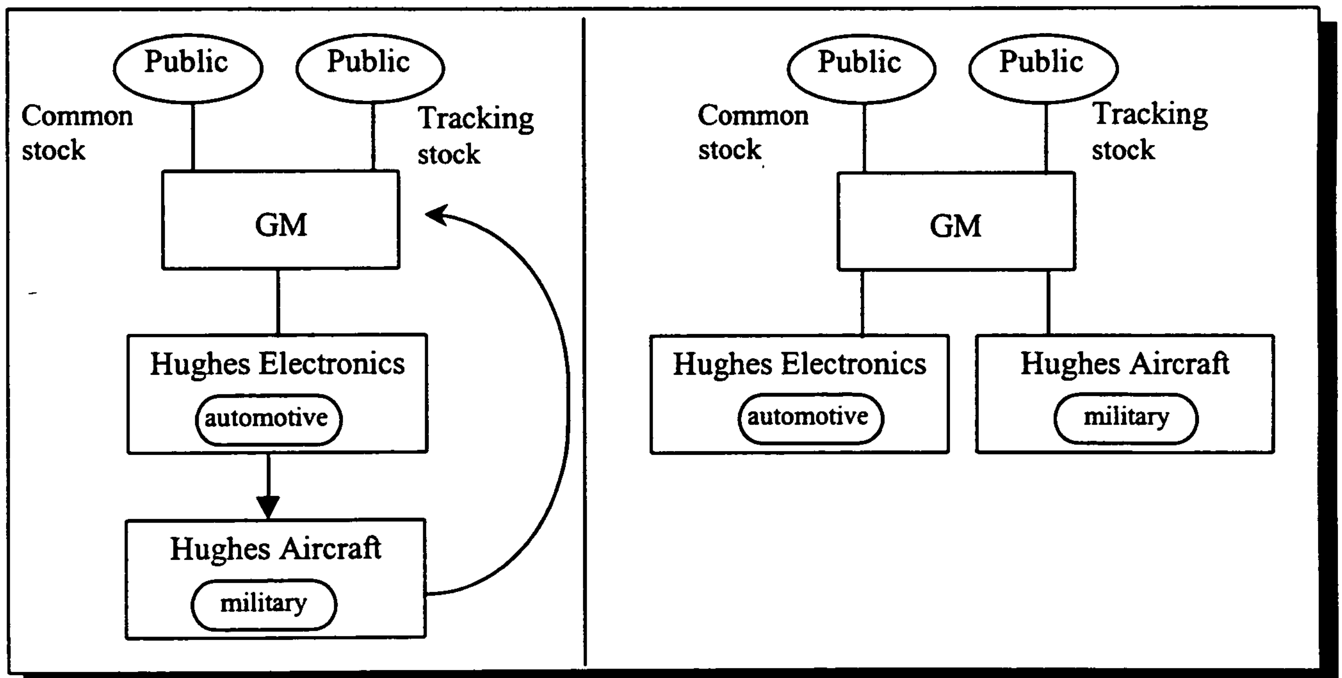
(1) Facts:

a) General Motors ("GM") owns all of the stock of Hughes Electronics Corp. ("Hughes Electronics"). GM has stock outstanding that is held by public shareholders. In addition, GM has issued a class of tracking stock that tracks the performance of Hughes Electronics; the tracking stock entitles the holders to 24 percent of Hughes Electronics' hypothetical earnings. If GM disposes of a Hughes business, the tracking shares automatically convert to regular GM shares, at a ratio of 120 percent of the tracking share price divided by the GM share price.

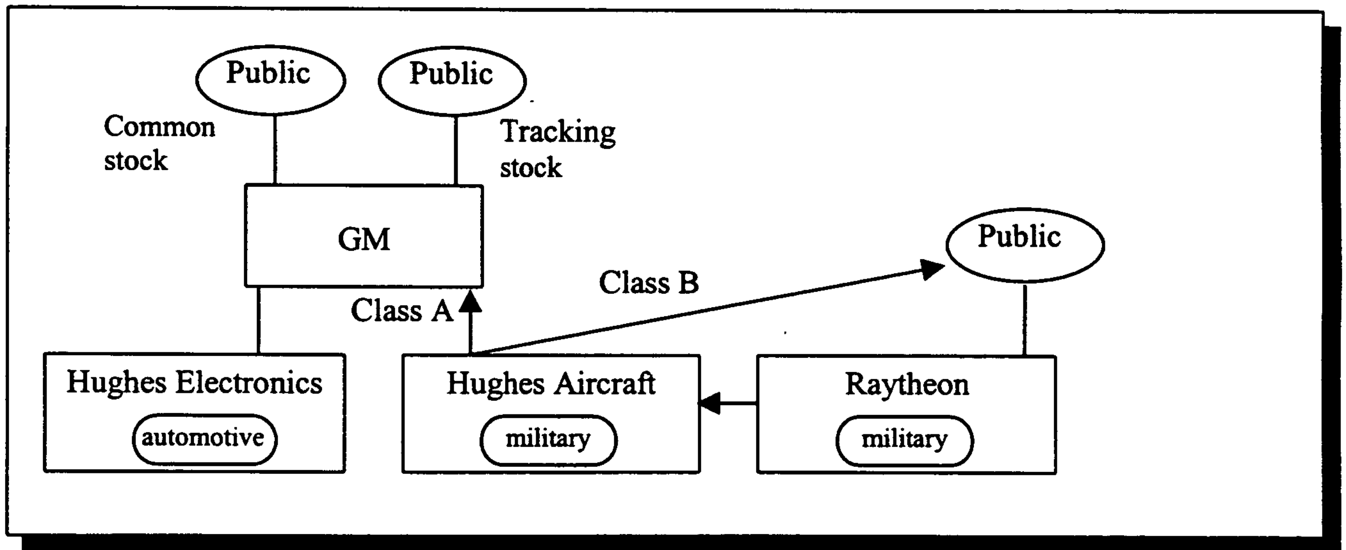
b) GM wishes to dispose of the military electronics ("military") business of Hughes Electronics, which accounts for about 40 percent of the subsidiary's value, to Raytheon Co. ("Raytheon") for approximately $9.5 billion in cash and Raytheon shares. GM plans to keep Hughes Electronics' automotive electronics ("automotive") business. Hughes Electronics has a substantial unrealized gain in the military electronics business.

c) GM therefore causes Hughes Electronics to contribute its military business to a new subsidiary, Hughes Aircraft, and distribute its shares of the new Hughes Aircraft to GM.

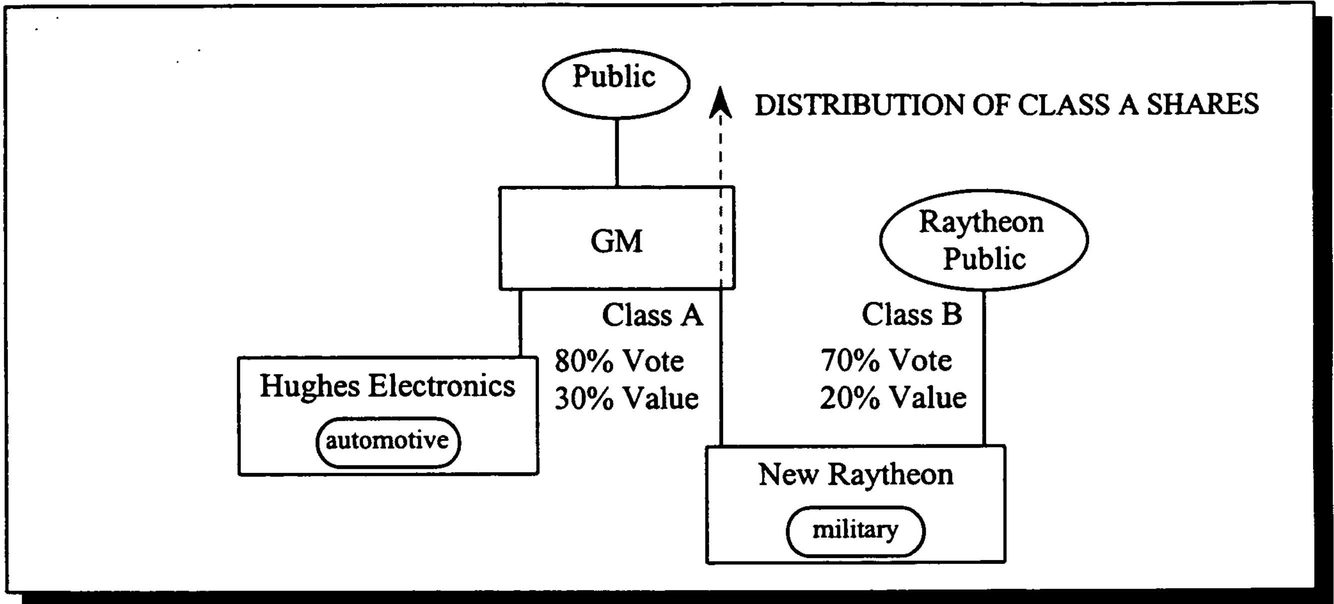


d) Hughes Aircraft will borrow roughly $4.4 billion and distribute the $4.4 billion to GM. (Raytheon will effectively assume this liability when it merges into Hughes Aircraft as described below).

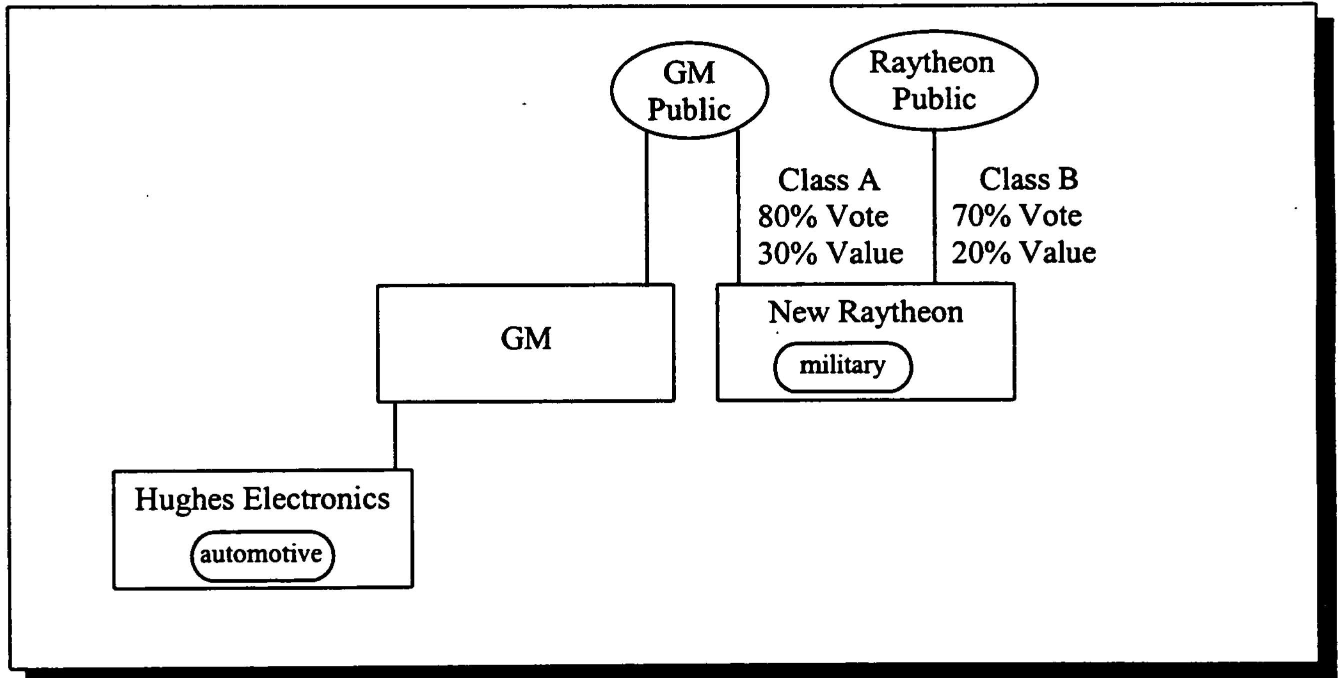
e) Raytheon will then merge with and into Hughes Aircraft in a transaction governed by section 368(a)(1)(A). (Although the surviving entity will be Hughes Aircraft, the merged companies will be renamed Raytheon.) Hughes Aircraft will issue two classes of stock, class A and class B in the merger. Class A (supervoting) shares will have 80 percent of the voting power and 30 percent of the value of the combined companies. Class B shares will have 70 percent of the value and 20 percent of the voting power. GM will exchange its Hughes Aircraft stock for Class A stock. Raytheon shareholders will exchange their Raytheon shares for the class B shares in the merger. This merger may cause the tracking stock to be converted into GM common stock.



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



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



(2) Issues:

a) Section 355(a)(1)(A) requires that the distributing corporation have "control," defined in section 368(c), of the controlled corporation immediately before the distribution. Under section 368(a)(1)(D), if the transaction also involves a "D" reorganization, the distributing corporation and its shareholders must "control" the distributee corporation immediately after the distribution. In addition, the distributing corporation must distribute all of its holdings in the controlled corporation or distribute shares representing "control" of the distributed corporation, provided that the transaction does not have the principal purpose of tax avoidance.

b) The distribution of Hughes Aircraft by Hughes Electronics to GM should qualify under section 355 and 368(a)(1)(D) despite the fact that Hughes Aircraft is distributed to the GM shareholders. See Rev. Rul. 62-138, 1962-2 C.B. 95 (second spin will not cause first spin to fail the "control" test).

c) The key question is whether the second distribution of Hughes Aircraft Class A stock to the GM shareholders qualifies under sections 355 and 368(a)(1)(D). Technically, control is defined as the ownership of 80 percent of all classes of voting stock and 80 percent of each other class of stock. Here both Class A and Class B shares are voting stock and are accordingly aggregated for purposes of the test. Thus, if the form is respected, GM owns 80 percent of the voting stock prior to the distribution. There are no classes of nonvoting stock. GM distributes all of its Class A stock to the GM shareholders who presumably retain this stock. Technically, therefore, the various control tests appear to be met.

d) One could view the transaction, however, as if Hughes Aircraft had acquired Raytheon for 70 percent of its sole class of common stock and Hughes Aircraft had then recapitalized into two classes of stock to provide GM with the requisite control for the second spin-off. The Service generally has approved recapitalizations intended to

ensure the requisite control to permit a spin-off. See, e.g., Rev. Rul. 69-407, 1969-2 C.B. 50; Rev. Rul. 56-117, 1956-1 C.B. 180; G.C.M. 34,122 (May 8, 1969). But see Rev. Rul. 63-260, 1963-1 C.B. 147 (in which the Service disqualified a spin-off preceded by a similar augmentation of voting power).

e) Additional issues arise with respect to the cash distribution.

i) Should this be treated as boot in the first section 355 transaction? If so, under Treas. Reg. § 1.1502-13(f), it will be deemed to be a dividend occurring before the spin-off and will result in a reduction in the basis of the corporation distributing the cash. Treas. Reg. § 1.1502-13(f)(3)(i) & (f)(7), Ex. 3(d).

ii) Query whether this cash distribution will trigger an excess loss account under Treas. Reg. § 1.1502-19 and if so, how this will be treated. An excess loss account in the stock of Hughes Aircraft should be triggered upon the deconsolidation of Hughes Aircraft. See Treas. Reg. § 1.1502-19(c)(1)(ii). Conversely, if Hughes Aircraft makes the distribution to Hughes Electronics before the first spin-off, arguably the resulting excess loss account will not be triggered, because the first spin-off does not result in a deconsolidation of Hughes Aircraft. The excess loss account in the Hughes Aircraft stock may be wholly or partly eliminated when GM substitutes part of its basis in Hughes Electronics onto the stock it receives in Hughes Aircraft. See Treas. Reg. § 1.1502-19(g), Ex. 3.

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

C. Device Restriction

1. In general

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

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

b. Whether a transaction is used principally as a device for the distribution of earnings and profits is determined by a review of all the facts and circumstances surrounding the transaction. Treas. Reg. § 1.355-2(d)(1).

(1) The regulations specifically enumerate various factors that are evidence of a device and that are evidence of the absence of a device. The strength of this evidence depends on all the facts and circumstances. The regulations also state that additional factors not expressly stated in the regulations bear on whether or not the transaction has been undertaken as a device. Treas. Reg. § 1.355-2(d)(1), (d)(2)(i).

(2) The regulations also provide that certain transactions are ordinarily not considered a device despite the existence of factors which evidence a device. Treas. Reg. § 1.355-2(d)(5)(i).

2. Evidence of a device

a. Pro rata distribution

A distribution that is pro rata or substantially pro rata presents the greatest potential for the withdrawal of earnings and profits and is

more likely to be undertaken as a device. Thus, the fact that a distribution is pro rata or substantially pro rata is evidence of a device. Treas. Reg. § 1.355-2(d)(2)(ii).

b. Subsequent sale or exchange of stock

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

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

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

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

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

e) Example

Corporation W is owned by individual A. W has one wholly owned subsidiary, X. Both corporations have been engaged in business for more than five years and have substantial accumulated earnings and profits. Under state law, W can no longer hold

the stock of X. Individual B has offered to purchase the stock of X. This offer was rejected and it was determined that the stock of X would be distributed to A. Before the distribution, A agrees to sell to B one-half of his interest in X after the distribution. Despite the existence of a non-tax reason for the distribution, the subsequent sale of stock is considered to be substantial evidence of a device.

(2) Rev. Proc. 96-30, § 4.05(6), 1996-1 C.B. 696, provides a safe harbor from the device test for corporations that, for a valid business reason, purchase their own stock after a section 355 distribution. In order to take advantage of the safe harbor, it must be represented in the ruling request that the following conditions are met with respect to both the distributing and controlled corporations:

a) there is a sufficient business purpose for the stock purchase;

b) the stock to be purchased is widely held;

c) the stock purchases will be made in the open market; and

d) there is no plan or intention that the aggregate amount of stock purchases will equal or exceed 20 percent of the outstanding stock of the corporation.

Even if the stock purchases do not meet these requirements, the Service will consider ruling on whether the purchases violate the device requirement of section 355(a)(1)(B) after considering all of the facts and circumstances of each case. See, e.g., P.L.R. 9622016 (Feb. 28, 1996) (repurchase of up to 15 percent of outstanding stock).

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

(4) For purposes of the device test, an exchange of stock pursuant to a plan of reorganization in which no gain or loss is recognized or only an insubstantial amount of gain is recognized is not considered to be an exchange and, thus, is not subject to the provisions relating to pre-arranged sales or exchanges. Treas. Reg. § 1.355-2(d)(2)(iii)(E).

a) Thus, a corporate division preceding a tax-free acquisition of the distributing or controlled corporation should not violate the device restriction of section 355.

b) The Service has ruled that a corporate division under section 355 accomplished to facilitate a subsequent tax-free acquisition of the distributing or controlled corporation is not a device for the distribution of earnings and profits. Rev. Rul. 78-251, 1978-1 C.B. 89; Rev. Rul. 75-406, 1975-2 C.B. 125; Rev. Rul. 72-530, 1972-2 C.B. 212; Rev. Rul. 70-434, 1970-2 C.B. 83.

c) Nevertheless, a corporate division undertaken to facilitate the tax-free acquisition of a controlled corporation may not meet the control requirements of section 355 as a result of the application of step-transaction principles. See Part III.B.4., supra (discussing Rev. Rul. 70-225, 1970-1 C.B. 80, obsoleted, Rev. Rul. 98-44, I.R.B. 1998-37 and Rev. Rul. 96-30, 1996-1 C.B. 36, obsoleted, Rev. Rul. 98-27, I.R.B. 1998-22).

d) A section 355 transaction followed by a tax-free reorganization will also be scrutinized under the continuity of interest requirement. See Part III.G., infra.

c. Nature and use of assets

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

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

a) This rule is broader than the rule contained in the proposed regulations that referred only to cash and other liquid assets and trades or businesses acquired within the five-year period ending on the date of the distribution. See Prop. Treas. Reg. § 1.355-2(c)(3).

b) The preamble to the regulations specifically refers to excess inventory as possibly evidencing a device. This was not covered by the proposed regulations.

(2) The existence of a device based on the nature of the assets depends in part on the ratio for each corporation of the value of the assets not used in an active trade or business to the value of the assets used in an active trade or business. Treas. Reg. § 1.355-2(d)(2)(iv) (B).

a) Different ratios for the distributing and the controlled corporation is not ordinarily evidence of a device if the distribution is not pro rata and such difference is attributable to a need to equalize the value of the stock distributed and the value of the stock and securities exchanged. Treas. Reg. § 1.355-2(d)(2)(iv)(B).

b) Evidence of a device presented by the transfer or retention of assets not used in an active trade or business can be outweighed by the existence of a corporate business purpose for those transfers or retentions. Treas. Reg. § 1.355-2(d)(3)(ii). See Part III.C.3.a., infra.

c) Query whether an imbalance in ratios as well as a transfer or retention of assets not used in an active trade or business, both being evidence of a device, results in section 355 being unavailable to a corporation with substantial assets not being used in an active trade or business?

i) It should be noted that the active business requirement may be satisfied if only five percent of a corporation's assets are used in the trade or business. See Part III.D.5., infra.

d) Assets that are not used in an active trade or business include cash and other liquid assets that are not related to the reasonable needs of the business. Treas. Reg. § 1.355-2(d)(2)(iv)(B).

(3) There is evidence of a device if a business of either the distributing or the controlled corporation has the principal function of serving the activities of the other corporation for a significant period of time after the separation, and

such business can be sold without adversely affecting the activities of the other corporation. Treas. Reg. § 1.355-2(d)(iv)(C).

a) The proposed regulations provided a similar rule, except that it was not limited to a situation in which the related function could be sold without adversely affecting the activities of the other corporation.

b) The limitation added by the final regulations is apparently designed to limit this provision to situations in which the related function could be easily sold thereby permitting a bail-out of earnings and profits.

c) Although such a functional relationship may violate the device requirement, it should satisfy the active business requirement, which permits the horizontal division of a business. <u>See</u> Part III.D.8., <u>infra</u>.

(4) <u>Examples</u>

a) Corporation W is owned by individual A. W has one wholly owned subsidiary, X. Both corporations have been engaged in business for more than five years and have substantial accumulated earnings and profits. Under state law, W can no longer hold the stock of X. It is determined that the stock of X is to be distributed to A. Prior to the distribution of X to A, W transferred cash to X not related to the reasonable business needs of the business of X. As a result of the transfer of cash, the ratio of the value of the assets not used in an active trade or business to the value of the assets used in an active trade or business is substantially greater for X than for W. This is relatively strong evidence of a device. The distribution is pro rata, which is also evidence of a device. The business purpose although normally evidence that the transaction was not undertaken as a device does not relate to the transfer of funds. The transaction is considered to be a device. Treas. Reg. § 1.355-2(d)(4), Ex. 3.

b) For eight years, corporation K has been engaged in the manufacture and sale of steel and steel products. For six years, K's wholly owned subsidiary, L, has owned and operated a coal mine for the sole

purpose of supplying K's coal requirements in the manufacture of its steel. It is proposed that the stock of L be distributed to the shareholders of K. If the coal mining business continued to operate in the same manner after the transaction, and the sale of the coal mine did not adversely affect the steel business, then the distribution of X would be considered evidence of a device. Treas. Reg. § 1.355-2(d)(2)(iv)(B).

3. Evidence of nondevice

a. Corporate business purpose

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

(1) The importance of achieving the purpose to the success of the business;

(2) The extent to which the transaction is prompted by a person not having a proprietary interest in either corporation, or by other outside factors beyond the control of the distributing corporation; and

(3) The immediacy of the conditions prompting the transaction.

Treas. Reg. § 1.355-2(d)(3)(ii).

b. Distributing corporation publicly traded and widely held

The fact that the distributing corporation is publicly traded and has no shareholder who is directly or indirectly the beneficial owner of more than five percent of any class of stock is evidence that the transaction is not a device. Treas. Reg. § 1.355-2(d)(3)(iii).

c. Distribution to domestic corporate shareholders

The fact that stock of the controlled corporation is distributed to one or more domestic corporations that, if section 355 did not apply, would be entitled to an 80-percent or 100-percent dividends-received-deduction under section 243(c) or section 243(a)(2) or (3)

is evidence that the transaction is not a device. Treas. Reg. § 1.355-2(d)(3)(iv).

4. <u>Transactions not ordinarily considered a device</u>

a. <u>Absence of earnings and profits</u>

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

(1) The last requirement of this safe harbor (<u>i.e.</u>, that the distributing corporation hold no appreciated property) may effectively eliminate the viability of this rule as to C corporations, since few if any corporations own no appreciated property.

(2) However, an S corporation with no preconversion earnings and profits may satisfy this safe harbor even if it does hold appreciated property. Thus, the safe harbor, while of limited utility for C corporations, may prove a valuable planning tool for S corporations. For example, an S corporation with a small amount of preconversion earnings and profits may choose to make a dividend distribution under section 1368(e)(3) in order to purge itself of earnings and profits prior to a divisive "D" reorganization.

b. <u>Section 302 or 303 transaction</u>

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

5. Additional factors not contained in the regulations

a. Prior sales of stock

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

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

b. Earnings of one business invested in other business

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

D. Five-Year Active Trade or Business Requirement

1. In general

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

b. With respect to split-ups, the distributing corporation must not hold any assets other than stock or securities in controlled corporations immediately before the distribution, and each of the controlled corporations must be engaged in the active conduct of a trade or business immediately after the distribution. Section 355(b)(1)(B). A de minimis test is applicable in determining whether the distributing corporation holds prohibited assets. Treas. Reg. § 1.355-3(a)(1)(ii).

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

A corporation is treated as engaged in the active conduct of a trade or business if each of the following four requirements is satisfied:

a. The corporation is engaged in the active conduct of a trade or business, or "substantially all" of its assets consist of stock or securities in corporations that it controls which are so engaged. Section 355(b)(2)(A). Thus, a corporation can conduct a business directly or it can hold the stock of subsidiaries that conduct an active business.

b. The trade or business has been actively conducted throughout the five-year period ending on the date of the distribution. Section 355(b)(2)(B).

c. The trade or business was not acquired during the five-year period ending on the date of the distribution in a transaction in which any gain or loss was recognized. Section 355(b)(2)(C).

d. Control of a corporation conducting such trade or business was not acquired by the distributing corporation or any distributee corporation directly or through one or more other corporations within the five-year period preceding the distribution in a transaction in which any gain or loss was recognized. Section 355(b)(2)(D).

3. Trade or business

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

a. The regulations provide a broad definition of what activities constitute a trade or business, primarily focusing on whether the purpose of the activities is to generate a profit. However, the regulations also provide that the activities must include all steps in the process of earning income, specifically noting that ordinarily these steps must include the collection of income and the payment of expenses. Treas. Reg. § 1.355-3(b)(2)(ii).

b. In 1988, the Service revoked a number of older revenue rulings, which concluded without analysis that a trade or business existed. Rev. Rul. 88-19, 1988-1 C.B. 114.

4. Active conduct

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

a. In order for a trade or business to be considered actively conducted, the corporation itself must perform active and substantial management and operational functions. Treas. Reg.

§ 1.355-3(b)(2)(iii); Rev. Rul. 88-19, 1988-1 C.B. 114. The Service has ruled that one managerial employee and one operating employee are sufficient. Rev. Rul. 73-234, 1973-1 C.B. 180, distinguished Rev. Rul. 86-126, 1986-2 C.B. 58.

(1) Generally, activities of independent contractors or others outside the corporation are not taken into account. Treas. Reg. § 1.355-3(b)(2)(iii).

(2) The Service has ruled that the active business requirement is not met with regard to the rental of an office building where the building is managed by an unrelated management company acting as an independent contractor. Rev. Rul. 86-125, 1986-2 C.B. 57.

(3) The Service has also ruled that the activities of tenant farmers are not taken into account in determining whether the landlord farmer is actively engaged in the farming business. Rev. Rul. 86-126, 1986-1 C.B. 59; cf. Rev. Rul. 73-234, 1973-1 C.B. 180 (landlord who had employee performing substantial managerial and operational functions considered to be in an active business).

(4) In addition, the corporation must carry on operational activities -- it cannot merely hold non-operating assets for use by a related corporation. See Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998).

(5) However, the Service has ruled that a corporation may take into account the operational activities of employees of an affiliated entity, as long as the corporation's officers perform active and substantial management functions for that affiliated entity. See Rev. Rul. 79-394, 1979-2 C.B. 141, amplified by Rev. Rul. 80-181, 1980-2 C.B. 121 (ruling that a controlled corporation with no paid employees of its own was engaged in an active business using employees of a sister corporation, where its officers performed substantial management functions); Rev. Rul. 92-17, 1992-1 C.B. 142 (ruling that a corporation that is a general partner in a limited partnership was engaged in an active business where its officers performed substantial management functions for the partnership).

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

(1) Holding stock, securities, land, or other property for investment purposes. Treas. Reg. § 1.355-3(b)(2)(iv).

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

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

d. An aspect of the "active conduct" test that is likely to generate increasing dissatisfaction on the part of taxpayers is the requirement that the business have generated gross receipts for the preceding five years.

(1) The Service apparently will not rule unless the taxpayer submits income statements demonstrating gross receipts. See Rev. Proc. 96-30, § 4.03(h), 1996-1 C.B. 696. By contrast, the regulations merely state that "ordinarily" the active conduct of a business includes the collection of income. The regulations suggest that the determination of whether an active business exists should be made based on all the facts and circumstances.

(2) The Service has previously ruled on one occasion that an oil and gas exploration business did not meet the active conduct test, because it had not generated gross receipts during the relevant period. See Rev. Rul. 57-492, 1957-2 C.B. 247.

(3) Gross receipts ordinarily are indicative of the active conduct of a business. However, the absence of such gross receipts should not preclude a finding of an active trade or business. The requirement that a business have gross receipts to be considered "active" reflects outdated assumptions based on a manufacturing economy. Increasingly, high technology businesses may spend a number of years developing intangible assets through research and development before these assets can be translated into a viable product for sale to customers in the ordinary course. Given the commitment of capital and personnel, such start-up companies should be treated as engaged in the active conduct of a business, regardless of whether the business has gross receipts. In an increasingly knowledge-based economy, the Code should not discriminate between businesses that are in different stages of the product development cycle.

e. Examples

(1) Corporation D, a bank, has for the past seven years owned an 11-story building. D occupies the ground floor of this building to conduct its banking business. The remaining 10 floors of the building are rented to various tenants. This rental activity is managed and maintained by employees of the bank. D proposes to transfer the building to a new corporation and to distribute the stock of the new corporation to its shareholders. The new corporation will manage the building, negotiate leases, seek new tenants, and will repair and maintain the building. Immediately after the distribution the activities in connection with banking will constitute the active conduct of a trade or business, as will the activities in connection with the rental of the building. Treas. Reg. § 1.355-3(c), Ex. 12.

(2) Corporation E, a bank, has for the past nine years owned a two-story building. E occupies the ground floor of the building and one-half of the second floor to conduct its banking business. The other one-half of the second floor is rented as storage space. E proposes to transfer the building to a new corporation and to distribute the stock of the new corporation to its shareholders. E will lease the space occupied by it from the new corporation and, under the lease, will repair and maintain its portion of the building and pay property taxes and insurance. The new corporation will not be engaged in the active conduct of a trade or

business immediately after the distribution. Treas. Reg. § 1.355-3(c), Ex. 13.

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

a. The Service has noted that there is no requirement in section 355(b) that a specific percentage of a corporation's assets be devoted to the active conduct of a trade or business. See Rev. Rul. 73-44, 1973-1 C.B. 182, clarified, Rev. Rul. 76-54, 1976-1 C.B. 96. In this ruling, less than half of the value of the controlled corporation was attributable to assets used in the corporation's active business. See also P.L.R. 8712019 (Dec. 18, 1986) (6 percent of the corporation's assets devoted to the active conduct of its trade or business); G.C.M. 36,069 (Nov. 5, 1974) (16 percent of the corporation's assets devoted to the active conduct of its trade or business).

b. In G.C.M. 34,238 (Dec. 15, 1969), the Service concluded that a corporation (Eversharp) having assets attributable to its active business equal to only five percent of the corporation's net book value, and holding large blocks of stock in two publicly traded corporations (Schick and Technicolor), could be considered to be engaged in the active conduct of a trade or business.

c. For ruling purposes, the Service has indicated that it generally will not rule favorably if the gross assets of the trades or businesses relied on to satisfy the active trade or business requirement of section 355(b) will have a fair market value that is less than five percent of the total fair market value of the gross assets of the corporation directly conducting the trades or businesses. The Service may rule that the trades or businesses satisfy the active trade or business requirement of section 355(b) if it can be established that, based upon all relevant facts and circumstances, the trades or businesses are not de minimis compared with the other assets or activities of the corporation and its subsidiaries. See Rev. Proc. 96-43, 1996-2 C.B. 330.

d. A high percentage of liquid or investment assets may, however, be evidence of a device.

(1) In one transaction, Distributing operated a business directly and also owned a large interest in portfolio stock of a publicly traded corporation. For valid business reasons, Distributing spun-off Controlled so that Controlled could do an IPO to pay down debt. The Service focused on the large percentage of portfolio stock held by Distributing but approved the transaction, because the stock had been held

by Distributing for a significant period of time, and the Service concluded that the stock was in the nature of an investment asset rather than a means of bailing out earnings and profits.

6. Five-year period

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

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

b. Change in business

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

c. Expansion of business

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

> [I]f a corporation engaged in the active conduct of one trade or business during that five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is

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

(2) This appears to overrule Boettger v. Commissioner, 51 T.C. 324 (1968) (business acquired within five years of split-up not considered an expansion even though it was the same type as the acquiring corporation's business and it was integrated into the acquiring corporation's operations).

(3) Thus, if the acquisition of a business constitutes an expansion, the expansion may qualify as a five-year trade or business even if the expansion itself has not been operated for five years. See Treas. Reg. § 1.355-3(c), Exs. 5, 7, and 8.

(4) An expansion of a business may occur in a different geographic location from that of the original operations of a qualifying business. See Treas. Reg. § 1.355-3(c), Ex. 7.

(5) The Service has also ruled that a dealer holding a franchise for the sale and service of a particular brand of automobile tires who acquired a franchise to sell and service another brand of tires is considered to be in two separate businesses. Rev. Rul. 57-190, C.B. 1957-1 C.B. 121. It is unclear whether this ruling is still valid given the Service's position in the regulations regarding an expansion in the same line of business inheriting the history of the existing business.

(6) The regulations now permit the division of a single business. It can be expected, therefore, that when a taxpayer is engaged in two similar businesses, one that satisfies the five-year requirement and one that does not, the taxpayer will argue that the newer business is an expansion of the older business. Presumably the Service will argue that two separate businesses exist.

(7) Example

Corporation P has owned and operated a department store in City W for nine years. Three years ago, it acquired a parcel of land in the suburbs of City W and constructed a

branch store. P proposes to transfer the suburban store to a new corporation and distribute the stock of the new corporation to its shareholders. Each corporation will satisfy the five-year active trade or business requirement. Treas. Reg. § 1.355-3(c), Ex. 7; accord, Estate of Lockwood v. Commissioner, 350 F.2d 712 (8th Cir. 1965).

(8) The regulations do not address whether a subsidiary's operations may constitute an expansion of the parent corporation's qualifying five-year trade or business. The Tax Court has held, however, that a subsidiary's operations may constitute an expansion of the parent corporation's qualifying business. See Athanasios v. Commissioner, 69 T.C.M. (CCH) 1902 (1995); cf. Rev. Rul. 79-394, 1979-2 C.B. 141, amplified by Rev. Rul. 80-181, 1980-2 C.B. 121 (ruling that a controlled corporation with no paid employees of its own was engaged in an active business using employees of a sister corporation, where its officers performed substantial management functions); Rev. Rul. 92-17, 1992-1 C.B. 142 (ruling that a corporation that is a general partner in a limited partnership was engaged in an active business where its officers performed substantial management functions for the partnership).

d. It appears that a distributing corporation can push-down a qualified five-year business to a controlled corporation that is not engaged in a qualifying business so that the controlled corporation satisfies the active business requirement. Rev. Rul. 73-44, 1973-1 C.B. 182, clarified, Rev. Rul. 76-54, 1976-1 C.B. 96.

e. The Service has ruled that a temporary cessation of activities is not taken into account for purposes of the five-year requirement. Rev. Rul. 57-126, 1957-1 C.B. 123.

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

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

a. Section 355(b)(2)(D) was amended by the 1987 Act to preclude the use of section 355 in the following transaction:

(1) In Rev. Rul. 74-5, 1974-1 C.B. 82, obsoleted, Rev. Rul. 89-37, 1989-1 C.B. 107, corporation P purchased all of the stock of X, which owned all the stock of Y. Two years after P's purchase of X, X distributed the stock of Y to P. As of the time of the distribution, X had owned the Y stock for the requisite five-year period. One year after the distribution of Y to P, P distributed the same Y stock to its shareholders.

(2) The Service concluded that the first distribution (Y stock to P) qualified as a section 355 transaction. Even though P acquired control of Y indirectly within five years, the Service concluded that section 355(b)(2)(D) (as then in effect) did not prevent the application of section 355.

(3) The Service reasoned that section 355(b)(2)(D) was intended to prevent a distributing corporation from accumulating excess funds to purchase stock of a corporation having an active trade or business and immediately distributing such stock to its shareholders.

(4) Thus, section 355(b)(2)(D) did not apply to P, because P was merely a shareholder and was not the distributing or controlled corporation. That is, P was not attempting to bail out its earnings through the distribution of Y stock.

(5) However, section 355(b)(2)(D) (as then in effect) did apply to the second distribution (Y stock distributed by P), since P had indirectly acquired the stock of Y in a taxable exchange (the purchase of X) within five years. Thus, under section 355(b)(2)(D), Y was not considered to be engaged in an active trade or business.

(6) As a result of the amendment to section 355(b)(2)(D) by the 1987 Act, the focus now is whether the distributee corporation or the distributing corporation acquired control, either directly or indirectly, of the corporation that is being distributed in a transaction in which any gain or loss is recognized. Thus, the distribution by X of the Y stock in Rev. Rul. 74-5 is no longer tax free. Rev. Rul. 74-5 was rendered obsolete by Rev. Rul. 89-37, 1989-1 C.B. 107.

(7) It should be noted that the 1987 amendment to section 355(b)(2)(D) only applies to corporate distributees, i.e., it does not apply to individuals, partnerships, or trusts. Furthermore, the 1987 amendment only applies to the acquisition of control as defined in section 368(c).

a) Thus, under section 355(b)(2)(D), as amended by the 1987 Act, it is possible for a non-corporate purchaser to acquire control of the distributing corporation or for a corporation to purchase less than an 80-percent interest in the distributee and distribute stock of a controlled corporation tax free under section 355.

b. Section 355(d) has further restricted the use of section 355 with respect to distributions made after October 9, 1990 to all distributees and not just corporate distributees. See Part III.I., infra.

8. Division of a functionally integrated business

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

(1) Vertical division

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

(2) Horizontal division

a) The regulations also provide that the horizontal division of a functionally integrated business satisfies the active trade or business requirement of section 355. See Treas. Reg. § 1.355-3(c), Ex. 9. The horizontal division of a functionally integrated business includes, for example, the separation of selling and manufacturing activities.

b) Nevertheless, the horizontal division of a business may violate the device requirement. See Part III.C., supra.

b. Because the division of a functionally integrated business can satisfy the active trade or business requirement, taxpayers will try to treat modifications to an existing business as a continuation of that business. See Part III.D.6.b., supra.

c. Examples

(1) Vertical division

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

(2) Horizontal division

Corporation I has processed and sold meat products for eight years. It has no other income. I proposes to separate the selling from the processing activities by forming corporation J to purchase for resale the meats processed by K. I will transfer to J certain physical assets pertaining to the sales function, plus cash for working capital, in exchange for capital stock in J, which will be distributed to the shareholders of I. Immediately after the distribution, I will be engaged in the active conduct of a meat processing business, and J will be engaged in the active conduct of a meat distribution business. The business of each corporation is deemed to have been actively conducted from the date I began its meat processing and sales business. Treas. Reg. § 1.355-3(c), Ex. 10.

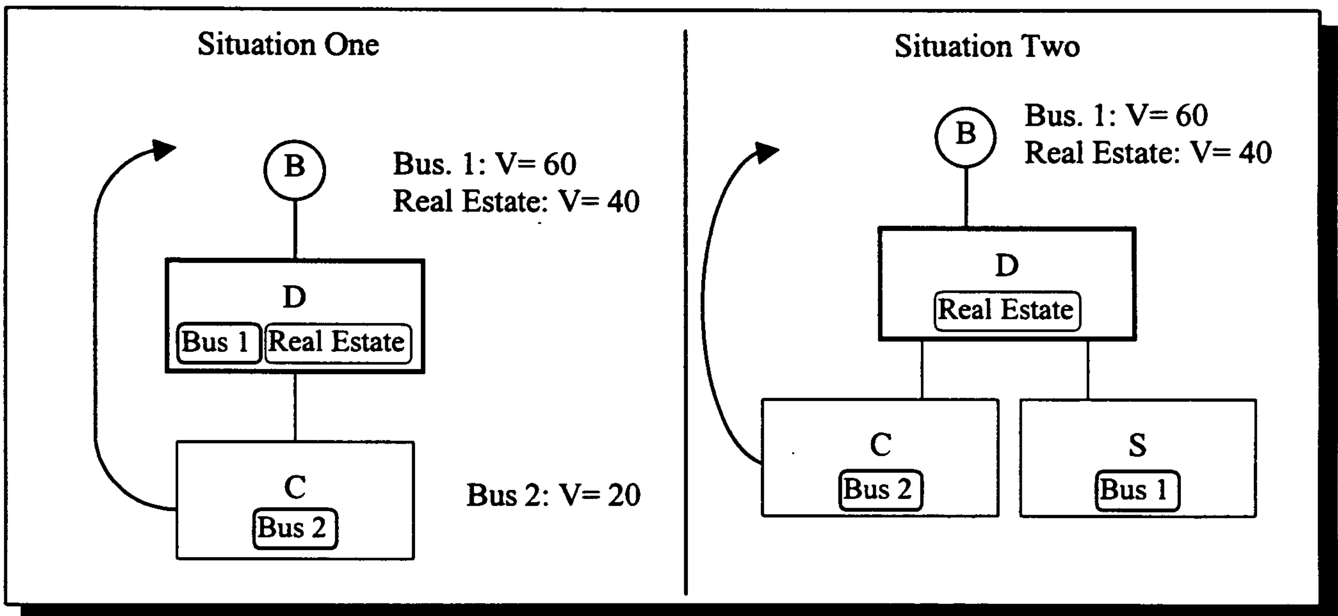
9. Direct vs. indirect conduct of a business

a. A major source of uncertainty under the active business requirement is the often arbitrary distinction drawn between the direct and indirect conduct of a business.

b. As discussed above, there is no statutory or regulatory requirement regarding the magnitude of the qualifying active business relative to other nonqualifying businesses when such businesses are conducted directly. By contrast, where a holding company is involved, section 355(b)(2)(A) requires that substantially all the assets of the holding company must consist of stock or securities in a corporation engaged in the active conduct of a trade or business for it to be considered so engaged.

(1) For advance ruling purposes, "substantially all of its assets" in this context means 90 percent of the fair market value of the gross assets of the corporation (undiminished by liabilities). Rev. Proc. 77-37, § 3.04, 1977-2 C.B. 568.

c. Example 8 -- Indirect conduct of active business



(1) Facts: Distributing actively conducts two five-year businesses, Business 1 and Business 2. Business 2, which has a value of $20, is conducted through C, a wholly owned subsidiary of D. Business 1 has a value of $60. Distributing also has passive real estate investments with a

value of $40. Distributing wishes to distribute all of its C stock in a spin-off to permit C to conduct an IPO.

(2) Situation 1. Assume first that Distributing directly conducts Business 1. The active business requirement should be met, because C conducts an active five-year business and Distributing conducts an active five-year business that constitutes 50 percent of D's net value (60 percent excluding the C stock).

(3) Situation 2. Now assume that, with the exception of its real estate investments, Distributing is a pure holding company and that Business 1 is indirectly conducted through S, a wholly owned subsidiary of D. Distributing will not meet the active business requirement, because the S stock constitutes at most 60 percent of D's gross assets. Therefore, "substantially" all of D's assets do not consist of stock of subsidiaries with active five-year businesses.

(4) As a consequence, it may be necessary for the holding company to restructure its holdings so that it satisfies this requirement.

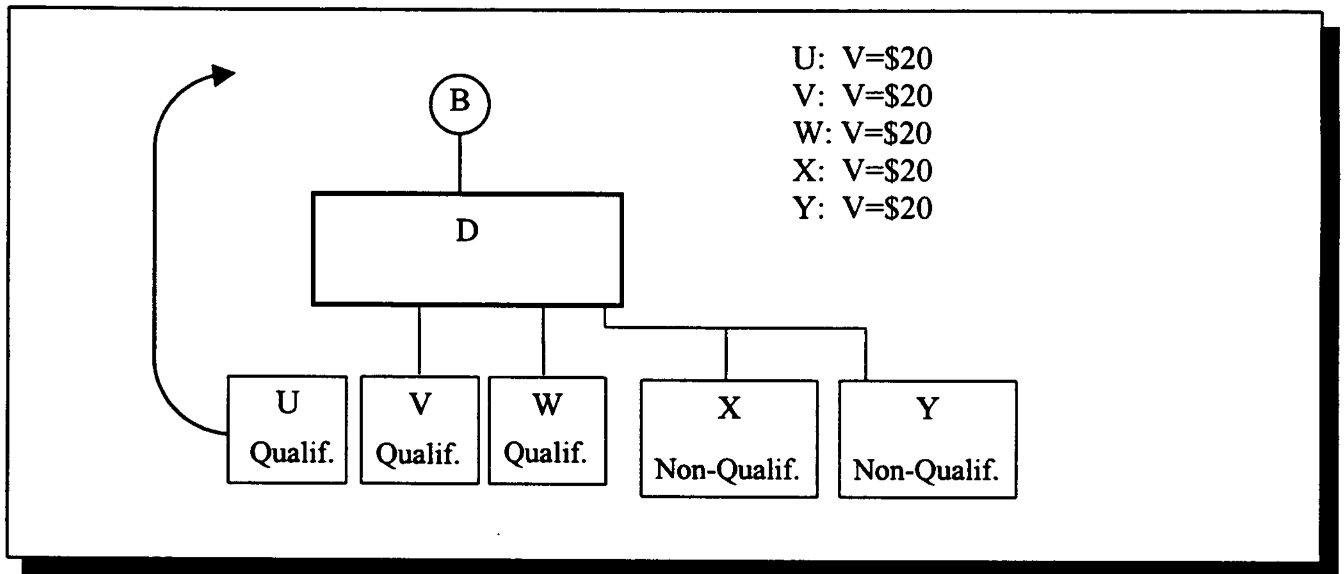
a) If the holding company holds assets other than stock or securities (e.g., cash, accounts receivable, or passive real estate investments), it may fail the active business requirement. To avoid this consequence, it could push-down these assets to a subsidiary that is itself engaged in the active conduct of a trade or business. Thus, in Situation 2, Distributing could transfer the real estate to C or S.

i) However, such a push-down to C might run afoul of the device requirement. See Part III.C., supra.

ii) The Service has stated that it will not rule on whether the active trade or business requirement is satisfied if, within the five-year period, the distributing corporation acquired control of the controlled corporation as a result of transferring cash or other liquid assets or inactive assets to the controlled corporation in a transaction under section 351 or 368(a)(1)(D). Rev. Proc. 96-3, § 4.01(31), 1996-1 C.B. 456.

b) On the other hand, if the assets of the holding company include stock of subsidiaries that are considered to be engaged in the active conduct of a trade or business as well as subsidiaries that are not so engaged, the holding company could restructure its holdings as discussed in the next example.

d. Example 9 -- Restructuring to satisfy active business requirement



(1) Facts: Distributing is a holding company. It has five subsidiaries U, V, W, X, and Y. U, V, and W are each actively engaged in a qualifying trade or business for purposes of section 355. X and Y were acquired in taxable transactions during the past five years and thus are not considered to be actively engaged in a qualifying trade or business. Distributing would like to spin off U to D's shareholder, B.

(2) Liquidation. Assuming that the value of X and Y exceeds 10 percent of Distributing's net value, Distributing will not be considered to be engaged in an active business, because "substantially all" of its assets are not stock or securities in subsidiaries that are so engaged. In order to satisfy the active business requirement, Distributing could liquidate V or W. Distributing will then be considered to be directly conducting an active business and will not be subject to the substantially all requirement. See Rev. Rul. 74-79, 1974-1 C.B. 8. Alternatively, operating subsidiaries may merge

upstream into the holding company. See, e.g., P.L.R. 8850065 (Dec. 16, 1988).

(3) Section 351 transfers. As an alternative to liquidation, Distributing could contribute the stock of X and Y to either V or W. After the contribution, it would only hold stock in subsidiaries engaged in an active business and thus should be able to spin off U in a section 355 transaction. See, e.g., P.L.R. 9145020 (Aug. 6, 1991); P.L.R. 8705081 (Nov. 6, 1986).

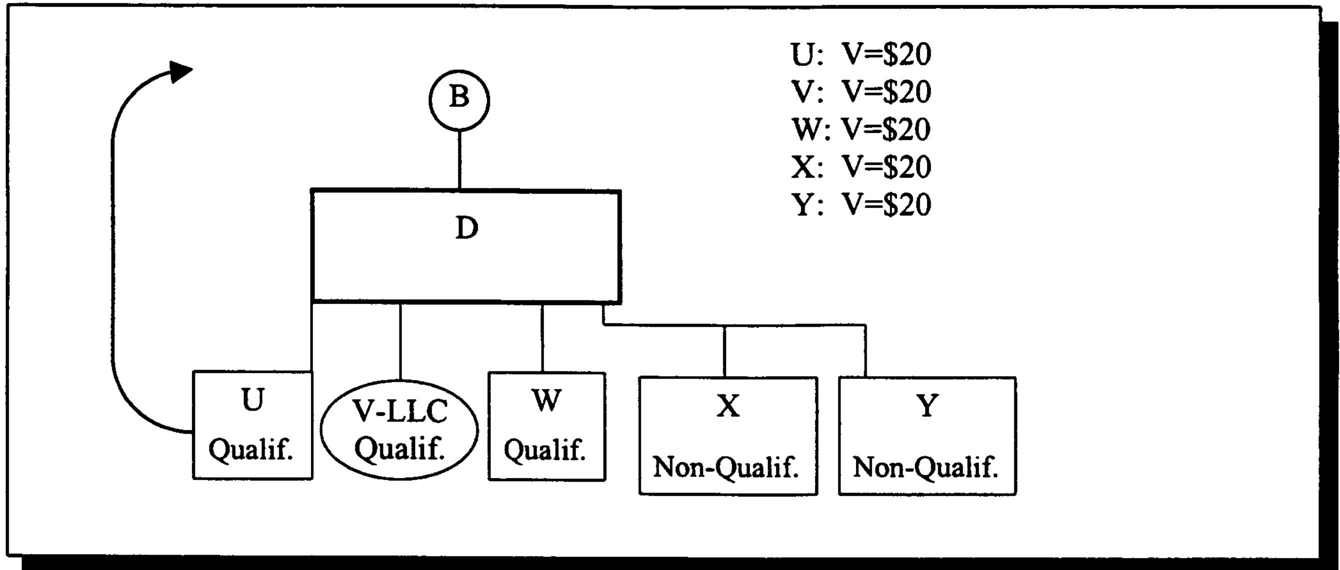
(4) Intercompany mergers. In addition, Distributing could merge X and Y into either U, V, or W in tax-free mergers. See, e.g., P.L.R. 9749018 (Sept. 11, 1997); P.L.R. 8931076 (May 12, 1989); P.L.R. 8850065 (Sept. 23, 1988); P.L.R. 8737076 (June 18, 1987); P.L.R. 8712019 (Dec. 18, 1986); P.L.R. 8421046 (Feb. 17, 1984).

(5) Such restructurings may not be possible, however, if the subsidiaries conducting the qualifying businesses are subject to significant contingent liabilities. In that event, Distributing may not want the other assets to be subject to such liabilities. For example, if V has significant contingent environmental liabilities, liquidating or merging V may subject all of the transferee's assets to those liabilities. Similarly, transferring stock of X and Y to V may resolve the active business requirement problem but provide additional value to V's creditors.

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

(6) Proposed legislation would obviate the need to restructure in order to meet the active trade or business requirement. Section 1107 of the Taxpayer Refund Act of 1999 (H.R. 2488) would amend section 355(b) to provide that for purposes of determining whether a corporation meets the

active trade or business requirement as a holding company, all members of the corporation's separate affiliated group will be treated as a single entity.



e. Another area of uncertainty involves businesses conducted through partnerships. It is not clear in all cases whether a partner in a partnership is considered to be engaged in the active conduct of the business of the partnership for purposes of section 355. See Gruse v. Commissioner, 59 T.C.M. (CCH) 368 (1990) (partner engaged in the business of his partnership for purposes of determining requisite profit objective under sections 162 and 212); Butler v. Commissioner, 36 T.C. 1097 (1961) (limited partner deemed to be in the business of the partnership for purposes of a business bad debt); Rev. Rul. 75-23, 1975-1 C.B. 290, obsoleted on other grounds, Rev. Rul. 87-80, 1987-2 C.B. 292 (partner that was a foreign corporation deemed to be in the business of the partnership for purposes of determining United States tax liability).

(1) In Rev. Rul. 92-17, 1992-1 C.B. 142, the Service ruled that a corporate general partner holding a 20-percent interest in a limited partnership, which owned several properties, was engaged in an active trade or business.

a) Although not entirely clear, it seems that the trade or business arose from the corporation's contractual obligation to provide management services to the limited partnership. The limited partnership provided day-to-day upkeep and maintenance,

negotiated leases, kept expense records, and dealt with the tenants. The officers of the general partner supervised certain of the activities of the limited partnership's employees and made significant business decisions. The general partner had no employees other than its officers. This activity, however, was sufficient to constitute the conduct of an active trade or business.

(2) Some commentators have questioned whether the trade or business is that of the partnership (the rental real estate business), which is then attributed to the corporate general partner. For example, if the corporation had been a 98-percent limited partner instead of a 20-percent general partner, it is questionable whether, under the ruling, the corporation would be deemed to be engaged in the active conduct of a business through the partnership.

(3) There appears to be no reason to distinguish for this purpose between satisfying the active business requirement through corporate subsidiaries or through limited partnerships. Increasingly, corporations engage in a variety of businesses through partnership or joint venture arrangements to avoid additional layers of corporate-level tax. The Service should issue guidance that clarifies in what circumstances indirectly conducted businesses should be treated as meeting the active business requirement.

(4) The government recently issued final regulations that resolve the "remote continuity" concerns presented by drop-downs to partnerships following acquisitive reorganizations. Treas. Reg. § 1.368-1(d). The preamble to the final regulations states that the regulations are not limited to transactions enumerated in section 368(a)(2)(C), but rather they apply to all reorganizations for which continuity of business enterprise is relevant. Thus, these regulations should resolve the remote continuity problem in the context of section 355 transactions. Similarly, these regulations should provide guidance with respect to the active trade or business requirement.

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

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

a. Stock in the controlled corporation must be distributed to the distributing corporation's shareholders with respect to their stock, or received in exchange for the distributing corporation's securities by the holders of such securities. Section 355(a)(1)(A). Stock for this purpose does not include warrants, convertible debt instruments, or other rights to purchase stock. Treas. Reg. § 1.355-1(b).

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

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

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

   (3) Neither of these situations should cause the distributing corporation to incur a tax liability, however. Section 355(c) treats only a distribution of property not in pursuance of a plan of reorganization as a distribution for purposes of section 311. See H.R. Rep. 100-795, at 373 (1988). Thus, even if the distributing corporation transfers securities of the controlled corporation that have appreciated in value to its security holders, it should not recognize any gain. This transfer is part of the plan of reorganization. But see Rev. Rul. 70-271, 1970-1 C.B. 166, distinguished, Rev. Rul. 75-450, 1975-2 C.B. 328 (indebtedness satisfied in a "C" reorganization using appreciated property resulted in gain under section 1001).

c. Section 355 does not require that stock or securities of the controlled corporation held by an entity related to the distributing corporation be distributed. Thus, presumably if P owns 80 percent of X and 100 percent of Y, and Y owns 20 percent of X, section 355 will apply to a distribution by P of its X stock even though Y continues to hold 20 percent of X.

2. A limited exception to the general rule that the distributing corporation must distribute all of the stock and securities of the controlled corporation is provided if the distributing corporation distributes an amount of stock in

the controlled corporation constituting control, and it can establish to the satisfaction of the Service that the retention of stock or securities in the controlled corporation does not have the principal purpose of avoiding federal income tax. Section 355(a)(1)(D)(ii); see also Treas. Reg. § 1.355-2(e).

a. The regulations provide, however, that ordinarily the corporate business purpose or purposes for the distribution require that all of the controlled corporation's stock and securities be distributed. Treas. Reg. § 1.355-2(e)(2).

b. The Service has found the requisite non-tax reason for permitting the retention of a portion of the stock or securities of a controlled corporation where the stock or securities are necessary to serve as collateral for bank financing.

(1) In Rev. Rul. 75-321, 1975-2 C.B. 126, the Service determined that the distribution of 95 percent of the controlled corporation's stock to comply with federal banking law satisfied the requirements of section 355(a)(1)(D)(ii) where the remaining five percent of the controlled corporation's stock was retained to serve as collateral for short-term financing necessary to the distributing corporation's remaining business enterprise.

(2) In Rev. Rul. 75-469, 1975-2 C.B. 126, the Service determined that retention of the controlled corporation's debenture by the distributing corporation, where the debenture was used as collateral by the distributing corporation to secure a loan from a bank, satisfied the requirements of section 355(a) (1)(D)(ii). See also P.L.R. 8927021 (Apr. 4, 1989); P.L.R. 8908075 (Dec. 2, 1988).

c. A retention of stock or securities may also be permissible if the stock or securities are retained to satisfy the requirements of a stock option plan or the requirements of state law.

3. For ruling purposes, the Service has stated that it will issue a favorable ruling regarding the retention of stock or options or any stock acquired upon the exercise of the options in a controlled corporation by a widely held distributing corporation if the distributing corporation establishes that the following requirements are satisfied:

a. A sufficient business purpose exists for the retention of the stock, options, and any stock acquired on the exercise of the options;

b. None of the distributing corporation's directors or officers will serve as directors or officers of the controlled corporation as long

as the distributing corporation retains the stock, options, or any stock acquired on the exercise of the options;

(1) Under appropriate facts and circumstances, the Service may issue a favorable ruling in cases in which the directors or officers of the distributing corporation will serve as directors or officers of the controlled corporation.

(2) For example, the Service may issue a favorable ruling if a director or officer of the distributing corporation serves as a director or officer of the controlled corporation solely to accommodate the controlled corporation's business needs.

c. The retained stock, options, and any stock acquired upon exercise of the options will be disposed of as soon as a disposition is warranted consistent with the business purpose given for the retention of the stock or options, but in any event, not later than 5 years after the distribution; and

d. The distributing corporation will vote the retained stock and any stock acquired on exercise of the options in proportion to the votes cast by the controlled corporation's other shareholders.

(1) For example, if after the distribution the other shareholders of Controlled vote 70 percent in favor of a matter and 30 percent against, Distributing would be required to vote the stock 70 percent in favor and 30 percent against the matter.

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

4. Under section 355(a)(3)(B), stock in the controlled corporation that was acquired in a taxable transaction by the distributing corporation within five years of the distribution of the controlled corporation's stock is treated as boot taxable to the distributee under section 356 and taxable to the distributing corporation under section 311(b) to the extent of any appreciation. Section 355(c); see also H.R. Rep. No. 100-795, at 373 (1988).

a. In applying section 355(a)(3)(B), it must be determined whether the stock of the controlled corporation was acquired in a taxable transaction, not whether stock of an underlying subsidiary on which the controlled corporation relies to satisfy the active

business test was so acquired. Dunn Trust v. Commissioner, 86 T.C. 745 (1986).

b. Stock tainted by section 355(a)(3)(B) cannot be considered in determining whether there has been a distribution of control. Treas. Reg. § 1.355-2(g)(1).

c. Furthermore, if a portion of the stock of the controlled corporation is tainted stock, then the retention of stock by the distributing corporation tends to establish that the retention is in pursuance of a plan having one of its principal purposes as the avoidance of federal income tax. Treas. Reg. § 1.355-2(e)(2).

5. Payment of accrued interest on the distributing corporation's securities with stock or securities of the controlled corporation is considered to be a transaction independent from the section 355 transaction. Such payment is not considered to be part of the section 355 distribution, nor is it considered to be boot. Section 355(a)(3)(C).

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

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

F. Business Purpose Requirement

1. In general

a. The regulations under section 355 make the business purpose requirement of paramount importance. Not only is a valid business purpose an independent prerequisite for a tax-free spin-off but the strength of the business purpose will also be taken into account in determining whether the transaction satisfies the device test. See Treas. Reg. § 1.355-2(d)(3)(ii).

b. In Gregory v. Helvering, 293 U.S. 465 (1935), the Supreme Court set forth the principle that literal compliance with the express statutory requirements of section 355 is not sufficient -- a valid business purpose for the transaction must also be present.

c. The regulations, following this principle, specifically state that the transaction must be "carried out for one or more corporate business purposes" in order to fall within the nonrecognition rules of section 355. Treas. Reg. § 1.355-2(b)(1).

(1) The regulations provide that a transaction is carried out for a corporate business purpose if it is motivated, in whole or in substantial part, by such purpose. Treas. Reg. § 1.355-2(b)(1).

(2) The regulations further provide that the corporate business purpose must be real and substantial and germane to the business of the corporation. The reduction of federal taxes does not qualify as a corporate business purpose. Treas. Reg. § 1.355-2(b)(2).

(3) The potential for avoiding federal taxes is relevant in determining whether a corporate business purpose motivated the distribution. Treas. Reg. § 1.355-2(b)(1).

a) This caveat may become problematic. For example, assume that a publicly held corporation spins off its subsidiary to maximize shareholder value. However, part of the increased value is attributable to the tax savings resulting from the tax-free distribution of property.

b) Query whether this transaction is supported by a valid business purpose. <u>See</u> Part III.F.2., <u>infra</u>, (addressing shareholder v. corporate business purpose). For ruling purposes, at least, it appears that nonrecognitions as a result of sections 355 and 361 arguably is ignored. <u>See</u> Rev. Proc. 96-30, § 4.04(5)(d), 1996-1 C.B. 696.

(4) The principal reason for the business purpose requirement is to limit the application of section 355 to transactions that satisfy each of the following requirements:

a) Transactions that are incident to readjustments of corporate structures required by "business exigencies;" and

b) Transactions that effect only a readjustment of continuing interests in property under modified corporate forms.

i) This aspect of the business purpose requirement, appears to overlap with the continuity of interest requirement.

ii) It also overlaps, to some extent, with the device requirement in that subsequent dispositions of stock in the controlling or distributing corporation indicate a device as well as the lack of continuing corporate interests.

Treas. Reg. § 1.355-2(b)(1).

(5) The regulations indicate that the business purpose must be an existing purpose. This is in accordance with several court cases.

a) In Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971), cert. denied, 400 U.S. 922 (1972), a closely held corporation distributed all of the stock of a leasing subsidiary to its shareholders. The Tax Court had found that the primary purpose of the distribution was to facilitate the shareholder's desire to exclude his daughters and future sons-in-law from the management of the distributing corporation's business, and to provide his daughters with an investment in a relatively safe enterprise (through subsequent bequests of the controlled corporation's stock to his daughters).

b) The taxpayers attempted to cast this estate planning purpose as a corporate business purpose in that the distribution would avoid possible interference with management by future sons-in-law.

c) However, the First Circuit noted that, from a corporate perspective, this was not an immediate business purpose. The envisaged possibility of future interference by in-laws was "so remote and so completely under the taxpayers' control" that it could not prevent the transaction from being a device.

d) Thus, the possibility of future management conflict apparently would not be acceptable for section 355 purposes.

e) Conversely, a valid business purpose would be present if the shareholders were already in conflict with respect to the management of the enterprise and separation was necessary to prevent further disruption. See Coady v. Commissioner, 33 T.C. 771 (1960), aff'd per curiam, 289 F.2d 490 (6th Cir. 1961).

f) In Rev. Rul. 75-337, 1975-2 C.B. 124, the Service indicated that a purpose germane to the continuation of the business in the "reasonably foreseeable future" would be acceptable.

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

2. Corporate vs. shareholder purpose

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

a. In Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962), rev'g and remanding, 34 T.C. 946 (1960), the Tax Court ruled that, since the only business purpose proffered was a shareholder purpose, the distribution in question could not qualify for tax-free treatment under the predecessor of section 355.

(1) In reversing the Tax Court, the Second Circuit held that a shareholder purpose may satisfy the business purpose requirement.

(2) However, the First Circuit, in Rafferty, supra, expressly refused to follow the Second Circuit's approach. According to the Rafferty court, although personal motives are not to be excluded from consideration, such motives will not prevent the transaction from being a device, unless they are "germane to the continuance of the corporate business." The court also indicated that a transaction should be scrutinized more closely in the absence of a direct benefit to the corporation.

b. Although the regulations require a corporate business purpose, they recognize that a shareholder purpose may rise to the level of a corporate purpose, stating that "depending upon the facts of a particular case, . . . a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose as to preclude any distinction between them." Treas. Reg. § 1.355-2(b)(2).

(1) The regulations provide as an example of a non-corporate purpose the personal planning purposes of a shareholder. Treas. Reg. § 1.355-2(b)(2). However, in Rev. Rul. 75-337, the shareholder's estate planning goals also served the corporate business purpose of ensuring smooth and continued operation of the corporation after the death of the shareholder.

(2) Business purposes that benefit both the corporation and the shareholder will be inspected closely by the Service.

3. Business purpose for the distribution

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

a. In Gada v. United States, 460 F. Supp. 859 (D. Conn. 1978), the court found that the purpose of shielding assets from risks of the other business cannot support the distribution of stock, because such a purpose could be accomplished simply by transferring the business assets to a new subsidiary (e.g., in section 351 transaction). The subsequent distribution of stock does not further the stated business purpose. See also Treas. Reg. § 1.355-2(b)(5), Ex. 3.

b. In Rev. Rul. 69-460, 1969-2 C.B. 51 (situation one), the Service ruled that a distribution of a subsidiary's stock to an employee to give him a proprietary interest in the subsidiary was not a valid business purpose for a section 355 transaction because the distribution was not necessary for this purpose. The employer could have given the employee an interest in the subsidiary without making a distribution.

It should be noted that the Service has frequently issued favorable rulings in similar situations where it has been represented that the

employee does not wish to own stock in a controlled subsidiary. Cf. Rev. Proc. 96-30, Appendix A, § 2.01, 1996-1 C.B. 696.

4. Relation to device test

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

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

(2) The business purpose requirement, on the other hand, serves to prevent the tax avoidance intent from arising in the first instance.

b. Thus, the taxpayer has the "negative" burden to show that the transaction is not a device and the "affirmative" burden to show a valid business purpose.

c. The discrete nature of these two tests was demonstrated by the Ninth Circuit in Commissioner v. Wilson, 353 F.2d 184 (9th Cir. 1965), rev'g, 42 T.C. 914 (1964).

(1) In Wilson, the Tax Court rejected the taxpayer's proffered business reasons for the distribution in issue, but nevertheless found that the transaction qualified for section 355 treatment because the transaction was not a device. No sale or liquidation of either the distributing or the controlled corporation occurred within the five-year period after the distribution and before trial, and there was nothing to suggest any intent to sell or liquidate either corporation.

(2) In other words, Wilson was a unique case where there was no tax avoidance motive present, but neither was there a business purpose. The Ninth Circuit, reversing the Tax Court, ruled that section 355 was not available because of the lack of a business purpose.

(3) The appellate court reasoned that without a business purpose requirement, a corporation could distribute investment assets to its shareholders who could hold such assets for retirement purposes without subjecting them to the risks of the business. Although the shareholder would

not have "cashed out" his corporate investment until future retirement, such treatment would be unfair to shareholders who simply received such assets as a dividend.

(4) According to the Ninth Circuit, Congress was willing to concede some tax advantages to a distribution when it serves a business purpose; otherwise, it should be taxable like any other dividend to a shareholder.

(5) It seems that both the "active trade or business" and the "device" requirements should be adequate to address the Ninth Circuit's concern.

(6) Notwithstanding the Wilson decision, the First Circuit, in Rafferty, supra, took a different approach. The First Circuit viewed the business purpose requirement as bearing on the issue of whether a distribution was a device.

a) In Rafferty, the First Circuit framed the issue as whether the shareholder's estate planning goals constituted a sufficient business purpose to prevent the transaction from being a device.

b) The appellate court stated that personal goals will not support a distribution that has considerable potential for use as a device for distributing earnings and profits unless such purposes are germane to the continuance of the corporate business.

c) The court noted that since the shareholder's alleged business purpose could be satisfied by a bail out of dividends, that purpose was not sufficient to prove that the transaction was not being used as a device.

d) The court concluded that in the absence of a direct benefit to the business of the original corporation (i.e., a corporate business purpose), and given evidence that the distribution put saleable assets in the shareholder's hands, no business purpose was present that was sufficient to overcome the Commissioner's determination that the transaction was a device.

(7) As the above cases indicate, the interrelationship between the business purpose test and the device test has not been clearly delineated.

a) The regulations provide that a corporate business purpose is evidence of the absence of a device. Treas. Reg. § 1.355-2(b)(4). The stronger the evidence of a device, the stronger the corporate business purpose necessary to overcome that evidence. Treas. Reg. § 1.355-2(d)(3)(ii).

b) It is understood that when there is evidence of a device, the Service may require independent third-party verification and substantiation as proof of the alleged business purpose.

i) For example, in Rev. Rul. 82-130, 1982-2 C.B. 83, a closely held parent distributed the stock of its subsidiary in order to facilitate a public offering of the parent's stock. The spin-off of the subsidiary was recommended by the parent's underwriters.

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

5. Ruling guidelines

a. Former ruling position of the Service

(1) The adverse tax consequences of a spin-off that fails the requirements of section 355 generally are dramatic. The distributing corporation will recognize gain to the extent of the appreciation in the stock of the controlled corporation. In addition, the full value of the controlled corporation stock distributed may be taxed to the recipient shareholders as a dividend. Because the law is so intricate and confusing, few companies will risk engaging is such a transaction without a favorable advance ruling from the Service.

(2) As a consequence, in many respects the Service's ruling standards and positions have become the "law" of section 355 for practical purposes. This is particularly apparent in the case of the "business purpose" requirement. Under the case law, the primary function of the business purpose requirement is to ensure that there are legitimate reasons for the transaction other than reduction of federal income tax.

(3) The Service has always taken the position that the existence of such a purpose is inherently a factual determination, the resolution of which is more appropriately the province of the Field Service on audit. Prior to 1996, there were a number of business purposes on which the Service would not rule, because it felt unable to determine as a factual matter whether the asserted purpose was genuine. Consequently, there was a relatively short list of purposes that were generally accepted by the Service, and taxpayers had an incentive to fit their proposed transaction into one of these pigeonholes.

b. Revenue Procedure 96-30

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

(2) The price of the Service's purportedly more flexible approach to the business purpose requirement is the more burdensome substantiation that may be requested.

(3) The new guidelines require taxpayers to explain why each asserted corporate business purpose cannot be achieved through a nontaxable transaction that does not involve the distribution of stock of Controlled and is neither impractical nor unduly expensive. For example, in appropriate cases, possible alternative transactions might include the transfer of assets to a partnership or limited liability company. However, an alternative transaction that will cause the loss of a favorable special tax status, such as an existing S corporation election, will ordinarily be viewed as unduly expensive.

(4) If the transaction will effect a reduction in federal taxes, or if it appears that the transaction will achieve one or more other non-corporate business purposes, the taxpayer is required to convince the Service by "clear and convincing evidence" that the distribution is motivated in whole or

substantial part by one or more corporate business purposes in order to obtain a favorable ruling.

a) Nonrecognition of income or gain to the shareholders or corporation resulting from the application of sections 355 or 361 is disregarded in determining the purposes for the transaction.

b) Thus, it appears the Service may now "weigh" the various purposes asserted by the taxpayer to determine which is the real or primary purpose.

(5) Taxpayers are required to submit extensive documentation to provide factual support for the asserted business purpose. The type and extent of the documentary substantiation required varies depending on the described business purpose and facts of the particular case.

a) Third-party documentation. If the transaction is being undertaken at the request of, or pursuant to the advice or analysis of, persons other than the distributing or controlled corporation, documentation of such third-party requests, advice, or analysis must be provided. Such documentation must include an explanation of the third party's qualifications to speak to the matter.

i) Business purposes for which such third-party documentation may be necessary include: risk reduction, cost savings, facilitating a stock or debt offering, other borrowing, obtaining regulatory relief, improving credit, and preserving a franchise.

ii) Third-party documentation prepared specifically for submission with the taxpayer's ruling request must contain an acknowledgment that the documentation will be submitted to the Service for use in determining the federal tax consequences of the transaction.

b) Additional documents. Other documents that may be required by the Service include:

i) Regulatory filings, such as any proxy statements, information statements, or prospectuses filed or prepared in connection

with the distribution or any related transaction, and any other documents that have been filed with any federal, state, local, or foreign regulatory body (such as the Securities and Exchange Commission) by the taxpayer;

ii) Materials that relate to the purpose for the distribution and were prepared for, or presented to, the taxpayer's board of directors, and any relevant portions of the board's minutes;

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

6. Specific business purposes

Appendix A of Rev. Proc. 96-30 sets forth certain specific business purposes that the Service will now entertain and special requirements for substantiating such purposes. Many of these purposes are ones that the Service formerly would not consider. The guidelines emphasize, however, that this list is not exclusive. Thus, business purposes that were formerly acceptable should continue to be acceptable, provided the more onerous substantiation requirements imposed by the new guidelines are met. The following business purposes are specifically discussed in Appendix A of Rev. Proc. 96-30:

a. Fit and Focus. The Service will now entertain ruling requests for distributions motivated by "fit and focus" concerns. See Rev. Proc. 96-30, Appendix A, § 2.05. The successful conduct of different trades or businesses within a single corporation or affiliated group depends on the existence of synergy between the businesses. When this synergy disappears, business considerations may dictate a separation of the businesses. Many large, publicly traded corporations seek to focus on their "core" business and to dispose of those other operations that do not fit with this focus. This strategy, referred to generically as "fit and focus," may occur for a number of reasons.

(1) Example 1. P owns Business 1, its primary business, and Business 2, a much smaller business, which P's top management believes is unlikely to generate significant future growth. The managers of Business 2 are dissatisfied, because the needs of its business are subordinated to the needs of Business 1, especially because the businesses are in competition for scarce capital. The Business 2 management is also frustrated because senior management lacks expertise in running Business 2. The separation of the businesses would permit P's management to focus on the core Business 1, while the Business 2 managers can focus on Business 2 and be rewarded accordingly. In theory, this should enhance the value of the separate entities in the aggregate.

(2) Example 2. The public capital markets view Business 2 as a burden on the earnings of Business 1. However, Business 2 has some valuable patents and other intangible assets and potentially could be reoriented as a high-tech growth business. Management believes Business 2 would be attractive to venture capital markets if it were a separate corporation. Venture capitalists may be unwilling to accept a small minority stake in P or an entity controlled by P. Further, Business 2 is capital-intensive while Business 1 is not. The businesses have different hurdle rates (i.e., rates at which potential investments become profitable), resulting in inherent conflicts regarding when and how to raise capital. Similarly, as a mature business, Business 1 may prefer to distribute earnings while Business 2 needs to retain earnings to finance expansion.

(3) Example 3. The businesses may no longer exhibit positive synergy. For example, the different businesses may find themselves in direct or indirect competition with one another. Similarly, there may be little or no overlap of products, distribution channels, technology, or manufacturing processes. Alternatively, the businesses may operate in different labor, regulatory, or operational environments.

(4) In the circumstances described above, separating the different businesses enhances the ability of each business to attract capital and operate with maximum profitability. These business advantages may be offset or eliminated, however, if the separation triggers significant tax liability. In most cases, therefore, the taxpayer will seek to treat the transaction as tax free under section 355 of the Code. In

the past, however, the Service has been unwilling to rule unless the reason for the transaction could be restated in a more acceptable form such as "cost savings."

(5) Although the Service will now entertain rulings on distributions to improve "fit and focus," there are a number of restrictions.

a) If Distributing is not publicly traded -- or is publicly traded, but has a significant (i.e., five-percent shareholder) -- the Service ordinarily will not rule unless the distribution (a) is non pro rata, or (b) effects an internal restructuring within an affiliated group.

b) The taxpayer must submit documentation describing in detail the problems associated with the current corporate structure and demonstrate why the distribution will lessen or eliminate these problems. Examples of probative documentation given by the new guidelines include internal reports and studies, and professional analyses (such as an opinion or reports prepared by investment bankers or management consultants). However, in the case of a non-pro rata distribution made to enable a significant shareholder or shareholder group to concentrate on a particular business, the Service ordinarily will not require third-party documentation or detailed studies.

c) The Service will closely scrutinize situations involving (1) any continuing relationship between the distributing and controlled corporations; (2) except for cases involving an internal restructuring of an affiliated group, any continuing cross-ownership of the distributing and controlled corporations; and (3) any internal restructuring where the distributee would not otherwise be entitled to a 100-percent dividends-received deduction.

(6) Recently, in P.L.R. 199919025 (Feb. 12, 1999); P.L.R. 199906007 (Nov. 2, 1998); P.L.R. 9843033 (Oct. 23, 1998); P.L.R. 9828017 (Apr. 9, 1998); P.L.R. 9812012 (Dec. 12, 1997); P.L.R. 9809035 (Nov. 25, 1997); P.L.R. 9804049 (Oct. 28, 1997), the Service allowed taxpayers to

use fit and focus as the business purpose for section 355 transactions.

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

(1) The Service will consider the nature and magnitude of the risks faced by the risky business. The taxpayer must submit information regarding the claims history of the risky business, or information regarding the typical risk experience of similar businesses in that industry.

(2) The Service will consider whether the assets and insurance associated with the risky business are sufficient to meet reasonably expected claims arising from the conduct of the risky business.

a) The taxpayer must submit the book value and approximate fair market value of the net assets, including intangibles, of the risky business and describe any other factors, such as liabilities that are not included on the taxpayer's balance sheet, that affect the value of the net assets of the risky business.

b) Facts regarding the cost and availability of insurance generally require third-party substantiation.

(3) The Service will consider whether, under applicable law, the distribution will significantly enhance the protection of the other businesses from the risks of the risky business and, whether, under applicable law, an alternative nontaxable transaction that does not involve the distribution of the controlled corporation's stock and is neither impractical nor unduly expensive (for example, creating a parent/subsidiary or holding company structure) would provide similar protection.

a) The taxpayer must include an analysis of the law and the application of the law to the relevant facts of the proposed transaction. An opinion of counsel may be required.

b) However, it is not necessary for the taxpayer to establish conclusively that, under applicable law, the proposed transaction will afford adequate

protection or that an alternative transaction would not afford adequate protection.

c) Until recently, the Service would generally not issue rulings where the asserted business purpose was risk reduction, despite concerns of environmental lawyers that liability for hazardous waste clean-ups under CERCLA may be imposed on any member of an affiliated group. The Service would, however, issue rulings in limited cases where the risky business was already contained in the distributing corporation and the safe business was operated by the controlled corporation, since the creditors of the risky business could reach the assets of the safe business through the stock of the controlled corporation. See Rev. Rul. 78-383, 1978-2 C.B. 142.

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

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

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

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

(5) Other recent rulings in which the Service has permitted risk reduction as a valid business purpose include P.L.R. 199923011 (Mar. 2, 1999) (toxic or explosive materials); P.L.R. 199915018 (Jan. 7, 1999) (potential liability claims);

P.L.R. 9852039 (Dec. 24, 1998) (assets located in city subject to environmental hazards); P.L.R. 9827031 (Apr. 3, 1998) (contingent liabilities); P.L.R. 9744008 (July 30, 1988) (environmental liabilities); P.L.R. 9730014 (Apr. 24, 1997) (litigation risks).

c. Facilitating an acquisition "of" Distributing. The Service will continue to entertain ruling requests where the asserted purpose for the distribution is to facilitate a proposed acquisition that will not be consummated unless unwanted assets are first distributed. See Rev. Proc. 96-30, Appendix A, § 2.07. Importantly, this recognizes that facilitating a subsequent reorganization may be a valid business reason for a spin-off. See, e.g., Rev. Rul. 68-603, 1968-2 C.B. 148; P.L.R. 9751043 (Sept. 25, 1997); P.L.R. 9306010 (Nov. 10, 1992); P.L.R. 9117054 (Jan. 30, 1991).

(1) To establish that a corporate business purpose for the distribution is to tailor the distributing corporation's assets to facilitate a subsequent tax-free acquisition of the distributing corporation by another corporation, ordinarily the taxpayer must demonstrate to the satisfaction of the Service that:

a) The acquisition will not be completed unless the distributing and controlled corporations are separated;

b) The acquisition cannot be accomplished by an alternative nontaxable transaction that does not involve the distribution of controlled corporation stock and is neither impractical nor unduly expensive;

c) The acquiring corporation is not related to the distributing or controlled corporation;

d) The acquisition will be completed within one year of the distribution.

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

(2) For example, in Rev. Rul. 76-527, 1976-2 C.B. 103, a subsidiary of a publicly held corporation offered to acquire the assets of a target in exchange for its own stock. However, the management of the target declined the stock offer, because the subsidiary's parent was engaged in an unrelated industry, and target management was reluctant to accept stock of a corporation controlled by such a parent. In order to enable the subsidiary to use its own stock in making acquisitions, the parent distributed the subsidiary's stock, pro rata, to its shareholders. The Service approved the transaction.

(3) On numerous occasions the Service has publicly ruled that the distributing corporation may distribute assets not wanted by the acquirer in a section 355 transaction so that the distributing corporation could be acquired in a reorganization. See, e.g., Rev. Rul. 68-603, 1968-2 C.B. 148; Rev. Rul. 70-434, 1970-2 C.B. 83; Rev. Rul. 78-251, 1978-1 C.B. 89. (As discussed in Part III.G., below, these transactions raise continuity of interest issues.)

(4) The Service has also approved the spin-off of unwanted assets to facilitate the merger of the corporation containing those assets which are wanted into the acquiring corporation. Mary Archer W. Morris Trust, 42 T.C. 7791 (1964), aff'd 367 F.2d 794 (4th Cir. 1965), acq. Rev. Rul. 68-603, 1968-2 C.B. 148. But see section 355(e), which effectively eliminates tax-free Morris Trust transactions and intragroup spins related to such transactions.

(5) In P.L.R. 8921065 (Feb. 28, 1989) (supplemented by P.L.R. 8933038), the Service approved the following spin-off. Affiliated Publications, owners of the Boston Globe also owned 47% of McCaw Cellular. The stock in McCaw had appreciated substantially and the shareholders of Affiliated wished to sell the McCaw stock. McCaw as a less than 80% subsidiary could not be spun-off to the shareholders and, therefore, if Affiliated sold the stock and distributed the proceeds to the shareholders there would be corporate and shareholder-level tax. In order to avoid this, a Morris Trust transaction was used. Affiliated Publications dropped the Boston Globe into a new Controlled corporation, and spun off Controlled. Affiliated Publications then merged into McCaw, with McCaw as the surviving corporation. The former Affiliated Publications shareholders received McCaw stock in return for Affiliated

stock and thus held shares directly in McCaw and in Controlled. See also P.L.R. 9117054 (Jan. 30, 1991).

(6) Arguably, the distribution of unwanted assets as a business purpose could have been adversely affected by the repeal of General Utilities. However, the Service has continued to issue private letter rulings under section 355 where facilitating a tax-free acquisition of the distributing corporation is the business purpose for the spin-off. See, e.g., P.L.R. 199904010 (Oct. 27, 1998); P.L.R. 9347023 (Aug. 30, 1993); P.L.R. 9306010 (Nov. 10, 1992); P.L.R. 9117054 (Jan. 30, 1991); P.L.R. 8923039 (Mar. 14, 1989). See Rev. Proc. 96-30, Appendix A, § 2.07.

d. Facilitating an acquisition "by" Distributing or Controlled. The Service will continue to entertain ruling requests where the asserted purpose for the distribution is to facilitate a subsequent acquisition of a target by Distributing or Controlled using stock. See Rev. Proc. 96-30, Appendix A, § 2.08.

(1) Again, this recognizes that facilitating a subsequent acquisition may be a valid reason for a spin-off. For example, in Rev. Rul. 72-530, 1972-2 C.B. 112, the Service approved of a distribution that facilitated an acquisition by the distributing parent corporation. See also, P.L.R. 199910026 (Dec. 10, 1998); P.L.R. 9833003 (May 8, 1998); P.L.R. 9821052 (Feb. 24, 1998); P.L.R. 9813015 (Dec. 22, 1997).

(2) To establish such a purpose, ordinarily, the taxpayer must demonstrate to the satisfaction of the Service that:

a) The combination of the target corporation with Distributing or Controlled will not be undertaken unless Distributing and Controlled are separated;

b) The acquisition cannot be accomplished by an alternative nontaxable transaction that does not involve the distribution of Controlled stock and is neither impractical nor unduly expensive;

c) The target corporation is not related to Distributing or Controlled;

d) The acquisition will be completed within one year of the distribution.

e. Competition. The Service will entertain ruling requests involving distributions intended to eliminate direct competition of a business with customers or suppliers. See Rev. Proc. 96-30, Appendix A, § 2.06.

(1) Ordinarily, the taxpayer must demonstrate to the satisfaction of the Service that:

a) One or more customers or suppliers have significantly reduced (or will significantly reduce) their purchases from, or sales to, Distributing or Controlled because of the competing business;

b) Because of the distribution, these customers or suppliers will significantly increase (or will not implement a planned significant reduction in) their purchases from, or sales to, Distributing or Controlled after the distribution;

c) These customers or suppliers do not object to the Distributing shareholders' ownership of stock of Controlled after the distribution;

d) Sales to these customers, or purchases from these suppliers, will represent a meaningful amount of sales or purchases by Distributing or Controlled after the distribution.

(2) In Rev. Rul. 56-450, 1956-2 C.B. 201, the Service permitted a tax-free spin-off where the customers of a subsidiary were in direct competition with the subsidiary's parent. As a result, the customers were reluctant to place orders with the subsidiary.

(3) Similarly, the Service has approved the distribution of the subsidiary in order to separate competing businesses. Rev. Rul. 59-197, 1959-1 C.B. 77. See also P.L.R. 199926001 (Jan. 12, 1999); P.L.R. 9317033; P.L.R. 9317028; P.L.R. 9308026; P.L.R. 9240028; P.L.R. 9214013; P.L.R. 9121068; P.L.R. 9051044.

(4) In order to obtain a favorable ruling from the Service, in most cases it is necessary to provide corroboration from customer/competitors describing the business tension and how it would be relieved as a result of a spin-off. See Rev. Proc. 96-30, Appendix A, § 2.06. Such corroboration may be difficult to obtain. Furthermore, in the case of a closely held corporation, it may be difficult to convince the Service

that a spin-off would resolve the situation, since the same individuals would continue to own and run both businesses.

f. Key Employees. The taxpayer may wish to give a key employee equity in only part of the business. See Rev. Proc. 96-30, Appendix A, § 2.01.

(1) To establish that a corporate business purpose for the distribution is to provide an equity interest in a business of Distributing or Controlled to a current or prospective employee, ordinarily the taxpayer must demonstrate to the satisfaction of the Service that:

a) The transfer of Distributing or Controlled stock to this employee will accomplish a "real and substantial purpose germane to the business" of Distributing, Controlled, or the affiliated group to which Distributing belongs. Among other things, the taxpayer must explain why the individual is considered a key employee, and why it is necessary to give the individual, or each individual, an equity interest of the type and amount proposed in the transaction.

b) Generally within one year of the distribution, the employee or employees must receive a "significant amount" of stock, unless this would be prohibitively expensive for the employee. We understand that the Service recently issued such a ruling when the stock to be issued constituted as little as two percent of the outstanding stock of a publicly traded company. However, the Service will only take into account stock that is to be purchased by the employee for this purpose -- not options or other rights to purchase stock in the future.

c) The taxpayer must demonstrate that the purpose cannot be accomplished by an alternative nontaxable transaction that does not involve the distribution of Controlled stock and is neither impractical nor unduly expensive. Where the taxpayer contends that a transaction involving a distribution will provide the employee with voting power representing a meaningful voice in the governance of their employer's business that is not available through an alternative transaction, the Service will consider such cases on a case-by-case

basis, taking into account factors such as the distribution of voting power among the shareholders, family relationships, and competing economic interests.

(2) Distributions designed to transfer an equity interest in the distributing corporation to key employees have been, and continue to be, approved by the Service. See Rev. Proc. 96-30, Appendix A, § 2.01; Rev. Rul. 69-460, 1969-2 C.B. 51 (situation two); Rev. Rul. 85-127, 1985-2 C.B. 119; Rev. Rul. 88-34, 1988-1 C.B. 115 (pro rata distribution to enable shareholders to hire new president is for a valid business purpose). See also P.L.R. 199924013 (Mar. 16, 1999); P.L.R. 199917026 (Jan. 27, 1999); P.L.R. 9849013 (Dec. 4, 1998); P.L.R. 9326016 (Mar. 31, 1996); P.L.R. 9249021 (Sept. 8, 1992); P.L.R. 9147043 (Aug. 20, 1991); P.L.R. 9037047 (June 20, 1990); P.L.R. 9027031 (Apr. 3, 1990); P.L.R. 8931017 (May 3, 1989).

g. Stock ownership plans.

(1) The same principles that apply to key employees also apply if the asserted business purpose is to transfer Distributing or Controlled stock to an ESOP. See Rev. Proc. 96-30, Appendix A, § 2.01. For purposes of this analysis, the ESOP is treated as a group of key employees. The distribution of Controlled stock in these transactions is made necessary, because section 409(l) requires an ESOP to invest in stock of a parent corporation rather than stock of a subsidiary, if the parent stock is publicly traded and the subsidiary stock is not publicly traded.

(2) The Service has previously ruled favorably on spin-offs undertaken to establish separate ESOPs for different types of businesses. See P.L.R. 199926017 (Mar. 30, 1999); P.L.R. 9752034 (Sept. 24, 1997); P.L.R. 9324004 (Mar. 11, 1993); P.L.R. 9250046 (June 11, 1992); P.L.R. 9149042 (Sept. 5, 1991); P.L.R. 9020048 (Feb. 23, 1990).

h. Raising Capital. The Service will entertain ruling requests for distributions intended to enhance the ability of Distributing or Controlled to raise capital more effectively. See Rev. Proc. 96-30, Appendix A, §§ 2.02 and 2.03; see also P.L.R. 199926026 (Apr. 1, 1999); P.L.R. 9846028 (Nov. 13, 1998); P.L.R. 9840030 (Oct. 2, 1998); P.L.R. 9836019 (Sept. 4, 1998). The taxpayer may believe capital can more effectively be raised if the businesses are separated.

(1) According to investment bankers, a spin-off before an IPO of Controlled can result in an IPO raising up to 10 percent more than it would if Controlled had not been traded and the underwriters had set the price at a discount to ensure success in the stock sale.

a) This is due in part to the fact that where Distributing is a publicly traded corporation, a distribution prior to the IPO allows the market to establish a trading range for Controlled.

b) A distribution prior to the IPO also eliminates the need for a minority discount, which would occur in an offering where a single shareholder (Distributing) owns a majority of Controlled's stock.

(2) In Rev. Rul. 82-130, 1980-2 C.B. 83, the Service held that a distribution to facilitate a public offering of Distributing stock was supported by a valid business reason.

a) It should be noted, however, that the factors generally cited as reasons why a spin-off will enhance the success of an IPO of Controlled will likely not be applicable to a spin-off prior to an IPO of Distributing.

b) It may thus be more difficult to obtain a letter from an investment banker, or other necessary documentation, evidencing the business purpose for the spin-off.

c) It may be possible to show that a spin-off will enhance the success of an IPO of Distributing by arguing that the market can better judge the value of each individual component. A similar argument -- that increased stock value would result from "clarity" in the market following a spin-off -- apparently was the purpose behind the spin-off by Coors of its non-beer business, and by Ralston Purina of its baking operations. However, without a corporate business purpose related to such increased stock value (such as a planned IPO, or planned acquisition using stock of Distributing or Controlled), this reason would appear to be an illegitimate shareholder purpose, rather than a legitimate corporate business purpose.

(3) To establish that the business purpose for the distribution is to facilitate a stock or debt offering, ordinarily the taxpayer must demonstrate to the satisfaction of the Service that:

a) The issuing corporation needs to raise a substantial amount of capital in the near future;

b) The stock or debt offering will raise significantly more funds per share if Distributing and Controlled are separated. The taxpayer ordinarily must submit substantiation in the form of opinions by professionals, such as investment bankers. However, the Service will generally acknowledge (without extensive substantiation) that an offering of publicly traded stock by a widely held corporation with no significant shareholders will raise more funds per share than an offering by the same corporation in the position of a controlled subsidiary;

c) The funds raised in the stock or debt offering will, under all circumstances, be used for the business needs of Distributing or Controlled;

d) The offering must be completed within one year of the distribution.

i. Cost savings. To establish that a corporate business purpose for the distribution is cost savings, ordinarily the taxpayer must demonstrate to the satisfaction of the Service that the distribution will produce "significant" cost savings. See Rev. Proc. 96-30, Appendix A, § 2.04.

(1) Cost savings generally are "significant" if savings for the three-year period following the distribution will exceed one percent of the affiliated group's net income for the three-year period preceding the distribution.

(2) Ordinarily, the taxpayer's submission should include analysis by qualified persons (for example, by the taxpayer's insurer for insurance savings, an investment banker for lower borrowing costs, or even the taxpayer's employees). The analysis must explain the savings and why the savings cannot be achieved through another nontaxable transaction.

a) Insurance cost savings: It may be possible for the two businesses to obtain insurance for a lower

aggregate cost if they are not conducted in the same corporation or in the same affiliated group. See, e.g., P.L.R. 9234006 (May 18, 1992); P.L.R. 9220044 (Feb. 14, 1992); P.L.R. 9121034 (Feb. 22, 1991); P.L.R. 9049005 (Sept. 5, 1990); P.L.R. 9030020 (Apr. 26, 1990); P.L.R. 8904018 (Oct. 27, 1988).

b) Finance cost savings and/or enhanced credit rating: By separating a business that is subject to substantial risks, or that has poor cash flow, from a safer, or more profitable, business, it may be possible to borrow money at a lower interest rate, or otherwise on more favorable terms. Spin-offs to enhance the credit ratings of Distributing and Controlled in order to retire expensive debt and to borrow more cheaply have been accepted by the Service as valid business purposes.

   i) In Rev. Rul. 77-22, 1977-1 C.B. 91, a distribution that enhanced access to credit for both the parent and the subsidiary qualified for section 355 treatment. See also P.L.R. 9351022 (Sept. 27, 1993); P.L.R. 9342007 (July 9, 1993); P.L.R. 9212005 (Dec. 19, 1991); P.L.R. 9125048 (Mar. 28, 1991); P.L.R. 9030050 (May 2, 1990); P.L.R. 8913050 (Jan. 4, 1989); P.L.R. 8823111 (Mar. 17, 1988).

   ii) The Service has also approved a spin-off of Controlled, which was structured so that Controlled could avoid state regulatory burdens and pay dividends directly to a higher tier entity, because payment of direct dividends by Controlled enabled the parent of the affiliated group to pay down its debt more quickly (under state law, dividends from Controlled could not be paid immediately to the higher tier entity). P.L.R. 9105033 (Nov. 6, 1990).

c) Administrative/personnel cost savings: By separating two dissimilar businesses, it may be possible to reduce administrative costs by decreasing the overall personnel of the two businesses or by reducing administrative expenses

(due to regulatory requirements or otherwise). In Rev. Rul. 88-33, 1988-1 C.B. 115, the Service ruled that the business purpose requirement was satisfied by a distribution of the stock of a controlled gaming subsidiary to remove the parent's nongaming business from the licensing review process and to free the parent from the administrative expense of licensing the gaming business. See also P.L.R. 9345013 (Aug. 11, 1993); P.L.R. 9334010 (May 27, 1993); P.L.R. 9024014 (Mar. 13, 1990); P.L.R. 8936044 (June 13, 1989); P.L.R. 8932029 (May 15, 1989).

7. As discussed above, the preceding list of business purposes is intended to be non-exclusive. Accordingly, the Service should continue to rule favorably in appropriate cases on business purposes that have been acceptable in the past. The following is a list of additional business purposes on which the Service has previously ruled favorably.

   a. Tax savings

      (1) A corporate business purpose can be the reduction of non-federal taxes. Treas. Reg. § 1.355-2(b)(2). See also P.L.R. 199909038 (Dec. 8, 1998); P.L.R. 9823052 (Mar. 11, 1998); P.L.R. 9720033 (Feb. 19, 1997); P.L.R. 9301007 (Oct. 2, 1992); P.L.R. 9230028 (Apr. 29, 1992).

      (2) However, the purpose of reducing non-federal taxes is not a valid business purpose for purposes of section 355 if:

         a) The transaction will effect a reduction in both federal and non-federal taxes because of the similarities between the federal tax law and the tax law of the other jurisdiction, and

         b) The reduction of federal taxes is greater than or substantially coextensive with the reduction of the non-federal taxes.

      Treas. Reg. § 1.355-2(b)(2).

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

      (4) In Rev. Rul. 76-187, 1976-1 C.B. 97, the Service ruled that a distribution made to substantially reduce the parent's state

and local taxes was supported by a valid business purpose. See also Rev. Rul. 79-289, 1979-2 C.B. 145 (avoidance of newly enacted state franchise taxes).

(5) In Rev. Rul. 89-101, 1989-2 C.B. 67, a first-tier foreign subsidiary corporation distributed the stock of a second-tier foreign corporation to the domestic parent to reduce the foreign withholding tax imposed on distributions by the second-tier corporation. The parent would be able to take advantage of a reduced treaty rate. The reduction of federal taxes was substantially less than the reduction of non-federal taxes. The Service ruled that the distribution was supported by a valid business purpose.

(6) The Service has also privately ruled that a business purpose is present where a spin-off of a foreign corporation results in the elimination or reduction of foreign taxes. P.L.R. 8908084 (Dec. 5, 1988); P.L.R. 8705081 (Nov. 6, 1986); P.L.R. 8511086 (Dec. 20, 1984).

b. Election of S status

(1) Following the 1986 Act, an issue arose as to whether the desire of either the distributing or the controlled corporation to make an S election constituted a valid business purpose for purposes of section 355.

(2) Tax practitioners argued that, where the S election is respected at the state level, a valid business purpose should be found in a distribution designed to make a corporation eligible for an S election. Cf. Rev. Rul. 76-187, 1976-1 C.B. 97 (distribution to reduce state and local taxes was supported by a valid business purpose).

(3) The Service has put this discussion to rest by explicitly providing in the regulations that the election of S status is not a valid corporate business purpose because of the reduction in federal taxes occurring as a result of such an election. Treas. Reg. § 1.355-2(b)(5), Exs. 6 and 7.

(4) Interestingly, in P.L.R. 8825085 (Mar. 28, 1988), the Service approved of a distribution where the taxpayer represented that merely qualifying as an S corporation would produce substantial state tax savings even if no actual election were made at the federal level. The taxpayer represented that a federal S election would not be

made for three years. Also, a secondary business motive was proffered by the taxpayer.

(5) Not permitting the election of S status to be a valid business purpose may create an anomalous result. A parent can liquidate its subsidiary under section 332 and make an S election. This does not require a separate business purpose. Under the regulations, a spin-off designed to render either the distributing or the controlled corporation eligible for S status cannot qualify for section 355. Such a result elevates form over substance. The inordinate tax burden that would be imposed under section 311(b), in effect, discriminates against taxpayers who cannot liquidate their subsidiaries. A distributing corporation can, however, qualify for S status if only 21 percent of its subsidiary's stock is distributed. Gain (but not loss) on the subsidiary's stock is recognized under section 311(b) on such a distribution.

(6) The Service has ruled, however, that the preservation of S status may be a valid corporate business purpose for the distribution of the controlled corporation's stock in a divisive "D" reorganization. In P.L.R. 9241021 (July 9, 1992), Distributing, an S corporation, could realize significant savings on the cost of its insurance by separating a high-risk business from its other, low-risk businesses. Although these insurance savings could have been realized simply by forming a new subsidiary and not distributing its stock, such a transaction would have caused Distributing to lose its S status, which would have resulted in increased taxes that would have more than offset any insurance savings. See also P.L.R. 9250027 (Sept. 11, 1992) (separation of businesses was a prerequisite to obtaining HUD financing, distribution was required to preserve S status).

(7) Appendix C of Rev. Proc. 96-30 now contains representations that must be made by the taxpayer when Distributing or Controlled will become eligible to elect S status as a result of the distribution. The taxpayer must represent that either:

a) Distributing is not eligible to elect S status and Controlled does not intend to elect S status; or

b) Distributing is not currently eligible but will become eligible to elect S status immediately after

the distribution and both corporations will elect S status; or

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

c. Separation to enhance profitability

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

(1) In Rev. Rul. 75-337, 1975-2 C.B. 124, the Service approved of a distribution designed to ensure retention of an existing franchise agreement. See also P.L.R. 8453020 (Sept. 27, 1984) (escape burdensome aspects of a distributorship contract); P.L.R. 8427074 (Apr. 3, 1984) (enhance access to government contracts award process).

(2) In Rev. Rul. 56-266, 1956-1 C.B. 184, the Service approved of a distribution where it was alleged that the distributing corporation's businesses could be operated more profitably on a separate company basis.

d. Contain labor problems

(1) In Olson v. Commissioner, 48 T.C. 855 (1967), rev'd on another issue, 49 T.C. 84 (1967); acq. 1968-2 C.B. 2, the distributing corporation's employees were seeking an election to have a union represent them as their collective bargaining agent. Labor counsel recommended the distribution of the corporation's only subsidiary in order to prevent the possible argument by the employees that the subsidiary would be subject to the outcome of the election at the parent level (the subsidiary's employees were non-unionized).

(2) The Tax Court was satisfied that the primary purpose of the distribution was to contain labor difficulties being experienced at the parent level, and to avoid any spread of the unionization activity to the subsidiary.

(3) If the distributing corporation cannot demonstrate that a distribution of the subsidiary would prevent the two corporations from being treated as a single employer unit under the labor laws, the Service might not consider such a purpose to be valid.

e. Removal of regulatory burdens

(1) In Rev. Rul. 82-131, 1982-2 C.B. 83, the Service approved of a distribution that improved the utility's chances of obtaining regulatory approval of a rate increase. See also Rev. Rul. 77-191, 1977-1 C.B. 94; P.L.R. 9026042 (Mar. 30, 1990); P.L.R. 8503052 (Oct. 23, 1984).

(2) Spin-offs to enable Distributing, engaged in one business, to avoid the regulatory burdens placed upon it because of its ownership of Controlled, engaged in another business, have been accepted. See, e.g., P.L.R. 199915026 (Jan. 11, 1999); P.L.R. 199914007 (Dec. 23, 1998); P.L.R. 9718024 (Jan. 31, 1997); P.L.R. 9322034 (Mar. 10, 1993); P.L.R. 9026042 (Mar. 30, 1990); P.L.R. 9209032 (Aug. 29, 1991).

(3) Distributing was permitted to distribute stock of Controlled to the parent of the affiliated group so that the parent could receive dividends directly from Controlled, thus alleviating the parent's need to seek state regulatory approval for indirect cash distributions from Controlled. P.L.R. 9105040 (Mar. 20, 1990).

(4) A spin-off of a foreign Controlled in order to allow it to undertake an IPO and to circumvent certain restrictions imposed in its country of incorporation (as a result of its ownership by a U.S. corporation) has also been upheld. P.L.R. 9045031 (Aug. 14, 1990).

f. Divestiture orders

The regulations provide that a distribution undertaken to comply with a divestiture order is supported by a valid business purpose. Treas. Reg. § 1.355-2(b)(5), Ex. 1. See Rev. Rul. 62-138, 1962-2 C.B. 95; Rev. Rul. 70-18, 1970-1 C.B. 74; Rev. Rul. 83-23, 1983-1 C.B. 82; see also P.L.R. 9114028 (Jan. 8, 1991) (spin-off of a subsidiary by a federal savings bank in order to avoid sanctions from the Office of Thrift Supervision); P.L.R. 9101029 (Oct. 10, 1990) (spin-off to comply with divestiture order of Federal Reserve Board).

g. Ward off hostile takeovers

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

(1) In P.L.R. 8819075 (Feb. 17, 1988), the corporation's investment banker had advised the corporation (1) that it was currently vulnerable to a takeover attempt, (2) that the takeover price may be inadequate, and (3) that several subsidiaries might be sold, thereby causing harm to the corporation and its shareholders. A Schedule 13D filing recently had been made by a person or entity with a history of take-over participation, suggesting that a takeover was imminent. The Service approved of a distribution that allegedly would make the distributing corporation less vulnerable to such a takeover attempt.

(2) However, in P.L.R. 9005070 (Nov. 9, 1989) the Service revoked P.L.R. 8930055 (May 3, 1989) (a ruling with facts similar to P.L.R. 8819075). The Service did not provide a reason for the revocation, and stated only that "the described transaction has not been consummated." P.L.R. 9005070 did not revoke P.L.R. 8819075.

(3) In P.L.R. 9020048 (Feb. 23, 1990), the Service approved a spin-off in order to allow the formation of an ESOP, which was intended, in part, to serve as an anti-takeover device.

h. Spin-Off to enable Controlled to raise equity in a private placement

(1) In 1994, Ethyl Corporation completed a spin-off transaction of its chemical businesses, which enabled the Albemarle Corporation (the newly formed controlled corporation) to raise capital in a private placement to Ethyl's largest shareholders. The prior spin-off was motivated, in part, because the dividend cost to the corporation of an offering of stock without the spin-off would have been considerably higher.

(2) Similarly, in P.L.R. 9244008 (July 10, 1992), the Service approved of a spin-off in order to allow a "strategic investor" to purchase 10 percent of Controlled stock following the transaction, where the strategic investor indicated that it would not be willing to make the investment in Distributing or in Controlled as a member of Distributing's group. See also P.L.R. 8744035 (Aug. 4, 1987); P.L.R. 8950019 (Sept. 15, 1989).

G. The Continuity of Interest Requirement

The section 355 continuity of interest regulations clarify many aspects of the continuity of interest requirement as it applies in a section 355 context. In

general, the new regulations codify the principles contained in previously published rulings (i.e., Rev. Rul. 69-293, 1969-1 C.B. 102 and Rev. Rul. 79-293, 1979-2 C.B. 125). However, section 355(d) and (e) also must be considered.

1. In general

a. Historically, the continuity of interest requirement was viewed as being subsumed within the device requirement. Following the 1986 Act, however, significant attention was devoted to whether section 355 could be used as a tool for the break-up of target corporations with minimal tax (i.e., as a substitute for the classic "mirror" transaction). Such "bust-up" transactions typically involve a distribution to a corporate shareholder, and the device test does not appear to be applicable -- no earnings pass out of corporate solution.

b. The regulations under section 355 provide, however, that the continuity of interest requirement is independent of the other requirements of section 355. Treas. Reg. § 1.355-2(c)(1).

c. These regulations further provide that "section 355 requires that one or more persons who, directly or indirectly, were owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation." Treas. Reg. § 1.355-2(c)(1).

(1) Recently, the Service issued final continuity of interest regulations under section 368. See Treas. Reg. 1.368-1(e)(1). However, such regulations do not apply to section 355 transactions.

(2) The new regulations, however, provide a useful analogy to the continuity of interest test under section 355. The regulations state that continuity of interest requires that "in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization." Treas. Reg. 1.368-1(e)(1).

(3) The new regulations further state that the purpose of the continuity of interest requirement is "to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations." Treas. Reg. § 1.368-1(e)(1).

d. The continuity of interest requirement under section 355 can be broken down into several key aspects:

(1) Degree of continuity;

(2) Post-distribution continuity;

(3) Pre-distribution continuity, i.e., historic continuity; and

(4) Continuity in both the distributing and the controlled corporations.

These are discussed below.

2. Degree of continuity

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

a. The regulations provide that the continuity of interest test is satisfied if shareholders of the distributing corporation maintain some minimum level of continuity in both the distributing and controlled corporations following the section 355 transaction. Treas. Reg. § 1.355-2(c)(1).

b. By way of example, the Service sets forth in the regulations that 20 percent continuity of interest is insufficient, whereas 50 percent continuity is sufficient. Treas. Reg. § 1.355-2(c)(2), Exs. 1-4.

c. However, where the spin-off involves a "D" reorganization, there is an additional requirement that either the distributing corporation or its shareholders control the spun-off corporation immediately after the transaction. See Part III.B.3., supra. Moreover, the Service had suggested that it may use the step-transaction doctrine to impose an 80 percent "control" requirement even for non-"D" section 355 transactions, which would tend to subsume the continuity requirement. See Rev. Proc. 96-39, 1996-2 C.B. 300. More recently, however, amendments to section 368(a)(2)(H)(ii) have limited the effect of the step-transaction doctrine. See also Rev. Rul. 98-44, I.R.B. 1998-37.

3. Post-distribution continuity

a. In general

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

(1) The continuity of interest requirement, as set forth in the regulations, requires a continuing level of equity participation in both the distributing and the controlled corporations.

(2) Where subsequent dispositions of stock cause the shareholder's ownership to drop below this minimum level, the Service can be expected to argue that continuity of interest is lacking.

(3) Nevertheless, at some point in time, the shareholder should be able to dispose of his entire stock interest without risking a loss of continuity (i.e., the shareholder's stock becomes "old and cold").

a) In the context of a reorganization, the Service has stated that it will treat a five-year period of unrestricted ownership as a sufficient period of time for purposes of satisfying the continuity of interest requirement, i.e. the stock is "old and cold". See Rev. Rul. 66-23, 1966-1 C.B. 67; Rev. Rul. 78-142, 1978-1 C.B. 111. A disposition of the stock after that point in time will not violate continuity of interest.

b) Nonetheless, the courts have held, in the context of a reorganization, that post-reorganization sales of stock less than five years after the reorganization did not violate the continuity of interest requirement. See Penrod v. Commissioner, 88 T.C. 1415 (1987) (sale within nine months of reorganization did not violate continuity). But see McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982) (sale within seven months of reorganization violated continuity); section 355(e) and (f), which effectively eliminated tax-free Morris Trust transactions and intragroup spins related to such transactions.

c) Whether a shareholder sells his stock before it becomes "old and cold" often turns on step-transaction principles. Determining factors include, for example, whether the disposition occurred in close proximity to the distribution, whether the disposition was a sale or a reorganization, and

whether the disposition was pursuant to a binding contract at the time of the distribution.

(4) As a condition of obtaining a ruling, the Service generally requests shareholders with a five-percent or greater interest in the corporation to state that they have no intention to dispose of the subsidiary stock received. This has created difficulty where corporate raiders have refused to provide such a statement.

(5) Query: To what extent should the actions of some shareholders affect the tax consequences of unrelated shareholders? For example, if an 80-percent shareholder immediately sells all of the stock received in a spin-off, should this necessarily render the transaction taxable to the remaining shareholders who did not "cash out" their 20 percent interest in the controlled corporation? Cf. Kass v. Commissioner, 60 T.C. 218 (1973), aff'd without op., 491 F.2d 749 (3rd Cir. 1974).

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

b. Subsequent distributions

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

(1) In Rev. Rul. 62-138, 1962-2 C.B. 95, a corporation transferred a business to a newly formed subsidiary and distributed the stock to its immediate parent corporation. The parent then distributed the stock to its shareholders.

(2) The Service concluded that the second distribution of the subsidiary's stock (from the parent to its shareholders) did not violate the continuity of interest requirement in old Treas. Reg. § 1.355-2(c) because the ultimate shareholders (i.e., the parent's shareholders) held "the same enterprises in modified corporate form as before the transaction and the corporate enterprises were continued as such." See also

Rev. Rul. 84-30, 1984-1 C.B. 114; P.L.R. 9020031 (Feb. 20, 1990).

a) In Rev. Rul. 62-138, the Service treated the drop-down of assets and subsequent distributions as a section 351 transaction (not a "D" reorganization) followed by a section 355 transaction (presumably to avoid the "D" reorganization control issue). However, in P.L.R. 9236007 (Feb. 14, 1992), and P.L.R. 9141029 (July 11, 1991), "D" reorganizations, followed by multiple spin-offs were approved.

b) Therefore it would appear that a "D" reorganization is permitted even if followed by multiple spin-offs of Controlled.

(3) Implicit in this conclusion is the view that either the direct or the ultimate shareholders of the distributing corporation can maintain a continuing proprietary interest in the controlled corporation after the distribution.

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

c. Subsequent transactions involving the distributing corporation

Continuity of interest issues also arise where, following a section 355 transaction, the shareholders of the distributing corporation exchange all of their stock in such corporation for stock of another corporation in a tax-free reorganization. In the past, the Service

has not viewed such transactions as violating the continuity of interest requirement.

(1) For example, in Rev. Rul. 70-434, 1970-2 C.B. 83, an acquiring corporation was interested only in one of the two businesses conducted by the target. The target transferred the unwanted assets to a newly formed subsidiary and distributed the stock of the subsidiary to its shareholders. The acquiring corporation then acquired all of the target stock in exchange for its voting stock.

a) The Service stated that the first transaction qualified as a "D" reorganization because the requirements of section 355 were met. The second transaction was held to be a B reorganization.

b) Implicit in this ruling is the fact that the subsequent reorganization involving the distributing corporation did not break continuity of interest with respect to the distributing corporation's shareholders. These shareholders retained a continuing equity interest in the distributing corporation through their acquiring corporation stock.

c) Note that section 355(e) would impose a corporate-level tax on the transaction in Rev. Rul. 70-434 if the target's shareholders do not receive more than 50 percent of the acquiring corporation's stock. Query whether Rev. Rul. 70-434 is still valid in light of the corporate-level tax imposed by section 355(e).

(2) Similarly, in Rev. Rul. 78-251, 1978-1 C.B. 89, a parent corporation spun off its subsidiary, and the parent was acquired in a B reorganization immediately thereafter. Compare Rev. Rul. 55-103, 1955-1 C.B. 31 (a subsequent sale of the distributing corporation's stock will cause the distribution to be treated as a device).

(3) It is unclear, however, whether the Service continues to take this position. Rev. Proc. 96-30, § 4.06 states that, in general, the Service will view the continuity of interest requirement as satisfied if one or more persons who, directly or indirectly, were the owners of the enterprise before the distribution own, in the aggregate, 50 percent or more of the stock of each of the modified corporate forms

in which the enterprise is conducted after the distribution. This may reflect a more restrictive approach to the continuity requirement by the Service. Significantly, the shareholders in the Morris Trust case received over 50 percent of the stock of the corporation that acquired the distributing corporation in the merger. See Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966). But see section 355(e), which effectively eliminated tax-free Morris Trust transactions.

d. Subsequent transactions involving the spun-off corporation

(1) Historically, subsequent transactions involving the controlled corporation have raised issues under the control requirements of sections 355(a)(1)(D) and 368(a)(1)(D). See, e.g., Rev. Rul. 70-255, 1970-1 C.B. 80; Rev. Rul. 96-30, 1996-1 C.B. 36. However, as discussed above in Part III.B., the issuance of Rev. Rul. 98-27 and the enactment of the 1998 IRS Restructuring Act significantly curtailed the potentially disastrous consequences that resulted if, following a section 355 transaction, the shareholders of the controlled corporation exchanged their newly received stock in such corporation for stock in another corporation in a purported reorganization. But see Part III.J., infra, for a discussion of section 355(e), which effectively eliminates tax-free Morris Trust transactions.

(2) In Rev. Rul. 75-406, 1975-2 C.B. 125, in order to comply with a government order, a publicly held corporation spun off a subsidiary to its shareholders. The shareholders then voted to merge the subsidiary with a third corporation. The Service specifically ruled that the continuity of interest requirement in section 355 was satisfied, because the shareholders maintained an interest in the subsidiary through their stock in the acquiring corporation.

(3) In P.L.R. 9016025 (Jan. 18, 1990), the Service ruled that a sale by Controlled of certain assets, including subsidiary stock, had no effect on a prior ruling approving a spin-off.

(4) In P.L.R. 9030037 (Apr. 30, 1990) the Service ruled that a stock repurchase plan (which excluded prohibited sellers) for up to five percent of outstanding stock of the controlled corporation, due to a decline in the stock's value, did not adversely affect the prior favorable rulings.

4. <u>Pre-distribution continuity, i.e. historic continuity</u>

A third aspect of the continuity of interest requirement is whether the "historic" shareholders must be the ones who receive (or maintain) the requisite stock interest in the controlled and distributing corporations.

a. The regulations require continuity of interest on the part of the "owners of the enterprise prior to the distribution or exchange" and specifically provide that the continuity of interest must be with respect to historic shareholders. Treas. Reg. § 1.355-2(c)(1), (2), Ex. 3. (The reference to owners presumably refers to shareholders, but query whether the phrase would include creditors of a financially troubled corporation.)

(1) Accordingly, as continuity of interest is measured with respect to historic shareholders, prior sales of stock by such shareholders may prevent a subsequent distribution from qualifying as a section 355 transaction.

(2) Although no explicit guidance on this issue is provided by the regulations, a shareholder of a corporation is usually considered as being an "historic" shareholder if his stock interest has become "old and cold." A common benchmark for stock becoming "old and cold" is a two-year holding period.

(3) However, the two-year period does not appear to be mandated. A period of less than two years may be sufficient to render a stock investment "old and cold."

(4) On the other hand, the step-transaction doctrine may apply to treat a shareholder who has held stock for a sufficient period of time as a non-historic shareholder. <u>See</u> F.S.A. 199929013 (Apr. 19, 1999).

a) In F.S.A. 199929013, P entered into an agreement with XS1, which granted XS2, a wholly owned subsidiary of XS1, a right to purchase P stock from its shareholders. Pursuant to the agreement, P also granted XS2 a one-year put option to require P to acquire its stock from XS2. The option commenced a specified number of years after the closing date. Upon exercise of the option, P had the right to settle the option in cash or with stock of its subsidiary, PS. XS2 exercised the option, and P transferred to XS2 shares of PS in exchange for its P stock, which the parties treated as a split-off.

b) The Service applied the step-transaction doctrine to treat the acquisition of P stock by XS2 and the exchange of the P stock for PS stock as part of one plan. As a result, XS2 would be treated as acquiring the P stock immediately before the stock exchange. The Service thus concluded that the transaction did not qualify under section 355, because it failed the continuity of interest requirement.

b. Section 355(b)(2)(D), in effect, also imposes a historic shareholder requirement in certain cases. Under section 355(b)(2)(D), a distribution will not be tax free if a distributee corporation or the distributing corporation acquired control of the distributing or controlled corporation within five years of the date of the distribution.

c. Similarly, if section 355(d) applies, then five years must elapse in respect of "disqualified stock" if the distribution is to be free of tax at the corporate level.

d. Where a distribution falls outside of section 355(b)(2)(D) or 355(d), a question arises as to whether historic shareholder continuity should apply.

(1) One can argue that historic continuity is needed only to prevent so-called "bust-up" transactions, which are used to distribute wanted or unwanted target assets and which are specifically targeted by section 355(b)(2)(D) and 355(d).

(2) Historic shareholder continuity tends to discriminate against closely held corporations since, as a practical matter, historic continuity is not enforced with respect to publicly held corporations. Indeed, in the context of acquisitive reorganizations, one court decision suggests that trading by public shareholders should be ignored for continuity purposes if it is not in concert with the corporation or controlling shareholders. See Seagram Corp. v. Commissioner, 104 T.C. 75 (1995).

5. Continuity in both the distributing and the controlled corporations

a. Another key aspect of the continuity of interest requirement is whether continuity must be maintained in both the distributing and the controlled corporations. The regulations explicitly provide that this is necessary. Treas. Reg. § 1.355-2(c)(2), Ex. 3.

b. To satisfy this requirement, it is not necessary for each shareholder to continue to own an equity interest in each corporation following the transaction. Rather, the continuing shareholders in one corporation do not necessarily have to be the same as the continuing shareholders in the other corporation.

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

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

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

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

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

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

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

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

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

Distributing and for Distributing to contribute the stock of Sub to Controlled.

iii) Even this transaction, however, could be viewed as failing to qualify as a "D" reorganization. Immediately after the transaction, there is no direct shareholder continuity of interest with respect to NewSub.

iv) However, if the "remote continuity" approach of Rev. Rul. 62-138 is applied, the transaction should be treated as a valid "D" reorganization.

c) It is also possible that, instead of a spin-off, the division of Sub could be structured as a split-off.

i) Prior to the division of Sub, Distributing could contribute a portion of the stock of Sub to Controlled.

ii) Sub would then form NewSub with a contribution of its Business B, and would distribute the NewSub stock to Controlled in exchange for its Sub stock.

iii) In this manner, the control requirement of section 368(a)(1)(D) and "post-transaction" continuity of interest are preserved.

iv) Some issue still remains as to "pre-transaction" continuity of interest. However, section 355(b)(2) provides an indication that pre-distribution intra-group transfers of stock should be disregarded.

H. Continuity of Business Enterprise Requirement

1. The regulations also appear to impose a continuity of business enterprise requirement on section 355 transactions stating that "section 355 contemplates the continued operation of the business or businesses existing prior to the separation." Treas. Reg. § 1.355-1(b).

2. The preamble to the continuity of business enterprise regulations, which were issued in January 1998, provides that the regulations are not limited to transactions enumerated in section 368(a)(2)(C) (i.e., "A," "B," "C," or "G" reorganizations), but rather they apply to all reorganizations for which

continuity of business enterprise is relevant. Preamble to Treas. Reg. § 1.368-1(d). Accordingly, the new continuity of business enterprise regulations, which generally expand the assets and business of the issuing corporation to include those of members of a qualified group of corporations, should apply to section 355 transactions.

3. It is not clear how the continuity of business enterprise requirement is applied to a section 355 transaction, and how it interacts with the other requirements of section 355.

   a. For example, assume that a corporation operates an historic five-year business which represents five percent of its assets. The corporation also holds cash or cash equivalents, which it received from the sale of its other historic business assets. The corporation apparently would still be considered as engaging in an active business under section 355(b)(2)(A) since it holds the five-year business. See G.C.M. 34,238 (Dec. 15, 1969); P.L.R. 8712019 (Dec. 18, 1986). Nevertheless, it is not clear whether the continuity of business enterprise requirement would prevent a distribution by the corporation from qualifying under section 355.

   b. Note that in a section 368 context, if the stock or assets of the distributing corporation were acquired by another corporation, such transaction would not be treated as a reorganization because the distributing corporation would have violated the continuity of business enterprise requirement. See Treas. Reg. § 1.368-1(d); Rev. Rul. 87-76, 1987-2 C.B. 84.

   c. The Service apparently has not applied the continuity of business enterprise requirement to prevent a distribution from qualifying under section 355.

   d. In any event, a corporation holding a significant amount of liquid assets may not qualify under section 355 because of the device restriction.

I. Section 355(d) Issues

1. In general

   a. Section 355(d) requires that the distributing corporation recognize gain (but does not require that the distributee shareholders recognize income) on a "disqualified distribution" of subsidiary stock or securities. A disqualified distribution means any distribution to which section 355 applies if, immediately after the distribution, a shareholder holds stock representing a 50-percent or greater interest (by vote or value) in either the distributing corporation or a controlled subsidiary that is attributable to stock or

securities that were acquired by "purchase" after October 9, 1990, and during the 5-year period ending on the distribution date ("disqualified stock").

b. Section 355(d) was enacted as part of the 1990 Act in order to restrict the availability of section 355 in certain cases discussed below.

(1) These restrictions were enacted in response to a growing Congressional perception that section 355(b)(2)(D) was capable of being circumvented (by the use of unaffiliated parties), and that section 355 was being used to promote transactions that were, in fact, disguised sales or devices to achieve tax-free stepped-up bases prior to sale.

(2) Most commonly it was felt that this occurred where corporations used section 355 to achieve a fair market value basis in the stock of a controlled subsidiary and then subsequently sold that stock at little or no gain (i.e., as mirror substitute transactions).

c. Under the section 355(d) rules, gain will be recognized by the distributing corporation on a disqualified distribution. If a disqualified distribution is made, then all gain in respect of the distributed shares will be realized -- not just that relating to disqualified stock.

d. Section 355(d) applies whether the distribution is part of a spin-off, split-off or split-up.

e. Section 355(d) does not just foreclose avoidance of section 355(b)(2)(D) but also, in the words of the House Report, will disallow favorable tax treatment for any transaction under section 355 that is "combined with a stock purchase resulting in a change of ownership, [which] in effect results in the disposition of a significant part of the historic shareholders' interests in one or more of the divided corporations." H.R. Rep. No. 101-881, at 341 (1990).

f. As drafted, section 355(d) is extremely broad. Recognizing the far, and in many instances unintended, reach of section 355(d), Congress specifically authorized the Treasury to issue such regulations "as may be necessary to carry out the purposes of this subsection, including . . . regulations modifying the definition of the term 'purchase.'" Section 355(d)(9).

g. On April 29, 1999, Service issued proposed regulations providing extensive guidance under section 355(d). The proposed

regulations adopt a reasonable approach that limits the reach of section 355(d) to transactions that violate its purposes. Prop. Treas. Reg. § 1.355-6(b)(3)(i).

(1) The proposed regulations contain an anti-avoidance rule, which permits the Service to treat any distribution as disqualified if the distribution or another transaction is engaged in or structured with a principal purpose to avoid the purposes of section 355(d). Prop. Treas. Reg. § 1.355-6(b)(4).

(2) The proposed regulations also provide that the distributing corporation may rely upon filings with the Securities and Exchange Commission in determining whether there is a disqualified shareholder and, absent actual knowledge, may presume that no less-than-five-percent shareholder acquired stock by purchase. Prop. Treas. Reg. § 1.355-6(f).

2. Disqualified distributions

a. Under section 355(d)(2), a "disqualified distribution" refers to any distribution if immediately after the distribution any person holds "disqualified stock" in the distributing or controlled corporation (or, if stock of more than one controlled corporation is distributed, in any controlled corporation), and such disqualified stock constitutes a 50-percent or greater interest in such corporation.

(1) For example, assume that A holds 50 percent of the stock of Distributing Corp and such stock is "disqualified stock" (as defined below). The remaining stock of Distributing Corp is owned by unrelated individuals. In 1996, Distributing Corp distributes the stock of its controlled subsidiary, pro rata, to its shareholders in a transaction that otherwise qualifies for section 355 treatment.

(2) After the distribution, A will own disqualified stock representing 50 percent in both Distributing and the former subsidiary. As a result, the distribution is a disqualified distribution.

b. A disqualified distribution can result even though a shareholder holds disqualified stock representing less than 50 percent of the distributing corporation before the distribution.

(1) To illustrate, assume that A and B both hold 50 percent of Distributing Corp (which in turn owns 100 percent of S Corp). One-half of B's stock (25 percent) is disqualified stock. All of A's stock has been held for more than five

years. In 1996, A and B decide to divide up the business by way of split-off, and 100 percent of S Corp is distributed to B.

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

c. The 50-percent requirement can also be met by aggregating purchased stock of the subsidiary (acquired within 5 years) with distributed stock.

(1) In November 1994, P purchased a 20-percent stock interest in Distributing Corp and 10-percent stock interest in S Corp (D Corp's controlled subsidiary). Such stock is disqualified stock. Within five years after that purchase, 40 percent of the stock of S Corp is distributed to P in exchange for his Distributing Corp stock in a split-off under section 355. The remaining 60 percent of the S stock is split-off to an historic 25-percent shareholder of Distributing in the same transaction.

(2) D Corp will have to recognize gain on the distributed stock of S Corp, because P's 50-percent interest in S Corp immediately after the distribution is disqualified stock.

3. Disqualified stock

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

b. Section 355(d)(6) provides that the five-year time period will be suspended whenever the stock or securities are subject to a substantial diminution of risk by the use of an option, a short sale, any special class of stock, or "any other device or transaction."

(1) Under the proposed regulations, whether a holder's risk of loss is substantially diminished will be determined "based on all facts and circumstances relating to the stock, the corporate activities, and arrangements for holding the stock." Prop. Treas. Reg. § 1.355-6(e)(4)(iii).

(2) However, Congress has stated that a holder's risk of loss will ordinarily not be considered to be substantially

diminished "solely by virtue of customary indemnities given by the seller of stock." H.R. Conf. Rep. No. 101-964, at 1089. Nonetheless, it is possible that mandatory redemption features, or simple put and call options may invoke suspension.

(3) The term "special class of stock" includes a class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to earnings, assets, or attributes of less than all the assets or activities of a corporation or any of its subsidiaries. Prop. Treas. Reg. § 1.355-6(e)(4)(iv).

a) For example, the term includes tracking stock and stock (or related instruments or arrangements) the terms of which provides for the distribution of any controlled corporation or other assets to the holder or to persons other than the holder. Prop. Treas. Reg. § 1.355-6(e)(4)(iv); see also H.R. Conf. Rep. No. 101-964, at 1089-90.

(4) It does not seem that warranties and indemnities of a seller will invoke a suspension, but mandatory redemption features, or simple put and call options may well.

4. Stock acquired by purchase

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

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

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

b. However, property acquired in a section 351 exchange for any cash or cash item, any marketable stock or security, or any debt of the

transferor is treated as acquired by purchase. Section 355(d)(5)(B).

(1) As suggested in the legislative history, the proposed regulations provide exceptions to this rule.

(2) Transfers to holding companies

a) If the transferor transfers marketable stock of a corporation in an amount that meets the requirements of section 1504(a)(2), the transferor will not be treated as purchasing the stock of the transferee. Prop. Treas. Reg. § 1.355-6(d)(3)(iii).

b) For example, if the public shareholders of P Corporation, acting pursuant to a plan or arrangement, transfer all the stock of P to D Corporation in exchange for all of the stock of D, the public shareholders of P will not be treated as purchasing the D stock, because they have transferred at least 80 percent (by vote and value) of the D stock. See Prop. Treas. Reg. §§ 1.355-6(d)(3)(iii)(B); -6(c)(4).

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

a) The section 351 transfer is not treated as a purchase, if:

i) The transferor is engaged in the active conduct of a trade or business, and the transferred items (i.e., the cash, marketable stock, or debt) are used in such trade or business;

ii) The transferred items do not exceed the reasonable needs of the trade or business;

iii) The transferor transfers the items as part of the trade or business; and

iv) The transferee continues the active conduct of the trade or business.

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

(4) Transfers between members of an affiliated group

a) Finally, the rule does not apply if transferor(s), transferee, and the controlled corporation are all members of the same affiliated group before the section 351 transaction (if the transferee is in existence prior to the transaction) and do not cease to be members of such affiliated group in any transaction related to the section 351 transaction (including any distribution of the controlled corporation). Prop. Treas. Reg. § 1.355-6(d)(3)(v); see also H.R. Conf. Rep. No. 101-964, at 1092-93.

b) For example, assume that P Corporation owns all the stock of D Corporation and contributes cash to D which is equal to 60 percent of the value of D in a section 351 transaction. Assume further that within five years after the cash contribution, D contributes assets to a newly formed controlled corporation, C Corporation, and distributes its C stock to its sole shareholder, P in a section 355(a) transaction. P's cash contribution to D is not treated as a purchase of D stock, because P, D, and C do not cease to be members of the affiliated group at any time. See Prop. Treas. Reg. § 1.355-6(d)(3)(v)(B), Ex.1.

c. Triangular reorganizations

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

(1) The proposed regulations generally treat a triangular asset reorganization as if the parent corporation

a) Acquired the assets and assumed the liabilities of the target corporation in a transaction in which the parent corporation's basis in the assets of the target corporation is determined under section 362(b), and

b) Transferred the acquired assets and liabilities to the subsidiary in a section 351 transfer.

(2) In the case of a reverse subsidiary merger under section 368(a)(2)(E) that also qualifies as a "B" reorganization or section 351 transaction, the proposed regulations provide that the total amount of stock treated as purchased by the parent corporation will be the higher of:

a) The amount of stock that would be treated as purchased under the general rule for triangular asset reorganizations, or

b) The amount of stock that would be treated as purchased under the transferred basis rule.

d. There are also special rules that apply to stock acquired in certain transferred basis and exchanged basis transactions.

(1) Under section 355(d)(5)(C), if a person acquires property in a carryover basis transaction from a person who purchased the property, then the transferee will be considered to have acquired the property by purchase on the date the transferor purchased the property. See also Prop. Treas. Reg. § 1.355-6(e)(2).

(2) In addition, if a person acquires an interest in an entity by purchase, and such interest is exchanged for an interest in a second entity where the adjusted basis of the second interest is determined in whole or in part by reference to the adjusted basis of the first interest, then the second interest is treated under the proposed regulations as having been purchased on the date the first interest was purchased. Prop. Treas. Reg. § 1.355-6(e)(3).

e. Deemed purchase rule

Section 355(d)(8)(B) contains special purchase rules whereby stock purchases by a corporation will be attributed to the corporation's shareholders, and purchases of a parent corporation will be treated as purchases of lower tier corporation stock.

(1) Assume that A has owned 40 percent of Distributing Corp, and Distributing has owned 60 percent of S Corp for more than five years. A is deemed to have owned 24 percent (i.e., 40 percent x 60 percent) of S for more than five years. In 1993, Distributing purchases an additional 20 percent of S. A is deemed to have purchased 8 percent (i.e., 40 percent x 20 percent) of S at that time. In 1994, A purchases an additional 10 percent of Distributing stock and is deemed to have purchased an additional 8 percent (i.e., 10 percent x 80 percent) of S's stock at that time also.

(2) A will be treated as owning all 80 percent of the S stock owned by Distributing (section 355(d)(7)(A)) and as having purchased in 1993 and 1994 a total of 16 percent of S's

stock as a result of the purchases of S stock by Distributing and purchases of Distributing stock by A (section 355(d)(8)).

(3) Elimination of basis

a) The proposed regulations provide that a person who acquires an interest in an entity by purchase ceases to be treated as having purchased stock owned by that entity under the deemed purchase rule when the person no longer owns the directly purchased interest. Prop. Treas. Reg. § 1.355-6(b)(3)(iv).

b) This rule essentially permits a shareholder to purge its tainted stock basis by eliminating it, such as through a liquidation or upstream merger.

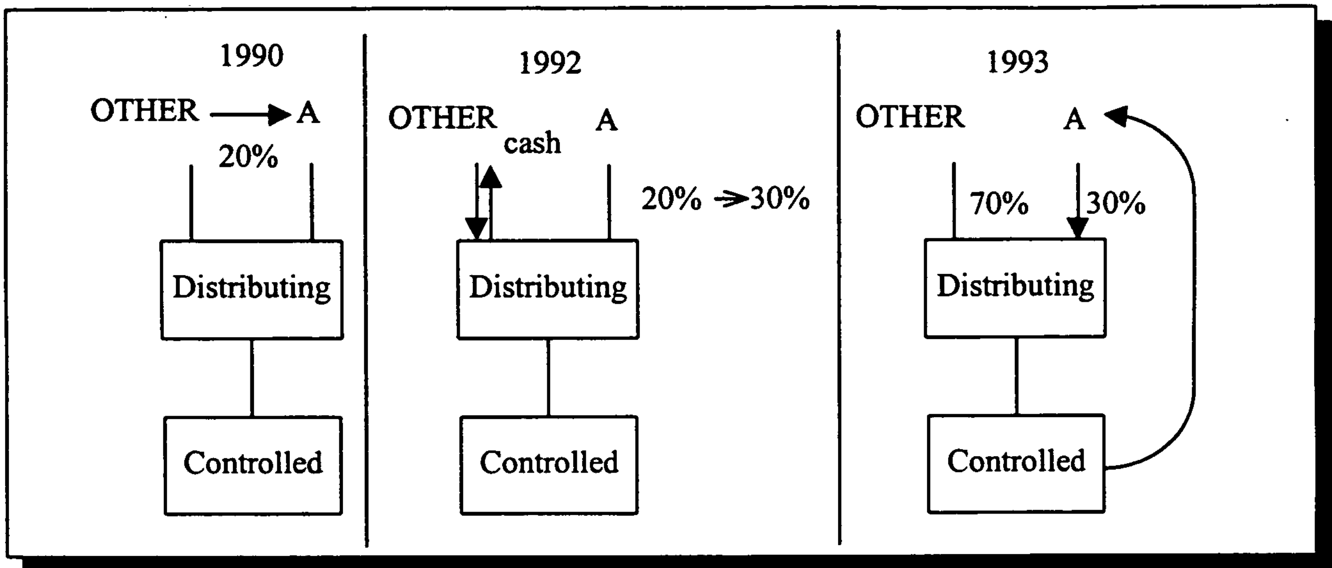
f. In certain cases redemptions of stock or distributions of boot will be classified as purchases. See H.R. Conf. Rep. No. 101-964, at 1092.

(1) Under the proposed regulations, the fact that a shareholder receives boot will generally not affect whether the acquisition is a purchase under section 355(d), as long as section 358(a)(1) applies to determine the transferor's basis in the stock received. Prop. Treas. Reg. § 1.355-6(d)(2)(i).

a) However, if the transferor receives nonqualified preferred stock or stock in a third corporation as boot, the transferor is treated as purchasing such stock on the date of the section 351 exchange or reorganization (because the transferor receives a fair market value basis in such stock). Prop. Treas. Reg. § 1.355-6(d)(2)(i)(A)(2); -6(d)(2)(i)(C), Ex.1; see sections 351(g) and 356(e).

b) Similarly, transferee corporations are generally not treated as purchasing stock received to the extent section 362(a) or (b) (or section 334(b)) applies to determine the transferee's basis in the stock received. Prop. Treas. Reg. § 1.355-6(d)(2)(i)(B)(1). However, to the extent the transferee's basis in the stock received is increased through the recognition of gain by the transferor, the stock is treated as purchased on the date of the stock acquisition. Prop. Treas. Reg. § 1.355-6(d)(2)(i)(B)(2).

(2) Example 10 -- "Purchase" by redemption



a) Facts: A purchases 20 percent of Distributing in November 1990. In 1992, Distributing redeems a portion of its own stock, which raises A's interest to 30 percent. In 1993, A receives 50 percent of the stock of Distributing's subsidiary, Controlled, in exchange for his Distributing stock.

b) The entire distribution is attributable to A's disqualified stock (the 20 percent acquired and 10-percent increase due to the previous redemption) and, therefore, should be a disqualified distribution.

c) The proposed regulations do not address the issue raised by this example.

i) They do, however, contain an anti-avoidance example wherein the following steps are undertaken with a principal purpose to avoid section 355(d): B owns all of D's stock; A purchases 45 of D's 100 outstanding shares from B; D distributes its C stock pro rata to A and B; D redeems 20 shares of B's D stock, and C redeems 20 shares of B's C stock, so that A is left with 45 of the 80 outstanding shares in both D and C. The proposed regulations conclude

that this violates the anti-avoidance provision and, thus, section 355(d) applies.

ii) This example is distinguishable from Example 10, above.

5. Fifty-percent test

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

a. Aggregation of interests

(1) Section 355(d)(7)(A) contains aggregation rules, which ensure that certain groups of related persons (as set out in sections 267(b) and 707(b)(1)) are treated as one person for purposes of ascertaining stock ownership. These groups include: husband and wife; parent and child; siblings; a partnership or partnerships owned more than 50 percent by an individual; a corporation and its more-than-50-percent individual owner; and two corporations that are members of the same controlled group.

(2) If a person owns more than 50 percent of a corporation, then under section 267(b), he is deemed to own all the stock owned by the corporation. For example, if A owns 60 percent of I Corp, which in turn owns 40 percent of D Corp; and if A owns 10 percent of D directly, then he will be deemed in aggregate to own 50 percent of D Corp (40 percent through ownership of I Corp and 10 percent individually).

(3) Section 355(d)(7)(B) provides that if two or more unrelated persons act pursuant to a plan or arrangement in relation to the acquisition of stock of the distributing corporation, then their interests will be treated as those of one person.

a) There is no requirement that the plan be in writing. The intent is clearly to prevent the perceived method of circumventing section 355(b)(2)(D) by use of unrelated entities acting in concert.

b) Under the proposed regulations, two or more persons will be treated as acting pursuant to a plan or arrangement only if they have a formal or informal understanding among themselves to make

a coordinated acquisition of stock. Prop. Treas. Reg. § 1.355-6(c)(4)(ii).

i) In determining whether an understanding exists, a principal element is whether the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders.

ii) Thus, a public offering is generally not treated as a plan or arrangement if each investor makes its own investment decision.

b. <u>Entity attribution rules</u>

(1) Section 355(d)(8) amends the attribution rules of section 318(a)(2) regarding the constructive stock ownership rules.

a) Under 355(d)(8), the threshold test for section 318(a)(2) is reduced from 50 percent to 10 percent.

b) Any stock owned by a partnership, trust or estate is considered to be owned proportionately by partners or beneficiaries without regard to whether the size of their interest exceeds 10 percent.

(2) It should be noted that the aggregation rule controls over any otherwise applicable entity attribution rule. Therefore if A owns 40 percent of D Corp, which owns 40 percent disqualified stock in S Corp, A will be deemed to own 16 percent of S Corp. If A increases his interest in D to 51 percent, he will deemed to own D's entire 40 percent interest in S.

c. <u>Treatment of options</u>

(1) The proposed regulations generally do not count options for purposes of section 355(d).

(2) However, Prop. Treas. Reg. § 1.355-6(c)(3) provides that an option that has not been exercised on the date of a distribution will be treated as exercised for purposes of section 355(d) if:

a) Its exercise would cause a person to become a disqualified person (alone or in conjunction with the deemed exercise of other options), and

b) Immediately after the distribution, it is "reasonably certain" that the option will be exercised. If either requirement is not satisfied, an unexercised option will not be treated as exercised.

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

(3) For purposes of these rules, the term "option" is broadly defined to include a call option, warrant, convertible obligation, the conversion feature of convertible stock, put option, redemption agreement, notional principal contract that provides for the payment of amounts in stock, stock purchase agreement or similar arrangement, or any other instrument that provides for the right to purchase, issue, redeem, or transfer stock (including an option on an option). Prop. Treas. Reg. § 1.355-6(c)(3)(v)(A). In addition, an option includes a cash settlement option, phantom stock, stock appreciation right, notional principal contract that provides for payment based on the price of stock, or any other similar interest (except for stock). Prop. Treas. Reg. § 1.355-6(c)(3)(v)(B).

(4) An "option" does not include certain instruments that are not normally abusive, including compensatory options and options that are part of a security arrangement in a typical lending transaction. Prop. Treas. Reg. § 1.355-6(c)(3)(vi).

(5) If an option is treated as exercised under the proposed regulations, it is treated as exercised on the date it was issued or most recently transferred. Prop. Treas. Reg. § 1.355-6(c)(3).

6. Purpose exception

a. Congress granted Treasury regulatory authority to exclude from section 355(d) transactions that do not violate the purposes thereof. For example, Treasury may modify the meaning of "purchase" so that certain acquisition cases will not be treated as purchases. See section 355(d)(9); H.R. Conf. Rep. No. 101-964, at 1091.

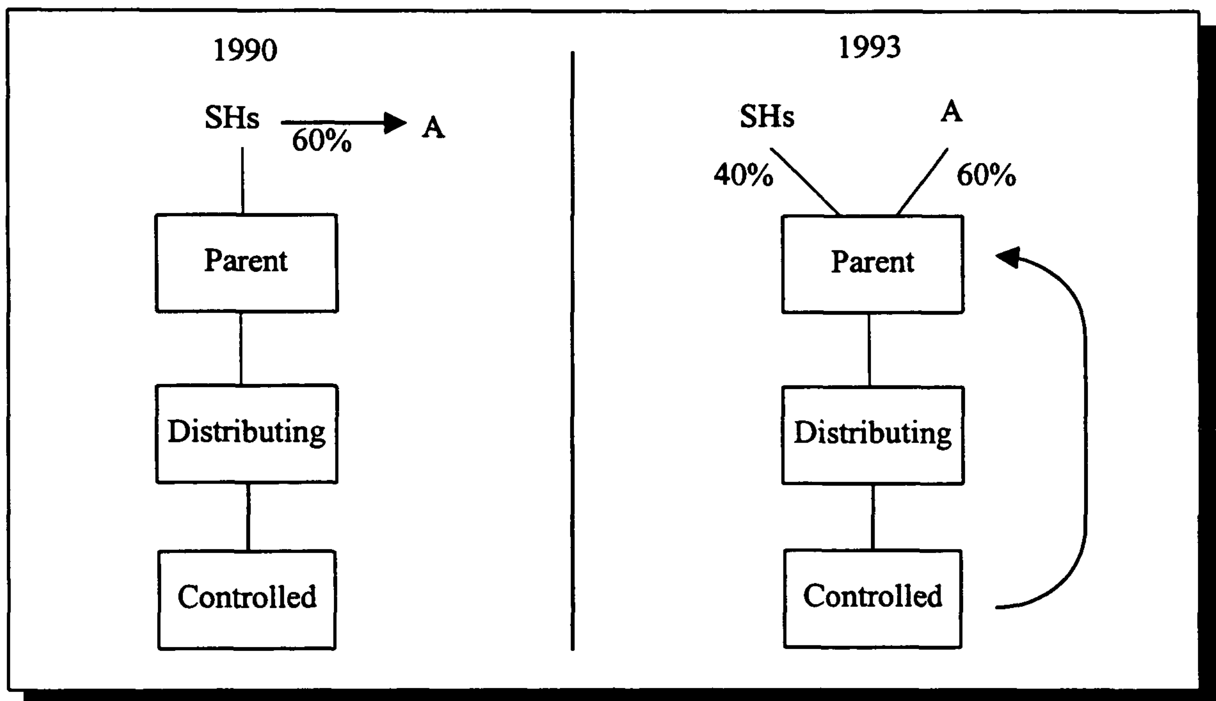
b. As discussed above, the Service has issued proposed regulations that limit the reach of section 355(d) to transactions that violate its purposes. Under the proposed regulations, if section 355(d) would otherwise apply to a distribution, the proposed regulations remove the distribution from section 355(d) if it meets a two-prong test: a "disqualified person" neither (1) increases its direct or indirect ownership in the distributing or controlled corporation nor (2)

obtains a "purchased basis" in controlled corporation stock (the "purpose exception"). Prop. Treas. Reg. § 1.355-6(b)(3)(i)(A), (B).

(1) A disqualified person is any person that, immediately after a distribution, holds the requisite 50-percent or greater disqualified stock interest in the distributing or controlled corporation. Prop. Treas. Reg. § 1.355-6(b)(3)(ii).

(2) Purchased basis is defined as basis in the controlled corporation's stock that is disqualified stock, unless the controlled corporation's stock and the distributing corporation's stock on which the controlled corporation stock is distributed are treated as acquired by purchase solely by reason of the deemed purchase rule of section 355(d)(8). Prop. Treas. Reg. § 1.355-6(b)(3)(iii).

c. Example 11 -- Purpose exception



(1) Facts: P owns all of the stock of D. P's basis in the D stock is $600, and the fair market value of D (including C) is $800. D owns all of the stock of C. D's basis in the C stock is $50, and the fair market value of C is $400. P and D have owned all of the stock of D and C, respectively, for more than five years. In 1990, Individual A purchases 60

percent of the P stock for $600 cash. In 1993, D distributes the C stock to P.

(2) Under the deemed purchase rule, A is treated as having purchased 60 percent of the stock of both D and C on the date A purchases 60 percent of the P stock. Thus, both the D and C stock constitute disqualified stock, and section 355(d) applies.

(3) However, under the purpose exception, section 355(d) will not apply, because the purposes of the section are not violated. Because the distribution was a pro-rata spin-off, A did not increase his interest in D or C. In addition, P's basis in the C stock is not a purchased basis, because both the D and C stock are treated as acquired by purchase solely by reason of the deemed purchase rule of section 355(d)(8). Prop. Treas. Reg. § 1.355-6(b)(3)(v), Ex.1.

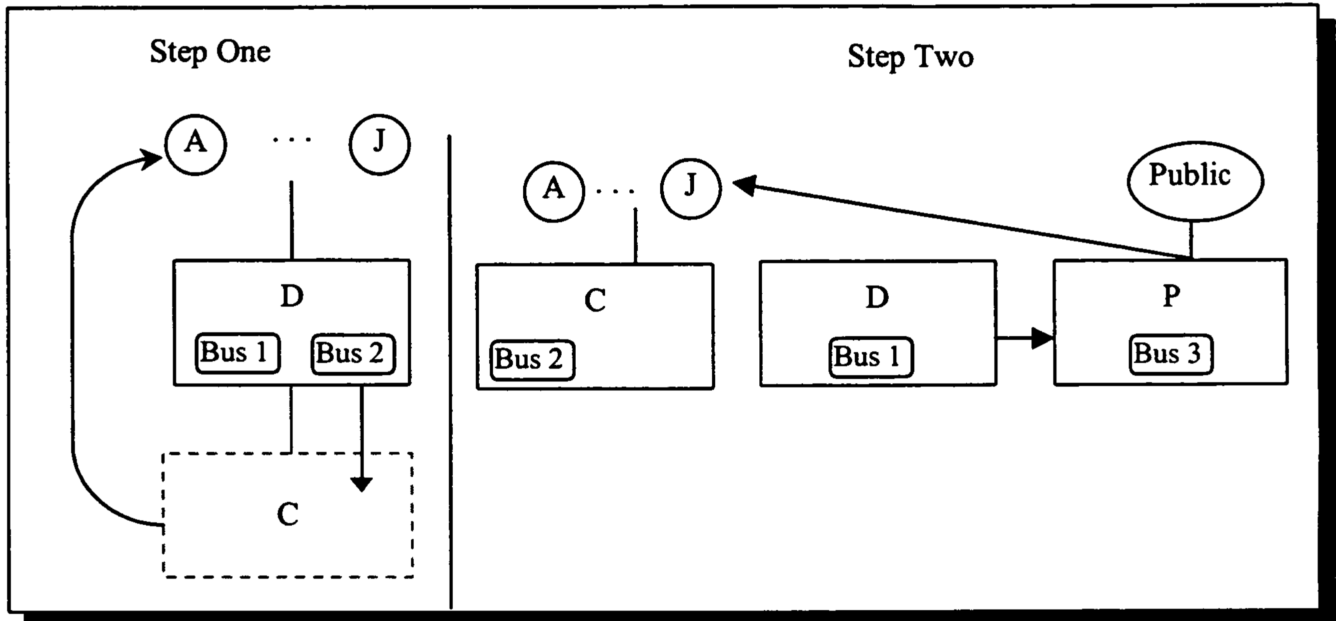
(4) If P further distributed the C stock to its shareholders pro rata, the purposes exception would not apply. A did not increase his interest in P or C. However, A's basis in the C stock is a purchased basis, because it was not treated as acquired by purchase solely under the deemed purchase rule. Prop. Treas. Reg. § 1.355-6(b)(3)(v), Ex.2.

a) It is only P's gain with respect to C that is recognized -- none of D's gain with respect to C should be recognized, since the intragroup spin-off was not a disqualified distribution. See P.L.R. 199931003 (Apr.21, 1999).

(5) Similarly, if P further distributed the C stock to A in exchange for A's purchased stock in P in a split-off, the purpose exception would not apply. Under these facts, both prongs of the purpose exception are violated. A has increased his ownership in C from a 60-percent indirect interest to a 100-percent direct interest. In addition, A's basis in the C stock is a purchased basis, because the P stock is not treated as acquired by purchase solely under the deemed purchase rule. Prop. Treas. Reg. § 1.355-6(b)(3)(v), Ex.3.

J. Section 355(e)

1. Example 12 -- Morris Trust (prior to TRA 1997)/ Rev. Rul. 70-434



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

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

b. Issues:

(1) The distribution of unwanted assets to facilitate the merger of the distributing corporation constitutes a valid business purpose for a spin-off. Mary Archer W. Morris Trust, 42 T.C. 779 (1964), aff'd, 367 F.2d 794 (4th Cir. 1966), acq. Rev. Rul. 68-603, 1968-2 C.B. 148; see also Rev. Proc. 96-30, Appendix A, § 2.07.

(2) It is not necessary that Distributing merge into P. It may also be acquired by P in a stock for stock exchange qualifying as a "B" reorganization. See Rev. Rul. 70-434, 1970-2 C.B. 83. The ruling declined to recharacterize such a transaction as a distribution of Controlled stock by P as consideration in the merger. In that event, the Controlled stock could have been viewed as "boot" that would have caused the transaction to fail to meet the requirement that the acquisition be "solely" for P voting stock.

(3) Importantly, the fact that the shareholders of Distributing will dispose of "control" of Distributing in a Morris Trust transaction does not prevent the distribution transaction from qualifying under section 355. There is no requirement that shareholders "control" Distributing before or after a distribution. Thus, even if the merger is "stepped together" with the distribution under the step-transaction doctrine, the distribution transaction should still qualify under section 355. But see section 355(e), discussed in Example 13, infra (imposing a corporate-level tax on Distributing).

(4) Continuity of interest should be satisfied even though the Distributing shareholders will own less than a 50-percent interest in the assets of Distributing. The Morris Trust case involved a merger in which the Distributing shareholders received over 50 percent of the stock of the combined entity. Thus, it does not provide direct authority for treating continuity as satisfied. Nevertheless, rulings issued by the Service have not imposed a requirement that the Distributing shareholders retain a 50-percent or greater interest in Distributing in Morris Trust transactions. See, e.g., Rev. Rul. 75-406, 1975-2 C.B. 125; Rev. Rul. 68-603, 1968-2 C.B. 148.

a) The Service's current approach to this issue is not entirely clear from the ruling guidelines. See Rev. Proc. 96-30, § 4.06. That provision states that, in general, the Service will view the continuity of interest requirement as satisfied if one or more persons who, directly or indirectly, were the owners of the enterprise before the distribution own, in the aggregate, 50 percent or more of the stock of each of the modified corporate forms in which the enterprise is conducted after the distribution. This could be interpreted as imposing substantially the same restrictions regarding post-distribution stock

ownership as section 355(e), outlined in Example 15, infra.

b) However, the regulations merely require that the business be continued in "modified corporate form." See Treas. Reg. § 1.355-2(c). This should include the indirect conduct of the business through P. See Rev. Rul. 75-406. It would be anomalous to treat continuity of interest as not met when Distributing shareholders receive solely stock of P and no other consideration in the merger.

(5) For similar reasons, there should be no limitation on the amount of new stock that may be issued by Distributing following a section 355 distribution of Controlled. Rev. Proc. 96-30 specifically recognizes that facilitating a subsequent IPO by Distributing may be a valid reason to spin-off a business. See Rev. Proc. 96-30, Appendix A, § 2.02. There is no requirement that historic shareholders maintain "control" of Distributing, and continuity should not be implicated by a dilutive transaction. Therefore, even if Distributing issues an amount of stock that reduces the interest of the historic shareholders below 50 percent, this should not implicate the prior spin-off. Nevertheless, prior to Rev. Proc. 96-30, the Service would not rule where Distributing intended to issue an amount of stock that exceeded 50 percent of its outstanding stock prior to the offering. Although this limitation is not reflected in Rev. Proc. 96-30, the Service's informal position may be unchanged.

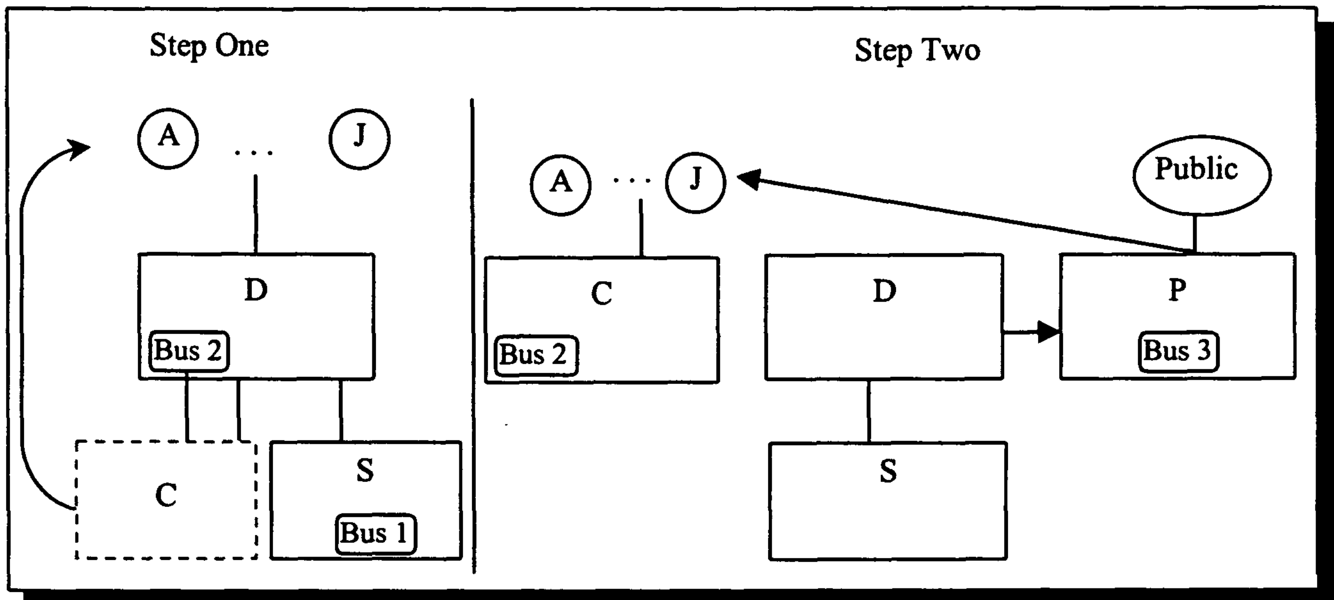
(6) Query whether the continuity of business enterprise requirement will be met if the value of the unwanted assets significantly exceeds the value of the wanted assets (for example, if the unwanted assets constitute 90 percent or more of Distributing's value).

(7) Notice that the subsequent acquisition of Distributing must be of a form that does not have a "substantially all" requirement. Accordingly, a "C" reorganization, a triangular merger under section 368(a)(2)(D), or a reverse triangular merger under section 368(a)(2)(E) will not be available. See Helvering v. Elkhorn Coal, 95 F.2d 732 (4th Cir. 1937). However, a reverse triangular merger may instead be structured as a "backwards B" reorganization, provided that (1) only voting stock of P will be issued in the merger; (2) P acquires 80 percent or more of

Distributing; and (3) the acquisition subsidiary is a transitory entity. See Rev. Rul. 67-448, 1967-2 C.B. 144. Because there is no "substantially all" requirement in a "B" reorganization, such a structure should be viable.

(8) See Examples 15-17, infra, for an explanation of section 355(e) and (f), which effectively eliminates tax-free Morris Trust transactions and intragroup spins related to such transactions.

2. Example 13 -- Morris Trust (prior to TRA 1997) /Business Purpose/ Preexisting Subsidiary



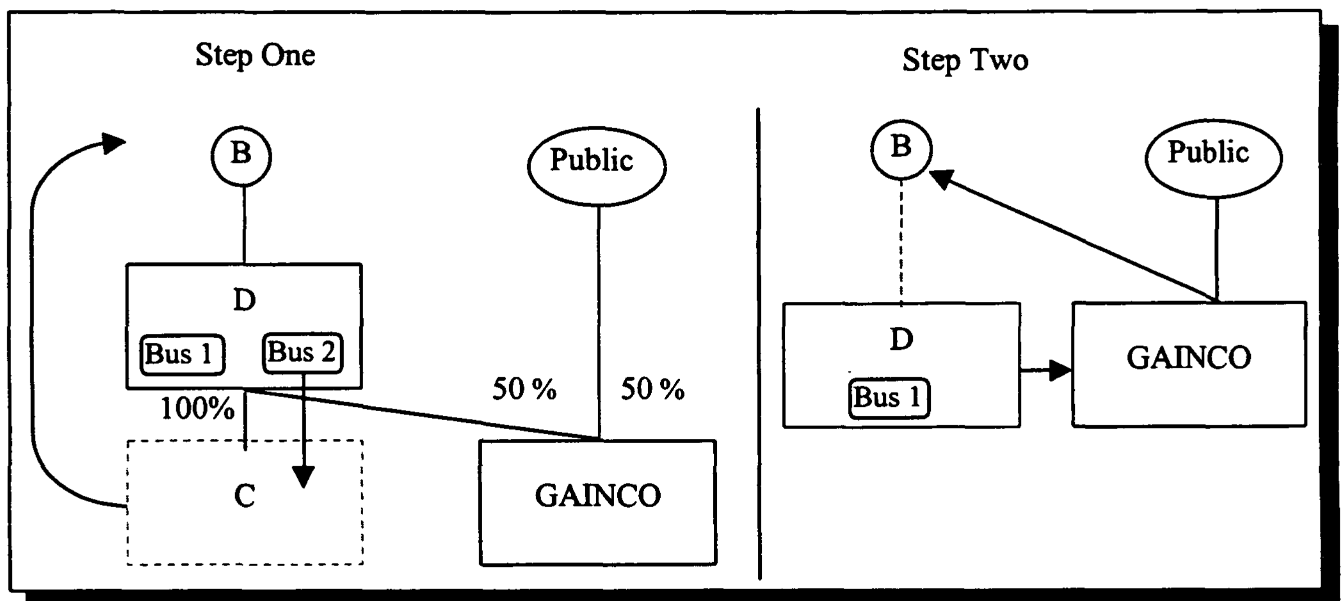
a. Facts: Ten individuals (A . . . J) own all of the stock of Distributing. Distributing conducts two qualifying five-year businesses, Business 1 and Business 2. Business 1 is conducted by a preexisting subsidiary, S. P, a public corporation, wants to acquire Business 1, but not Business 2. P is willing to issue 10 percent of its outstanding stock in exchange for Business 1. Distributing's shareholders are willing to dispose of Business 1 for P stock. Thus, the facts are identical to the Morris Trust structure described in Example 12, except that the wanted business is conducted indirectly by a subsidiary of Distributing rather than directly.

The parties agree on the following transaction: (i) Distributing will contribute Business 2 to a newly formed subsidiary, Controlled;

(ii) Distributing will distribute the stock of Controlled to its shareholders pro rata; (iii) Distributing will merge into P, and the Distributing shareholders will transfer their Distributing stock to P in exchange for P voting stock.

b. It is questionable whether the business purpose requirement would be satisfied in this case. P could have achieved the same result by acquiring the stock of S in exchange for P stock. However, if P is a public corporation, it may argue that it does not want a significant block of its stock held by Distributing. See Examples 15 and 16, infra, for an explanation of section 355 (e) and (f), which effectively eliminates tax-free Morris Trust transactions and intragroup spins related to such transactions.

3. Example 14 -- McCaw Cellular / Petrie Stores



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

This structure was used in the merger of Affiliated Publications into McCaw Cellular, following the spin-off of the Boston Globe. See P.L.R. 8921065 (Feb. 28, 1989) (supplemented by P.L.R. 8933038) (May 23, 1989)). A similar downstream merger was

used to dispose of appreciated Toys-R-Us stock held by Petrie Stores. See P.L.R. 9506036 (Nov. 15, 1994).

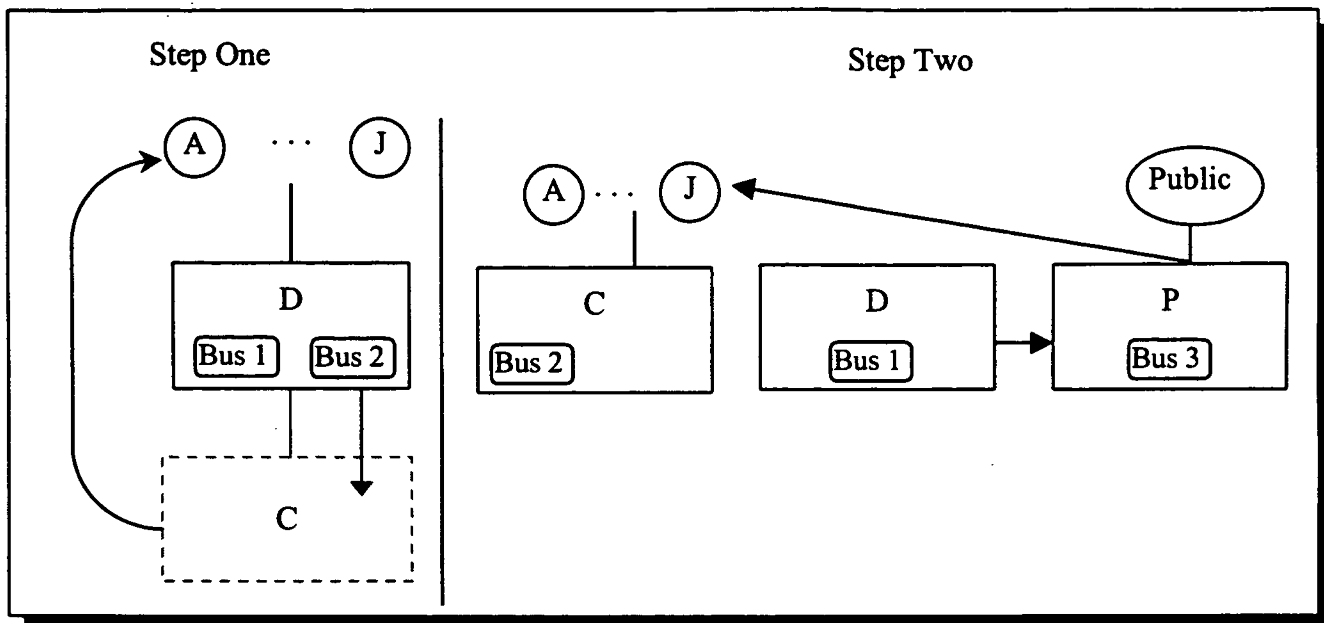
b. If the business retained by Distributing (Business 1) is small compared to the business distributed to the shareholders (Business 2) and the value of the GainCo stock received, this transaction has much the same effect as a distribution of the appreciated GainCo stock to the shareholders of Distributing. However, by structuring the transaction as a merger, GainCo stock may be disposed of without recognizing any corporate-level tax.

    (1) A downstream merger is economically similar to a liquidation. Nevertheless, the Service has ruled that taxpayers may choose the form of their transaction, and that the tax consequences will be governed by which form is chosen. Rev. Rul. 70-223, 1970-1 C.B. 79; T.A.M. 8936003 (June 7, 1989). In P.L.R. 9104009 (Oct. 24, 1990), the Service reached this same conclusion, but indicated that the issue was being studied in connection with regulations under section 337(d), and that a different result might be reached in the future in order to avoid the circumvention of the General Utilities repeal. Subsequently, in Rev. Proc. 94-76, 1994-2 C.B. 825, the Service announced it was studying downstream mergers. Recently, however, the Service announced that this study has been abandoned. See Notice 96-6, 1996-1 C.B. 358.

c. Provided a downstream merger is respected as such, the distribution should qualify under section 355. This result is possible, because the taxpayer may choose to structure the transaction as a distribution of Business 2 rather than a distribution of Business 1 -- i.e., a smaller business may spin off a much larger business. Even under the Service's pronouncements discussed in Part III.B.4. above (which suggest that the Service may reorder transactions under the step-transaction doctrine), this distribution should qualify under section 355. There is no requirement that the recipient shareholders have control of Distributing before or after the distribution. There also appears to be no authority to recharacterize the transaction as a spin-off of Business 1 rather than Business 2 based on the relative sizes of the businesses.

    (1) Arguably, however, the continuity of business enterprise requirement may not be satisfied with respect to the merger if the sole asset of Distributing is portfolio stock.

4. Example 15 -- Morris Trust Legislation: TRA 1997



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

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

b. Issues:

(1) Under Example 12, supra, this transaction would be tax free to D, C, and A...J, as a result to the Tax Court's holding in Morris Trust.

(2) However, on August 5, 1997, President Clinton signed TRA 1997, which added section 355(e) and (f) to the Code, effectively eliminating all Morris Trust transactions where a person acquires stock representing at least 50 percent of the value of Distributing or Controlled.

(3) Under section 355(e), if there is a section 355 distribution that is part of a plan pursuant to which one or more persons acquire stock representing at least a 50-percent interest in the distributing corporation or controlled corporation, the distributing corporation must recognize gain. There is no gain recognition at the shareholder level. Section 355(e)(2)(B) creates a rebuttable presumption that any acquisition occurring two years before or after a section 355 distribution is part of a plan including such distribution.

a) Gain is recognized in the amount that the distributing corporation would have recognized had it sold its controlled corporation stock for its fair market value on the date of the distribution.

b) Any gain recognized is treated as long-term capital gain.

c) In determining whether a person holds stock or securities in a corporation, the section 318(a)(2) attribution rules generally apply.

(4) Section 355(e)(3)(A) provides exceptions for certain acquisitions. The statute does not apply to:

a) The acquisition of stock in the controlled corporation by the distributing corporation (e.g., in a "D" reorganization);

b) The acquisition of stock in a controlled corporation by reason of holding stock in the distributing corporation (e.g., in a split-off);

c) The acquisition of stock in any successor corporation of the distributing corporation or controlled corporation by reason of holding stock in such distributing or controlled corporation; and

d) The acquisition of stock to the extent that the percentage of stock owned by each shareholder owning stock in the distributing or controlled corporation immediately before the acquisition does not decrease.

i) This exception was amended by the 1998 IRS Restructuring Act. Prior to the amendment, the exception applied to the

acquisition of stock if shareholders owning, directly or indirectly, 50 percent or more of either the distributing or controlled corporation before the acquisition own indirectly 50 percent or more in such distributing or controlled corporation after such acquisition.

ii) Literally read, the exception as initially drafted would preclude application of section 355(e), because in a typical Morris Trust transaction, there will be no change in the ownership of the corporation holding the unwanted assets.

(5) Section 355(e) also provides that a plan (or series of related transactions) will not cause gain recognition under the anti-Morris Trust rule if, immediately after the completion of the plan or transaction, the distributing and controlled corporations are members of the same affiliated group.

a) For example, assume P corporation owns all of the stock of S corporation, and S owns all of the stock of S1 corporation, and all three corporations are members of the same affiliated group. Assume further that P merges into unrelated X corporation, in a transaction where X's former shareholders own 50 percent or more of the surviving X corporation.

b) If, as part of the merger, S1 distributes S to X in a transaction that otherwise qualifies under section 355, the transaction is not treated as one that requires gain recognition, if S and S1 are members of the same affiliated group following the transaction. See H.R. Conf. Rep. No. 105-220, at 532 (1997).

(6) Section 355(e) further provides that, except as provided in regulations, if a successor corporation in an "A," "C," or "D" reorganization acquires the assets of the distributing or any controlled corporation, the shareholders (immediately before the acquisition) of the successor corporation are treated as if they acquired stock in the corporation whose assets were acquired.

(7) Section 355(e) does not apply to a distribution pursuant to a title 11 or similar case.

(8) In addition, TRA 1997 changed the test for determining control immediately after a distribution in a section 355 transaction from 80 percent of the vote and 80 percent of each nonvoting class of stock to at least 50 percent of the vote and value of the controlled corporation.

   a) TRA 1997 did not change the requirement that the distributing corporation distribute 80 percent of the voting power and 80 percent of each other class of stock of the controlled corporation in the transaction.

   b) However, the IRS Restructuring Act replaced this modified control test with a provision that states that, if the requirements of section 355 are met, the fact that the shareholders of the distributing corporation dispose of part or all of their controlled corporation stock will not be taken into account for purposes of determining whether the transaction qualifies under section 368(a)(1)(D). Section 368(a)(2)(H)(ii).

(9) Section 355(e) further authorizes the Service to prescribe regulations necessary to carry out the purposes of the legislation, including regulations:

   a) providing rules where there is more than one controlled corporation;

   b) treating two or more distributions as one distribution; and

   c) providing rules similar to the substantial diminution of risk rules of section 355(d)(6) where appropriate for purposes of the legislation.

(10) The provision applies to distributions after April 16, 1997, unless such distribution is:

   a) made pursuant to an agreement which was binding on the effective date and at all times thereafter;

   b) described in a ruling request submitted to the Service on or before the effective date; or

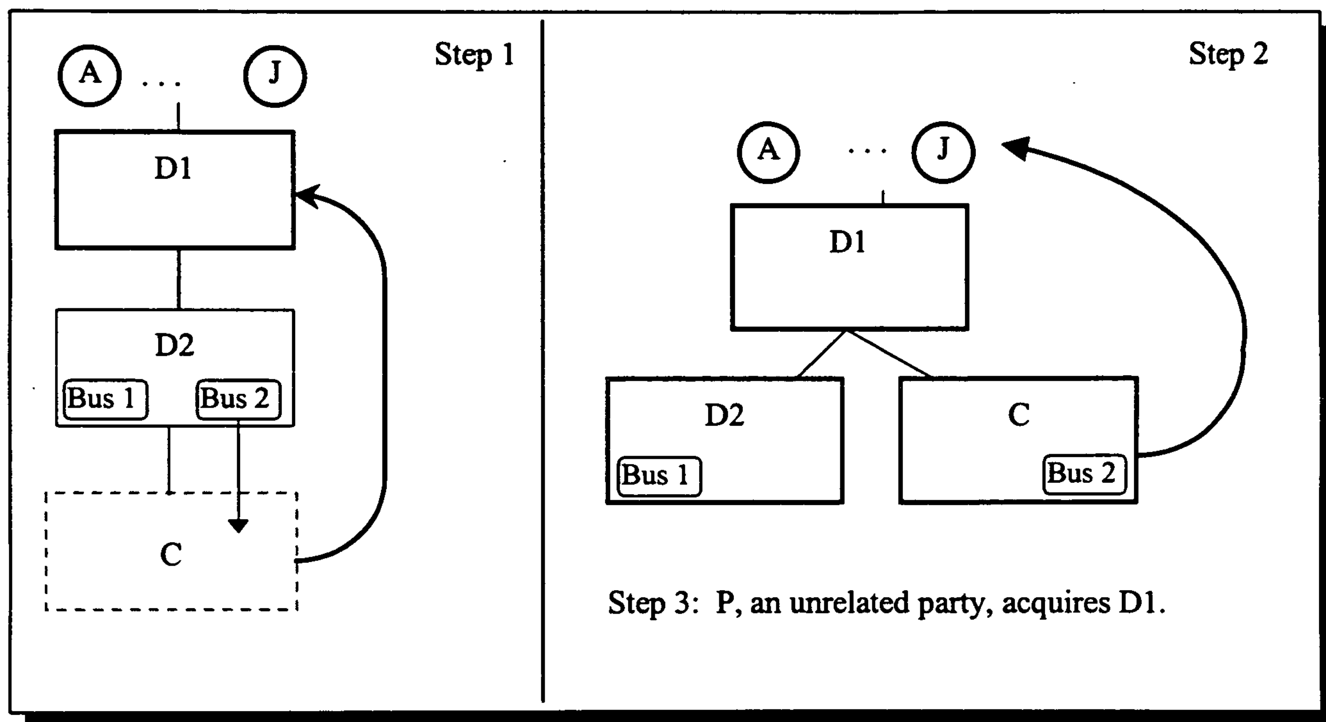
   c) described on or before the effective date in a public announcement or in a filing with the Securities and

Exchange Commission required solely by reason of the distribution.

These exceptions only apply if the agreement, etc. identifies the acquirer of the distributing or controlled corporation, whichever is applicable. Note that a contract that is binding under State law, but is not written, still may be eligible for transitional relief. See H.R. Conf. Rep. No. 105-220, at 536-37.

(11) Although disguised sale transactions, such as the General Motors/Raytheon deal referred to in Example 7 above was thought to be the intended target of any new legislation, the intent of TRA 1997 was to eliminate all future Morris Trust transactions, except those where the acquirer acquires less than a 50-percent interest in the distributing or controlled corporation.

5. Example 16 -- Intragroup Spinoff / Morris Trust Legislation: TRA 1997



a. Facts: Ten individuals (A . . . J) own all of the stock of D1. D1 owns all of the stock of D2. D2 conducts two qualifying five-year businesses, Business 1 and Business 2. The parties want to separate Business 2 from Business 1 for business reasons, and sell

D1. The parties agree on the following transaction: (i) D2 will contribute Business 2 to a newly formed subsidiary, Controlled; (ii) D2 will distribute the stock of Controlled to D1, its sole shareholder; (iii) D1 will distribute the stock of Controlled to its shareholders pro rata, (iv) P, an unrelated party, will then acquire D1.

b. Issues:

(1) Under pre-TRA 1997 law, this transaction would be tax free to D1, D2, C, and A . . . J.

(2) However, TRA 1997 added section 355(f) to the Code, which would eliminate the use of section 355 for intragroup spin-offs that are part of a Morris Trust-type transaction, except as provided in regulations.

(3) Under section 355(f), intragroup spins are generally not taxed (but are subject to the issuance of regulations under section 358). However, section 355(f) provides that section 355 will not apply to distributions of stock from one member of an affiliated group to another member if the distribution is part of a Morris Trust transaction described in section 355(e).

a) Thus, in the example, D2 will recognize deferred intercompany gain as if it had sold C stock on the date of the distribution (and such gain will be triggered into income upon the spin of C outside the group).

i) Moreover, D1 will receive a taxable dividend, which will be eliminated under Treas. Reg. § 1.1502-13(f).

ii) D1 will receive a fair market value basis in the C stock.

iii) D1's basis in its D2 stock will increase by the amount of the gain recognized and decrease by the fair market value of the stock of C.

b) Furthermore, D1 will recognize gain as if D1 had sold its C stock on the date of the distribution, as a result of the Morris Trust rule outlined in Example 15. The amount of gain should only be the amount

of gain accrued on D1's C stock while it held C directly.

c) The total amount of tax would be the same if, instead of acquiring D1, P acquired C.

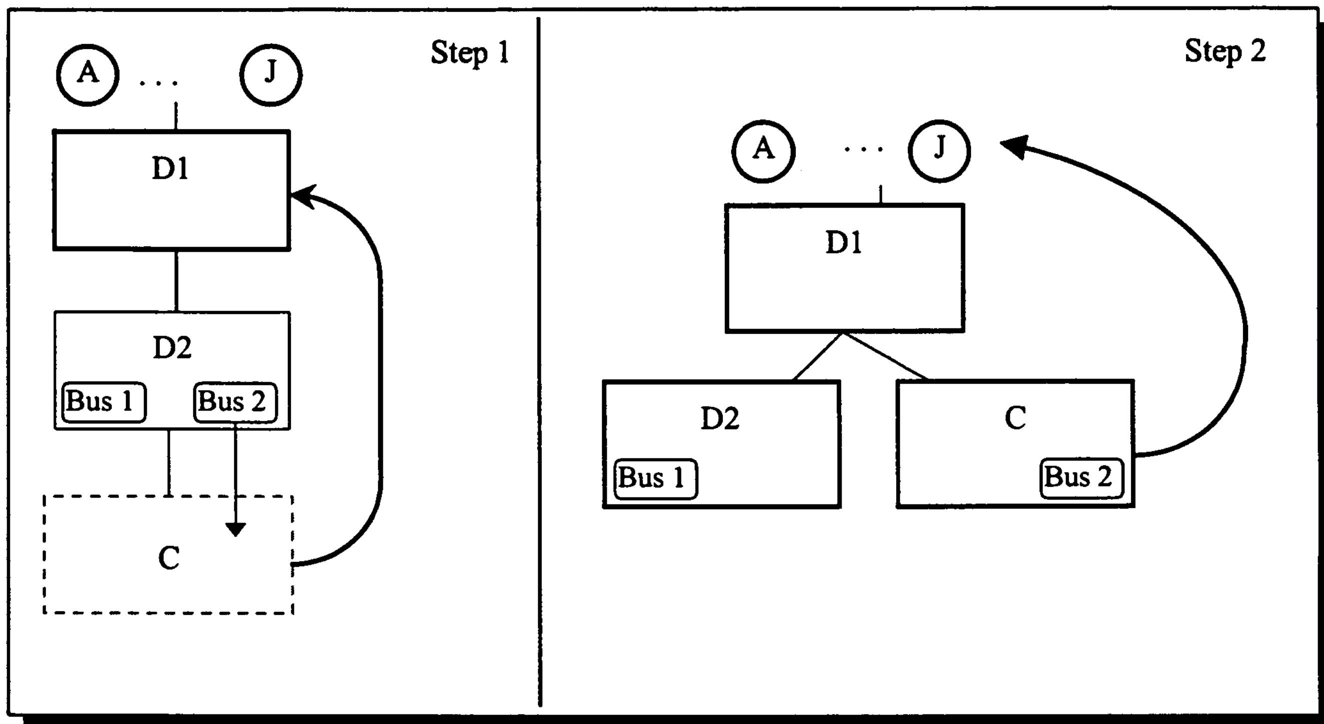
d) Variation on Example: Assume that D2 distributed C to D1, D1 distributed D2 to A...J, and P acquired D1. If P's shareholders own 50 percent or more of the stock of the new merged corporation, D2 will again recognize deferred intercompany gain as if it had sold C stock on the date of the distribution, under the intragroup spin rule. In addition, D1 would recognize gain as if D1 sold its D2 stock on the date of the distribution, under the Morris Trust rule outlined in Example 15. See H.R. Conf. Rep. No. 105-220, at 534.

(4) In addition, the legislative history to section 355(f) clarifies that all of the Morris Trust provisions in section 355(e) apply in determining whether the intragroup spin provisions apply. For example, an intragroup spin-off in connection with a transaction that does not cause gain recognition under section 355(e) as a result of the exceptions contained therein is not subject to the intragroup spin-off rules. See H.R. Conf. Rep. No. 105-220, at 534.

(5) Further, TRA 1997 added section 358(g) to the Code, which allows Treasury to provide adjustments to the adjusted basis of stock in the case of intragroup distributions to which section 355 applies, in order to appropriately reflect the proper treatment of such distributions. See Example 17 for a discussion of Treasury's authority.

c. Section 355(f) generally applies to distributions made after April 16, 1997, with the transition rules referred to in Example 15.

6. Example 17-- Intragroup Spinoffs Without Morris Trust Transactions: TRA 1997



a. Facts: Ten individuals (A . . . J) own all of the stock of D1. D1 owns all of the stock of D2. D2 conducts two qualifying five-year businesses, Business 1 and Business 2. The parties want to separate Business 2 from Business 1 for business reasons. The parties agree on the following transaction: (i) D2 will contribute Business 2 to a newly formed subsidiary, Controlled; (ii) D2 will distribute the stock of Controlled to D1, its sole shareholder; and (iii) D1 will then distribute the stock of Controlled to its shareholders pro rata.

b. Issues:

(1) If the above transaction satisfies all the requirement of section 355, it will be tax free. TRA 1997 did not change the tax-free status of the above transaction.

(2) However, the TRA 1997 allows Treasury to provide adjustments (under section 358) to the adjusted basis of stock in the case of intragroup distributions to which section 355 applies, in order to appropriately reflect the proper treatment of such distributions. Treasury's authority to provide adjustments under the TRA 1997 is limited to

adjustments to the adjusted basis of stock in a corporation that is a member of an affiliated group and is held by another member of such group.

a) The Conference Report to TRA 1997 notes two concerns that it hopes regulations will address: (1) the possibility that corporations can eliminate excess loss accounts in lower tier subsidiaries, and (2) the possibility that corporations can manipulate basis allocation rules, and increase stock basis relative to asset basis in one corporation, while correspondingly decreasing stock basis relative to asset basis in another corporation. See H.R. Conf. Rep. No. 105-220, at 535-36.

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

7. Proposed regulations under section 355(e)

a. On August 19, 1999, the Service issued proposed regulations under section 355(e), which provide guidance as to what constitutes a "plan or series of related transactions" within the meaning of section 355(e).

b. The proposed regulations generally treat this test of whether a plan exists as a subjective one that depends ultimately on the intent and expectations of the relevant parties.

(1) The preamble to the proposed regulations notes that Congress intended the phrase "plan (or series of related transactions)" to be interpreted broadly. Preamble to Prop. Treas. Reg. § 1.355-7, 64 Fed. Reg. 46,155, 46,157 (1999).

c. The proposed regulations rely on a variety of factors to determine whether a plan exists, including the timing of the transactions, the business purpose for the distribution, the likelihood of an acquisition, the intent of the parties, the existence of agreements, understandings, arrangements, or substantial negotiations, and the causal connection between the distribution and the acquisition. Preamble to Prop. Treas. Reg. § 1.355-7, 64 Fed. Reg. at 46,157.

(1) For example, the proposed regulations treat a distribution for the purpose of facilitating a public offering by the distributing or controlled corporation of more than 50

percent of its stock as part of a plan for purposes of section 355(e). See Prop. Treas. Reg. § 1.355-7(a)(8), Exs. 1, 9.

(2) Other examples of acquisitions that the proposed regulations consider to be part of the same plan as the distribution include the following:

a) The distributing corporation distributes the stock of a controlled corporation so as to maximize the possibility of its being acquired. See Prop. Treas. Reg. § 1.355-7(a)(8), Ex. 5.

b) An acquiring corporation announces an intention to acquire the distributing corporation in order to acquire the controlled corporation's business. The distributing corporation reasonably anticipates that an acquisition of a 50-percent or greater interest in the distributing corporation is more likely than not to occur because of market conditions and the acquiring corporation's available capital and success in acquiring other corporations. The distributing corporation distributes the controlled corporation to (i) lower its financing costs and (ii) deter the acquisition of the distributing corporation (by separating it from the more attractive controlled corporation). See Prop. Treas. Reg. § 1.355-7(a)(8), Ex. 2.

c) The distributing corporation distributes the stock of its controlled corporation. Although the distributing corporation has not been approached by any potential acquirers of the controlled corporation, the distributing corporation would reasonably anticipate that, under the current market conditions, if the controlled corporation is separated from the distributing corporation, an acquisition of 50 percent or more of the controlled corporation is more likely than not to occur. See Prop. Treas. Reg. § 1.355-7(a)(8), Ex. 4.

d) The distributing corporation distributes the stock of its controlled corporation solely to facilitate acquisitions by the distributing corporation using its stock. Although the distributing corporation has had no contact with specific target corporations and does not ultimately know how much of its stock will be used in acquisitions, the distributing

corporation would reasonably have anticipated that it was more likely than not that target shareholders would acquire 50 percent or more of the distributing corporation's stock in these acquisitions. See Prop. Treas. Reg. § 1.355-7(a)(8), Ex. 7.

e) The distributing corporation announces that it will distribute the stock of its controlled corporation. After the announcement, the distributing corporation's investment banker informs it that there is a lot of interest in new investment in the distributing corporation now that it will no longer own the controlled corporation. The distributing corporation would reasonably have anticipated that it was more likely than not that one or more persons would acquire 50 percent or more of the distributing corporation's stock. See Prop. Treas. Reg. § 1.355-7(a)(8), Ex. 8.

f) The proposed regulations also treat a successful hostile takeover as part of a plan. See Preamble, 64 Fed. Reg. at 46,157.

d. The proposed regulations provide that the plan of the distributing corporation, the controlled corporation, or the controlling shareholders of the distributing or controlled corporation are relevant for purposes of section 355(e). See Preamble, 64 Fed. Reg. at 46,157.

e. The preamble to the proposed regulations, relying on the legislative history's statement that public offerings of sufficient size can trigger section 355(e), provides that there does not need to be an identified acquirer on the date of the distribution. See Preamble, 64 Fed. Reg. at 46,157. Thus, a unilateral plan of the distributing or controlled corporation or a controlling shareholder of the distributing or controlled corporation is sufficient under the proposed regulations.

f. Under section 355(e), a plan is presumed to exist if a person or persons acquire 50 percent or more of the distributing or any controlled corporation during the four-year period beginning two years before the distribution, unless it is established otherwise.

(1) The proposed regulations provide guidelines for overcoming the four-year presumption. There are separate guidelines depending upon whether the acquisition occurs before or after the distribution, but in each instance, the

proposed regulations require clear and convincing evidence to overcome the presumption.

(2) With respect to acquisitions that occur within two years before the distribution, the distributing corporation may rebut the presumption by satisfying one of two tests:

a) At the time of the acquisition, the distributing corporation and its controlling shareholders did not intend to effectuate a distribution. Prop. Treas. Reg. § 1.355-7(a)(2)(v)(A).

b) Provided that no person acquiring an interest becomes a controlling shareholder by reason of the acquisition (or thereafter during the two-year period beginning on the date of the distribution), the distributing corporation can overcome the presumption by establishing that the distribution would have occurred at approximately the same time and under substantially the same terms regardless of the acquisition. Prop. Treas. Reg. § 1.355-7(a)(2)(v)(B).

(3) With respect to acquisitions that occur more than two years before a distribution, the presumption shifts in favor of the distributing corporation. Prop. Treas. Reg. § 1.355-7(a)(3)(ii).

(4) With respect to acquisitions that occur within two years after the distribution, the distributing corporation may overcome the presumption using one of two alternative tests:

a) If the acquisition occurred more than six months after the distribution (and there was no agreement, understanding, arrangement, or substantial negotiations at the time of the distribution or within six months thereafter), the distributing corporation may overcome the presumption by establishing that the distribution was motivated in whole or in substantial part by a corporate business purpose -- other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired. Prop. Treas. Reg. § 1.355-7(a)(2)(ii).

b) The distributing corporation may overcome the presumption by satisfying a three-prong test:

i) (A) Neither the distributing or controlled corporation nor a controlling shareholder of either corporation intended that one or more person would acquire a 50-percent or greater interest or (B) the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in the distributing or controlled corporation;

ii) Neither the distributing or controlled corporation nor their controlling shareholders reasonably would have anticipated that it was more likely than not that one or more persons, who would not have acquired the interests if the distribution had not occurred, would acquire a 50-percent or greater interest within two years after the distribution; and

iii) The distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired.

Prop. Treas. Reg. § 1.355-7(a)(2)(iii).

(5) With respect to acquisitions occurring more than two years after the distribution, such an acquisition is considered part of a plan only if there was no agreement, understanding, or arrangement concerning the acquisition during the two-year period after the distribution. Prop. Treas. Reg. § 1.355-7(a)(3)(i).

g. Although the proposed regulations provide guidance on the issue of what constitutes a plan, they create some significant concerns with regard to the scope of section 355(e).

(1) The rebuttals discussed above appear to be the exclusive means of overcoming the statutory presumption. Thus, if a distributing corporation does not fall within one of the

rebuttals, section 355(e) applies, regardless of the existence of other facts and circumstances negating a plan. Rather than constituting an absolute rule, the rebuttals should simply be safe harbors to satisfy the burden of proof.

(2) The business purpose rebuttal (i.e., where the acquisition did not occur within six months after the distribution, the distributing corporation can overcome the presumption by showing that there was a corporate business purpose for the distribution, other than facilitating an acquisition or making an acquisition less likely) is too narrow. A business purpose to facilitate any acquisition -- even an acquisition of stock by key employees or an acquisition of less than 50 percent of stock in a public offering -- precludes the use of this rebuttal. The alternative, three-prong, rebuttal is extremely onerous, which could have a chilling effect on many basic spin-offs.

(3) Third, the proposed regulations do not address public trading or the exercise of compensatory stock options. These acquisitions clearly should not trigger section 355(e).

IV. PLANNING TRANSACTIONS/ALTERNATIVES TO SPIN-OFFS

A. "Synthetic" Spin-Offs

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

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

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

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

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

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

(3) If the preferred stock in the above facts constitutes nonqualified preferred stock, the transfer of assets to Controlled in exchange for the preferred stock and exchange rights may not qualify as a valid section 351 transaction. See section 351(g)(1).

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

c. Shareholders receiving the exchange rights would have ordinary income equal to the fair market value of the rights (to the extent of TCI's earnings and profits).

d. The exchange by the TCI shareholders of their TCI stock for LMC stock should constitute a tax-free section 351 transaction (as it is part of the overall plan in which TCI transfers assets to LMC).

B. Subsidiary Tracking Stock

1. Individual A owns all of the stock of T. T owns all of the stock of T-1. T has a value of $200, $80 of which is attributable to T-1. P is interested in T-1, but not T. P buys 40 percent of the T stock for $80.

2. An immediate distribution of the T-1 stock does not qualify under section 355 because historic continuity of interest is not satisfied.

3. Suppose P cannot wait until its interest in T becomes "old and cold" before the distribution of T-1 stock is made.

   a. P can benefit from T-1's financial performance if it exchanges its T stock for another class of T stock that pays dividends based on T-1's earnings.

   b. Once P's subsidiary tracking stock becomes "old and cold," P can exchange such stock for the actual T-1 stock. In the interim, P will have participated solely in T-1's earnings.

   c. As an alternative to the above structure, P could have acquired its subsidiary tracking stock directly from T and then had such stock redeemed when its interest in T became "old and cold."

4. USX Corporation has issued tracking stock, which (unlike most tracking stock) also provided that liquidating distributions were tied to the value of the tracked assets at the time of liquidation. The voting power of the tracking stock was tied to the relative fair market value of the tracked assets and thus changed from time to time.

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

5. It should be noted that if more than 50 percent of the stock of T-1 is acquired as a result of the redemption of tracking stock then section 355(d) will apply regardless of the period of time between the acquisition of the T stock and the exchange for T-1 stock (section 355(d)(6)(B)).

6. More recently, RJR Nabisco announced plans to create a separate class of stock pegged to the performance of its food businesses. Under the original plan, existing shareholders would receive a stock dividend of one-eighth of a share of the new class of stock for each share currently owned. In addition, the new class of stock would be sold to the public in an IPO. Subsequently, it was decided that the new class of stock would be offered only to the public, and that no distribution would be made to existing shareholders.

C. Dividend Followed by Public Offering

1. Corporation P owns all of the stock of S. P and S do not file a consolidated return. The value of S is $500, P's basis in its S stock is $100, and S has earnings and profits in excess of $400.

2. P wants to sell its S stock, but does not want to recognize any gain.

3. P causes S to declare $400 dividend payable with a $400 promissory note.

4. P then causes S to make a public offering of its stock, the proceeds of which would be used to retire the note and possibly to redeem P's stock in S.

5. If the form of the transaction is respected, P may claim a deduction for 100 percent of the $400 dividend under section 243(a)(3), and will recognize no gain on the sale or redemption of its stock (the basis of $100 will be equal to the stock's fair market value). Litton Industries v. Commissioner, 89 T.C. 1086 (1987).

6. If, however, the public offering is arranged prior to the issuance of the dividend (or if the steps may be linked together into an integrated transaction through some other means), the payment of the dividend may be disregarded and the $400 may be treated as part of the purchase price of the stock. This would result in P recognizing the full $400 gain inherent in the S stock. Waterman S.S. Co. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), rev'g, 50 T.C. 750 (1968).

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

D. Option to Purchase Corporate Assets

1. Corporation P is planning to expand its operations into a new field, and for this purpose is going to form a new, wholly owned subsidiary, S, with a capital contribution of $100 (S will issue 100 shares of stock).

2. Immediately after the formation of S, P distributes to its shareholders a fully assignable and transferable right to purchase S stock for $1 per share, exercisable in, for example, ten years.

3. The distribution will constitute a taxable dividend under section 301.

    a. P will argue that the value of this right should not be significant, since the strike price is equal to the current value of the S stock.

    b. However, there is presumably some value to the right, because it allows a holder to share in the appreciation of the S stock without risking any of his own capital. It would be advisable for P to obtain an independent appraisal of the value of the right prior to undertaking this course of action.

c. Were the right not to be assignable and transferable independently of the P stock, the Service might argue that no distribution was made at the time the rights were originally issued, rather a distribution would be made at the time the rights became exercisable. Compare Rev. Rul. 80-292, 1980-2 C.B. 104 with Palmer v. Commissioner, 302 U.S. 63 (1937).

4. If, after ten years, the stock of S has, as desired, significantly appreciated, P's shareholders can exercise their options to purchase S stock at $1 per share. No tax should result to P, since P's amount realized will equal its basis in the stock of S. Nor should any tax result to P's shareholders, since the exercise of an option simply results in adding the basis of the option to the cost basis of the property purchased under the option. Rev. Rul. 70-521, 1970-2 C.B. 72.

E. Transaction to Thwart Hostile Takeovers

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

2. The spin-off of T-1 prior to the acquisition of T may not qualify as a section 355 transaction, because the continuity of interest requirement may not be satisfied. If that is the case, the distribution will be taxable to T under section 311(b) and taxable to T's shareholders as a dividend. This tax cost may effectively thwart the hostile takeover.

3. However, the hostile nature of the takeover may be considered to be an independent event and thus continuity may be considered to be satisfied. See Rev. Rul. 75-406, 1975-2 C.B. 125.

4. Nevertheless, a successful hostile takeover may result in corporate-level tax under section 355(e). See Part III.J., supra.

V. REQUESTING A PRIVATE LETTER RULING UNDER SECTION 355

A. In General. General rules governing requests for letter rulings are contained in Rev. Proc. 99-1, 1999-1 I.R.B. 6. Requests should be directed to CC:DOM:CORP:T, the technical section of the corporate division of the IRS Office of Chief Counsel. The filing fee for a request under section 355 generally is $5,000. The request must be accompanied by a declaration, signed by the taxpayer (or in the case of a corporation, a corporate officer) under penalties of perjury, attesting to the accuracy of the facts contained in the ruling request.

B. Checklist. Rev. Proc. 96-30, 1996-1 C.B. 696, provides a list of items that must be included in a request for a letter ruling under section 355. The request must provide detailed information regarding both the Distributing and controlled corporations, including: the stock ownership of the corporations; five years of financial data for each corporation (on a pro forma basis if the controlled corporation is newly formed); the number of employees used in each trade or business for the preceding five years; the history of any acquisitions or dispositions of trades or businesses; a description of any assets held that are not used in a trade or business; and a detailed description of the business purpose for the transaction (to the extent the spin-off is prompted by a request or advice from a third party, it is advisable to include documentation from such third party).

C. Change in Facts. Frequently changes occur in the facts described in a ruling request between the date of submission and the time that the ruling is issued or the transaction occurs. A question arises in such circumstances as to whether the taxpayer should update or supplement the ruling request.

1. Although a ruling request is signed by the taxpayer under penalties of perjury, neither regulations nor Rev. Proc. 99-1 require the taxpayer to supplement the request if facts subsequently change.

2. However, under Rev. Proc. 99-1 § 12 a ruling may be revoked retroactively, even if relied upon by the taxpayer, if

   a. There has been a misstatement or omission of material fact;

   b. The facts at the time of the transaction are materially different from the facts on which the letter ruling was based; or

   c. There has been a change in the applicable law.

3. There is little clear guidance as to what represents a "material" fact for these purposes. Cases tend to reach conclusory opinions as to what is material. See, e.g., Boggs v. Commissioner, 784 F.2d 1166, 1171 (4th Cir. 1986); Wisconsin Nipple & Fabricating Corp. v. Commissioner, 67 T.C. 490, 497 (1976). If one would reasonably conclude that a change in facts would cause a change in the analysis of the transaction, then that change in facts is likely to be "material" and it would be prudent to supplement a ruling request.

APPENDIX A

Requirements for Business Purpose Listed under Rev. Proc. 96-30

1. Key Employees.

- The transfer of Distributing or Controlled stock to the employee will accomplish a "real and substantial purpose germane to the business" of Distributing, Controlled, or the affiliated group to which Distributing belongs. Among other things, the taxpayer must explain why the individual is considered a key employee, and why it is necessary to give the individual an equity interest of the type and amount proposed in the transaction.

- Generally within one year of the distribution, the employee or employees must receive a "significant amount" of stock, unless this would be prohibitively expensive for the employee. Apparently, the Service is willing to issue rulings when the stock to be issued will constitute as little as two percent of the outstanding stock of a publicly traded company. However, they will only take into account stock that is to be purchased by the employee for this purpose and not options or other rights to purchase stock in the future.

- The taxpayer must demonstrate that the purpose cannot be accomplished by an alternative nontaxable transaction that does not involve the distribution of Controlled stock and which is neither impractical nor unduly expensive. Where the taxpayer contends that a transaction involving a distribution will provide the employee with voting power representing a meaningful voice in the governance of their employer's business that is not available through an alternative transaction, the Service will consider such cases on a case-by-case basis, taking into account factors such as the distribution of voting power among the shareholders, family relationships, and competing economic interests.

- The same principles as apply to key employees also apply if the asserted business purpose is to transfer Distributing or Controlled stock to an ESOP. For purposes of this analysis, the ESOP is treated as a group of key employees.

2. Raising Capital Through Stock Offering.

- The issuing corporation needs to raise a substantial amount of capital in the near future;

- The stock offering will raise significantly more funds per share if Distributing and Controlled are separated. The taxpayer ordinarily must submit substantiation in the form of opinions by professionals such as investment bankers. However, the Service will generally acknowledge (without extensive substantiation) that an offering of publicly traded stock by a widely held corporation with no significant shareholders will raise more funds per share than an offering by the same corporation in the position of a controlled subsidiary;

- The funds raised in the stock offering will, under all circumstances, be used for the business needs of Distributing or Controlled;

- The offering must completed within one year of the distribution.

3. Raising Capital Through Debt Offering or Borrowing.

- The issuing (or borrowing) corporation needs to raise a substantial amount of capital in the near future;

- The debt offering (or borrowing) will raise significantly more funds if Distributing and Controlled are separated.

- The taxpayer ordinarily must submit substantiation in the form of opinions by professionals such as investment bankers.

- The funds raised will, under all circumstances, be used for the business needs of Distributing or Controlled;

- The offering (or borrowing) must completed within one year of the distribution.

4. Cost savings.

- The taxpayer must demonstrate to the satisfaction of the Service that the distribution will produce "significant" cost savings.

- Cost savings generally are "significant" if savings for the three-year period following the distribution will exceed one percent of the affiliated group's net income for the three-year period preceding the distribution.

- Ordinarily, the taxpayer's submission should include analysis by qualified persons (for example, by the taxpayer's insurer for insurance savings, an investment banker for lower borrowing costs, or the taxpayer's employees). The analysis must explain the savings and why the savings cannot be achieved through another nontaxable transaction.

5. Fit and Focus.

- If Distributing is not publicly traded -- or is publicly traded, but has a significant (i.e., five-percent shareholder) -- the Service ordinarily will not rule unless the distribution (a) is non pro rata or (b) effects an internal restructuring within an affiliated group.

- The taxpayer must submit documentation describing in detail the problems associated with the current corporate structure and demonstrate why the distribution will lessen or eliminate these problems. However, in the case of a non pro rata distribution made to enable a significant shareholder or shareholder group to concentrate on a particular business, the Service ordinarily will not require third-party documentation or detailed studies.

- The Service will closely scrutinize situations involving (1) any continuing relationship between Distributing and Controlled; (2) except for cases involving an internal restructuring of an affiliated group, any continuing cross ownership of Distributing and Controlled; (3) any internal restructuring where the distributee would not otherwise be entitled to a 100 percent dividends-received deduction.

6. Competition.

- Ordinarily, the taxpayer must demonstrate to the satisfaction of the Service that:

    - One or more customers or suppliers have significantly reduced (or will significantly reduce) their purchases from, or sales to, Distributing or Controlled because of the competing business;

    - Because of the distribution, these customers or suppliers will significantly increase (or will not implement a planned significant reduction in) their purchases from, or sales to, Distributing or Controlled after the distribution;

    - These customers or suppliers do not object to the Distributing shareholders' ownership of stock of Controlled after the distribution;

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

- In most cases, corroboration from customers or suppliers will be necessary.

7. Facilitating an acquisition "of" Distributing.

- To establish that a corporate business purpose for the distribution is to tailor Distributing's assets to facilitate a subsequent tax-free acquisition of Distributing by another corporation, ordinarily, the taxpayer must demonstrate to the satisfaction of the Service that:

  - The acquisition will not be completed unless Distributing and Controlled are separated;

  - The acquisition cannot be accomplished by an alternative nontaxable transaction that does not involve the distribution of Controlled stock and is neither impractical nor unduly expensive;

  - The acquiring corporation is not related to Distributing or Controlled;

  - The acquisition will be completed within one year of the distribution.

8. Facilitating an acquisition "by" Distributing or Controlled.

- The taxpayer must demonstrate to the satisfaction of the Service that:

  - The combination of the target corporation with Distributing or Controlled will not be undertaken unless Distributing and Controlled are separated;

  - The acquisition cannot be accomplished by an alternative nontaxable transaction that does not involve the distribution of Controlled stock and is neither impractical nor unduly expensive;

  - The target corporation is not related to Distributing or Controlled;

  - The acquisition will be completed within one year of the distribution.

9 Risk Reduction.

- The Service will consider the nature and magnitude of the risks faced by the risky business. The taxpayer must submit information regarding the claims history of the risky business, or of the typical risk experience of similar businesses in that industry.

- The Service will consider whether the assets and insurance associated with the risky business are sufficient to meet reasonably expected claims arising from the conduct of the risky business. The taxpayer must submit the book value and approximate fair market value of the net assets, including intangibles, of the risky business and describe any other factors, such as liabilities that are not included on the taxpayer's balance sheet, that affect the value of the net assets of the risky business. Facts regarding the cost and availability of insurance generally require third-party substantiation.

- The Service will consider whether, under applicable law, (1) the distribution will significantly enhance the protection of the other businesses from the risks of the risky business, and (2) an alternative nontaxable transaction that does not involve the distribution of Controlled stock and is neither impractical nor unduly expensive would provide similar protection.

- The taxpayer must include an analysis of the law and the application of the law to the relevant facts of the proposed transaction. It is not necessary for the taxpayer to establish conclusively that, under applicable law, the proposed transaction will afford adequate protection or that an alternative transaction would not afford adequate protection. Nevertheless, the taxpayer must convince the Service that, based on objective analysis of the law and its application to the facts, risk reduction is a real and substantial purpose for the transaction.