Corporate Divisions Under Section 355

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THIRTY-FIFTH WILLIAM AND MARY TAX CONFERENCE
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CORPORATE DIVISIONS UNDER SECTION 355

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I. INTRODUCTION

A. Historic Focus

1. Traditionally, the focus under section 355 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. Given the repeal of the capital gains provisions in the Tax Reform Act of 1986 (the "1986 Act"), this issue is of less importance currently.

3. Despite 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 of the Internal Revenue Code of 1986, as amended (the "Code") 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 1986 Act.

B. Current Importance

1. The repeal of the General Utilities doctrine results 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. Congress, however, 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.

C. 1987 Amendment Limits Section 355 To Divisive Transactions

Under the Revenue Act of 1987 (the "1987 Act"), Congress amended section 355(b)(2)(D) in an effort to prevent its use in acquisitive type transactions.

D. New Regulations

1. Regulations under section 355 were initially issued in 1955.

2. Proposed regulations were released in 1977.

3. New final regulations under section 355 were released on January 4, 1989. These regulations are applicable to transactions occurring after February 6, 1989.

4. These new regulations are intended to clarify existing law.

a. Treasury officials indicate that the new final regulations are not intended to make significant changes in the application of section 355. Officials note that the regulations do not directly address the repeal of the General Utilities doctrine and its impact on section 355.

b. It was Treasury's intent in issuing these regulations to maintain the stability that has arisen through the rulings process in interpreting section 355. Thus, the new final regulations incorporate many provisions contained in the proposed regulations.

c. The regulations do, however, appear to shift the emphasis of section 355 from the device restriction to the business purpose requirement. Moreover, the new regulations
substantially tighten the business purpose requirement, clarify the continuity of interest test, and make certain changes in the device and active trade or business tests. Furthermore, many of these changes reflect the impact of General Utilities repeal.

d. The new regulations do not, however, reflect the amendments to section 355 made by the Revenue Act of 1987 (the "1987 Act") and the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Technical Corrections Act"). Also, separate regulations under section 337(d) are expected to be issued in the future.

E. Future of Section 355 -- Subchapter C Study

Treasury is currently reviewing the corporate tax provisions as part of its subchapter C study. It is understood that a significant part of this study is devoted to whether section 355 should be retained in light of the General Utilities repeal. Needless to say, 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. The presence of sections 338(h)(10) and 336(e) both indicate that three levels of tax were not intended.

   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.

(1) Also, Notice 87-14 prevents a basis adjustment if the subsidiary is sold to a corporate purchaser. Thus, the third level of tax on the subsidiary's assets cannot be avoided.

(2) Thus, a repeal of section 355 would be inconsistent with this policy and 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 which 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).

c. 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.

4. Conceivably, Treasury could propose to further narrow the scope of section 355. For example, the initial 1987 tax bill passed by the House of Representatives denied the use of section 355 to a distribution within an affiliated group. H.R. 3545, 100th Cong. 2d Sess. § 10139(b)(2) (1987). Fortunately, this provision was not enacted.

F. Section 355 -- Overview

1. 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") without the recognition of gain or loss by the shareholders or security holders of the distributing corporation.

2. 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 distribution of the stock of a corporation that is controlled by the distributing corporation ("controlled corporation"). 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. In a split-off, the 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.
d. "D" Reorganization -- Division of one or more businesses

In a divisive "D" reorganization, part of the assets of the distributing corporation which constitute a business are transferred to the controlled corporation and then the stock of the controlled corporation is distributed to the shareholders of the distributing corporation in a section 355 transaction. § 368(a)(1)(D).

3. Tax consequences of a section 355 transaction

a. No gain at shareholder level

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

b. No corporate level gain

A distribution qualifying under section 355 will also not result in the imposition of any corporate level tax.

c. Gain on the distribution of boot

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

d. Basis of stock and securities

(1) The basis of the stock and securities received in a section 355 transaction is determined with reference to the basis of the stock and securities in the distributing corporation. § 358.

(2) The aggregate basis of the stock and securities in the distributing corporation is allocated on a fair market value basis between the stock and securities retained in the distributing corporation and the stock and securities received in the controlled corporation.
e. Tax attributes

(1) Divisive "D" reorganization

(a) 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 § 381(a).

(b) 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.' Reg. § 1.312-10(a).

(2) Spin-off or split-off

(a) 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. Reg. § 1.312-10(b).

(b) 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 corporations' losses.
(3) **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.

**II. 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 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.

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

There must be continuity of the pre-distribution businesses after the distribution.

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. Detailed Analysis

1. Control

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. § 355(a)(1)(A).

b. 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. § 368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.

c. 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.

d. 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. 89-3, 1987-1 I.R.B. 29 § 4.24.

2. Device restriction
   a. 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); Reg. § 1.355-2(d)(1).

   (1) As stated previously, the focus under section 355 has traditionally been whether the transaction was undertaken by the shareholders in order to bail out earnings and profits at favorable capital gains rates. However, as also noted, this issue is of less importance currently given the repeal of the favorable capital gains rates. Nevertheless, this issue remains relevant and the regulations specifically provide that a device can include a transaction that effects the recovery of basis. 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.

   (2) 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. Reg. § 1.355-2(d)(1).

   (3) 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. Reg. § 1.355-2(d)(1), (2)(i).

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

b. Evidence of a device

(1) 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. Reg. § 1.355-2(d)(2)(ii).

(2) Subsequent sale or exchange of stock

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

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

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

iv) 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 was 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. Reg. § 1.355-2(d)(2)(iii)(D).

v) 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.

(b) Subsequent sales or exchanges of stock will also be scrutinized under the continuity of interest requirement applicable to a section 355 transaction. See II.B.6., below.

(c) 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 prearranged sales or exchanges. Reg. § 1.355-2(d)(2)(iii)(E).

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


iii) Nevertheless, a corporate division undertaken to facilitate the tax-free
acquisition of a newly-created controlled corporation may not qualify as a section 355 transaction because the control requirement of section 368(a)(1)(D) is not satisfied. Rev. Rul. 70-225, 1970-1 C.B. 80.

iv) A section 355 transaction followed by a tax-free reorganization will also be scrutinized under the continuity of interest requirement. See II.B.6., below.

(3) 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. Reg. § 1.355-2(d)(2)(iv)(A).

(a) 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. Reg. § 1.355-2(d)(2)(iv)(B).

i) 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. Reg. § 1.355-2(c)(3).

ii) The preamble to the regulations specifically refers to excess inventory as possibly evidencing a device. This was not covered by the proposed regulations.
(b) 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. Reg. § 1.355-2(d)(2)(iv)(B).

i) 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. Reg. § 1.355-2(d)(2)(iv)(B).

ii) 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. Reg. § 1.355-2(d)(3)(ii). See II.B.2.c.(1), below.

iii) 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?

iv) It should be noted that the active business requirement is satisfied if only five percent of a corporation's assets are used in the trade or business. See II.B.3.h., below.
v) 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. Reg. § 1.355-2(d)(2)(iv)(B).

(c) 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. Reg. § 1.355-2(d)(iv)(C).

i) 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.

ii) 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.

iii) 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. See II.B.3.g.(3)(b), below.

(d) Examples

i) 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. Reg. § 1.355-2(d)(4) ex. 3.

ii) 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. Reg. § 1.355-2(d)(2)(iv)(B).

iii) Corporation I has processed and sold meat products for eight years. It has no other income. I proposes to separate its selling and processing activities by forming corporation J, to purchase for resale the meats processed by I. I will transfer to J certain physical assets pertaining to the sales function, plus cash for working capital, in exchange for the capital stock of J which will be distributed to the shareholders of I. If the sales corporation merely functions as the exclusive agent for the manufacturing corporation after the transaction and could be sold without adversely affecting the business of I, then this is considered evidence of a device. Reg. § 1.355-2(d)(2)(iv)(B).

c. Evidence of nondevice

(1) 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:

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

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


(2) 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. Reg. § 1.355-2(d)(3)(iii).

(3) 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. Reg. § 1.355-2(d)(3)(iv).

d. Transactions not ordinarily considered a device

(1) Absence of earnings and profits

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

Query: Does the last requirement of this safe harbor, i.e., that the distributing corporation hold no appreciated property, effectively eliminate the viability of this rule?

(2) Section 302 or 303 transaction

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. 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. Reg. § 1.355-2(d)(5)(i).

e. Additional factors not contained in the regulations

(1) Prior sales of stock

(a) 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 indicated that it will correct this omission. See Rev. Rul. 59-197, 1959-1 C.B. 77. But see Reg. § 1.355-2(c)(2) ex. 2.

(b) Such a transaction may also run afoul of the continuity of interest requirement. See II.B.6.d., below.
(2) 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 the second business in a section 355 transaction. In Rev. Rul 59-400, 1959-2 C.B. 114, the spin-off of a rental real estate business was not a valid section 355 transaction because the earnings of a hotel business were used to finance the growth of the real estate business.

3. Active trade or business requirement

a. In general

(1) 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. § 355(b)(1)(A).

(2) 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. § 355(b)(1)(B). A de minimis test is applicable in determining whether the distributing corporation holds prohibited assets. Reg. § 1.355-3(a)(1)(ii).

b. Statutory requirements for an active trade or business

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

(1) 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. § 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.

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

(3) 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. § 355(b)(2)(C).

(4) Control of a corporation conducting such trade or business was not acquired by the distributing 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. § 355(b)(2)(D).

c. Trade or business

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

(1) 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 one of these steps is the collection of income and the payment of expenses. Reg. § 1.355-3(b)(2)(ii).

(2) The Service recently revoked a number of older revenue rulings which concluded without analysis that a trade or business existed. Rev. Rul. 88-19, 1988-13 I.R.B. 5.
d. **Active conduct**

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

(1) In order for a trade or business to be considered to be actively conducted, the corporation itself must perform active and substantial management and operational functions. Reg. § 1.355-3(b)(2)(iii); Rev. Rul. 88-19, 1988-13 I.R.B. 5. The Service has ruled that one managerial employee and one operating employee are sufficient. Rev. Rul. 73-234, 1973-1 C.B. 180.

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

(b) 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.

(c) 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. Compare 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).

(2) The active conduct of a trade or business does not include the following:

(a) Holding stock, securities, land,
or other property for investment purposes; or

(b) 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. See Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971) (net lease of real estate by subsidiary to parent corporation not viewed as an active business).

Reg. § 1.355-3(b)(2)(iv).

(3) Furthermore, the regulations provide that a separation of real property which is occupied or substantially occupied before the distribution 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. 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.

(4) It is not clear 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 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 (partner that was a foreign corporation deemed to be in the business of the partnership for purposes of determining United States tax liability).

(a) In general under the passive loss rules, a limited partner is not considered to be engaged in the
active business of its partnership. Furthermore, a corporate general partner is not considered to be engaged in the active business of its partnership unless it has a 10 percent or greater interest in the profits and losses of the partnership. Temp. Reg. §§ 1.469-1T(g)(3)(i)(B), 1.469-5T(e)(3).

(b) The size of the partnership interest and the value of a corporation's investment in the partnership as compared to the corporation's net worth may have a bearing on this issue.

(5) Examples

(a) Corporation D, a bank, has for the past 7 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. Reg. § 1.355-3(c) ex. 12.

(b) 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. Reg. § 1.355-3(c) ex. 13.

e. **Five-year period**

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

(1) 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. § 355(b)(2). 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.

(2) 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. Reg. § 1.355-3(b)(3)(ii).
(a) If a corporation engaged in the active conduct of a trade or business purchased, created, or otherwise acquired another business in the same line of business during the five-year period, then the purchase, creation, or other acquisition of the 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. Reg. § 1.355-3(b)(3)(ii). 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).

(b) The Service has ruled that a temporary cessation of activities is not taken into account for purposes of this requirement. Rev. Rul. 57-126, 1957-1 C.B. 123.

(c) 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.

Query: Is this ruling 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?

(3) 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

(4) The regulations now permit the division of a single business. See II.B.3.g., below. 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.

(5) Example

Corporation P has owned and operated a department store in City W for 9 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 to distribute the stock of the new corporation to its shareholders. Each corporation will satisfy the active business requirement. Reg. § 1.355-3(c) ex. 7. Accord, Estate of Lockwood v. Commissioner, 350 F.2d 712 (8th Cir. 1965).

f. 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

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

(a) In Rev. Rul. 74-5, 1974-1 C.B. 82, 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.

(b) 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.

(c) 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.

(d) 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.

(e) 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.

(f) As a result of the amendment to section 355(b)(2)(D) by the 1987 Act, the focus 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, 1989-11 I.R.B. 4.

(2) It should be noted that the 1987 Act change 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 Act change only applies to the acquisition of control as defined in section 368(c).

(a) Thus, it may be 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) However, such transactions will be subject to the continuity of interest requirement. See II.B.6., below.

g. Division of a functionally integrated business

(1) The original regulations under section 355 provided that the division of a single business would not be tax-free. Old 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). As a consequence, the final regulations permit the division of a single business. Reg. § 1.355-1(b).

(a) **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 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.

(b) **Horizontal division**

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

ii) Nevertheless, the horizontal division of a business may violate the device requirement. See II.B.2.b.(3)(c), above.

(2) 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 II.B.3.e., above.

(3) Examples

(a) 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 is then to 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. Reg. § 1.355-3(c) ex. 4.

(b) 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. Reg. § 1.355-3(c) ex. 10.

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

(1) 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. Rev. Rul. 73-44, 1973-1 C.B. 182, clarified by 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 PLR 8712019 (6 percent of the corporation’s assets devoted to the active conduct of its trade or business).

(2) In G.C.M. 34238, the Service concluded that a corporation having assets attributable to its active business equal to only five percent of the corporation’s net book value could be considered to be engaged in the active conduct of a trade or business. It is understood from informal conversations with the Service that in certain limited circumstances a corporation can satisfy the active business test even if only one percent of its assets are devoted to the active conduct of its trade or business.

(3) A high percentage of liquid or investment assets may be evidence of a device, however. See II.B.2.b.(3), above.
i. Holding company vs. directly conducting business

(1) Section 355(b)(2)(A) requires that substantially all the assets of a 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. For advance ruling purposes, "substantially all of its assets" in this context means 90 percent in gross value of stock and securities in controlled operating subsidiaries. Rev. Proc. 77-37, § 3.04, 1977-2 C.B. 568.

(2) 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 or accounts receivable), it may fail the active business requirement. To avoid this consequence, it could push-down these assets into a subsidiary that is itself in the active conduct of a trade or business. However, such a push-down may run afoul of the device requirement. See II.B.2., above.

(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 liquidate one of the qualifying subsidiaries so that it would be directly engaged in the active conduct of a trade or business and not subject to the "substantial assets" requirement. Alternatively, it could contribute the stock of the non-qualifying subsidiaries to a qualifying subsidiary so that it does satisfy
the "substantial assets" requirement.

(3) This restructuring may, however, be scrutinized under the device requirement. See II.B.2., above.

(4) Examples

(a) Corporation P is a holding company. It has five subsidiaries U, V, W, X, and Y. U, V, and W are each actively engaged in a 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 trade or business. P would like to spin-off U to the P shareholders. However, P is not currently 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, P could liquidate V. P 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. 81.

(b) As an alternative to the liquidation in the previous example, P 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.

j. Ruling position

The Service has stated that it will not rule on whether the active 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. 89-3, 1989-1 I.R.B. 29 § 4.24.

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

a. 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. § 355(a)(1)(D)(i).

(1) 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. § 355(a)(1)(A). Stock for this purpose does not include warrants, convertible debt instruments, or other rights to purchase stock. Reg. § 1.355-1(b).

(2) 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. § 355(a)(3)(A).

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

(b) Furthermore, if no securities are surrendered, the recipient is taxable on the fair market value of the securities distributed under section 356. Reg. § 1.355-2(f)(1).
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, 100th Cong. 2d Sess. 373 (1988). Thus, even if the distributing corporation transfers securities of the controlled corporation which 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 (indebtedness satisfied in a "C" reorganization using appreciated property resulted in gain under section 1001).

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.

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. § 355(a)(1)(D)(ii). See also Reg. § 1.355-2(e).

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. Reg. § 1.355-2(e)(2).

(2) 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.

(a) In Rev. Rul. 75-321, 1975-2 C.B. 123, 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.

(b) 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).

(3) 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.

c. For ruling purposes, the Service has stated that it will issue a favorable ruling regarding the retention of stock in a controlled corporation by a widely-held distributing corporation if

(1) A sufficient business purpose exists for the stock retention;

(2) None of the distributing corporation's directors or officers will serve as
director or officer of the controlled corporation as long as the distributing corporation continues to hold the controlled corporation’s stock;

(3) The retained stock will be disposed of as soon as a disposition is warranted given the business purpose for the retention of the stock but in no event later than five years after the distribution; and

(4) The distributing corporation votes the retained stock in proportion to the votes cast by the controlled corporation’s other shareholders.


d. 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. § 355(c). See also H.R. Rep. 100-795, 100th Cong. 2d Sess. 373 (1988).

(1) 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).

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

(3) 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. Reg. § 1.355-2(e)(2).

e. 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. § 355(a)(3)(C).

f. 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).

g. 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 Reg. § 1.355-2(a).

5. Business purpose requirement

The new regulations significantly fortify the business purpose requirement. Once taken for granted by many taxpayers, the business purpose test may now be difficult to satisfy. As indicated below, the Service will scrutinize the proffered business purpose closely to determine whether any Federal tax savings are present at the corporate level (e.g., such as a subsequent S election), and whether alternative tax-free means of accomplishing the stated business purposes are available.

a. In general

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. 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. 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. 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. 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. 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.

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

(a) Transactions which are incident to readjustments of corporate structures required by "business exigencies"; and
(b) Transactions which 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.


(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), a closely-held corporation distributed all of the stock of a leasing subsidiary to its shareholders. The Tax Court 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 court noted that, from a corporate perspective, this was not an immediate business purpose. The envisaged possibility of future interference by in-laws was too remote and under the taxpayer's control to 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 amending the proposed regulations, Treasury initially considered adopting a "principal purpose" standard (i.e., that the principal purpose of the section 355 distribution must be the business purpose). However, the new regulations reject this approach in favor of a facts and circumstances approach.

b. **Corporate vs. shareholder purpose**

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

(1) In *Estate of Parshelsky v. Commissioner*, 303 F.2d 14 (2d Cir. 1962), rev'q 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.

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

(b) 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 the transaction will be scrutinized more closely in the absence of a direct benefit to the corporation.

(2) 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 “[d]epending 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.” Reg. § 1.355-2(b)(2).

(3) The regulations provide as an example of a non-corporate purpose the personal planning purposes of a shareholder. Reg. § 1.355-2(b)(2). However, in Rev. Rul. 75-337, 1975-2 C.B. 124, the shareholder’s estate planning goals also
served as the corporate business purpose of ensuring smooth and continued operation of the corporation after the death of the shareholder.

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

c. 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 means of achieving the corporate business purpose are impractical or unduly expensive, then the business purpose supports a distribution. Reg. § 1.355-2(b)(3).

(1) 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 Reg. § 1.355-2(b)(5) ex. (3).

(2) In Rev. Rul. 69-460 (situation 3), 1969-2 C.B. 51, 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.

d. Relation to device test

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

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

(2) 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.

(3) 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'd, 42 T.C. 914 (1964).

(a) 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.

(b) 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.

(c) 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.

(d) 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.

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

(4) 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, supra, 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 sufficient to overcome the Commissioner's determination that the transaction was a device.

(5) 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. Reg. § 1.355-2(b)(4). The stronger the evidence of a device, the stronger the corporate business purpose necessary to overcome that evidence. 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.

e. Specific business purposes

(1) Tax savings

(a) A corporate business purpose can be the reduction of non federal taxes. Reg. § 1.355-2(b)(1).

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

i) 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

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

Reg. § 1.355-2(b)(2).

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

(d) 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).

(e) The Service has 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. PLR 8705081; PLR 8511086.

(2) Election of S status

(a) 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.

(b) 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).

(c) 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. Reg. § 1.355-2(b)(5) ex. 6 and 7.

(d) Interestingly, in PLR 8825085, 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 was 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.

(e) 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 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 subsidiary.

(f) 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.

(g) Query whether a spin-off to preserve S status would be considered a valid business purpose? For example, an S corporation which is engaged in two trades or businesses determines that it is necessary to separate the two businesses to limit liability with respect to each. A drop-down of one business into a subsidiary would achieve the business purpose of limiting liability. However, a spin-off of the subsidiary is necessary to preserve S status.
(3) **Facilitation of acquisitions**

Section 355 distributions are frequently used to facilitate acquisitions involving either the distributing or the controlled corporation.

(a) 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.

(b) In Rev. Rul. 72-530, 1972-2 C.B. 112, the Service approved of a distribution which facilitated an acquisition by the distributing parent corporation.

(c) On numerous occasions the Service has publicly ruled that the distributing corporation may distribute unwanted assets 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 will be discussed below, these transactions raise continuity of interest issues).

(d) It is unclear what effect General Utilities repeal has on this purpose.
(4) Separation to enhance profitability

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

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

(b) 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.

(c) A distribution made to increase profits through reduced expenses should also be supported by a valid business purpose. See PLR 8651033 (reduce insurance expense).

(5) Employee compensation and equity interests

(a) Distributions designed to transfer an equity interest in the distributing corporation to key employees have been approved by the Service. See Rev. Rul. 69-460, 1969-2 C.B. 51 (situation two); Rev. Rul. 85-127, 1985-2 C.B. 119.

(b) In addition, distributions to remove impediments to the installation of new compensation packages designed to attract and retain key employees have also been approved. See PLR 8147153.
(6) **Obtain additional financing**

(a) In Rev. Rul. 82-130, 1980-2 C.B. 83, the Service held that a distribution to facilitate a public offering of the parent’s stock was supported by a valid business reason. See also, Rev. Rul. 85-122, 1985-2 C.B. 118 (placement of parent’s debentures).

(b) Similarly, in Rev. Rul. 77-22, 1977-1 C.B. 91, a distribution which enhanced access to credit for both the parent and the subsidiary qualified for section 355 treatment. See also PLR 8823111 (spin-off to raise subsidiary’s credit limit).

(c) In PLR 8338031, a distribution to facilitate a public offering of the controlled corporation’s stock was approved by the Service.

(7) **Insulation from risk**

Depending upon the particular circumstances, insulating the risks of one business from those of another may qualify as a valid business purpose.

(a) If a corporation conducts two businesses -- one that is subject to substantial risk and the other which is not, a section 355 distribution is not necessary to insulate the safe business from the risks of the other business.

i) In order to insulate the safe business from the risks of the other business, the corporation can contribute the assets of the risky business to a newly-formed subsidiary. A subsequent distribution of the newly-formed subsidiary is not necessary to achieve the corporate business purpose.
ii) Accordingly, the distribution will not be subject to section 355. Reg. § 1.355-2(b)(5) ex. (3).

(b) However, if the risky business is already contained in the distributing corporation and the safe business is operated by the controlled corporation, a distribution may be necessary to insulate the safe business from the risks of the other business, since the creditors of the risky business can reach the assets of the safe business through the stock of the controlled corporation. Thus, if it can be shown that the subsidiary's stock or assets are subject to risk, a distribution may qualify for section 355 treatment. See Rev. Rul. 78-383, 1978-2 C.B. 142.

(8) Enhancing customer relations

In Rev. Rul. 56-450, 1956-2 C.B. 201, 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. The Service approved of the distribution of the subsidiary in order to remove the subsidiary from control of its customers' competitor. See also Rev. Rul. 59-197, 1959-1 C.B. 77.

(9) Contain labor problems

(a) In Olson v. Commissioner, 48 T.C. 855 (1967), reversed 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 nonunionized).

(b) 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.

(c) 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.

(10) Removal of regulatory burdens

In Rev. Rul. 82-131, 1982-2 C.B. 83, the Service approved of a distribution which improved the utility's chances of obtaining regulatory approval of a rate increase. See also Rev. Rul. 77-191, 1977-1 C.B. 94; PLR 8503052.

(11) Divestiture orders


(12) Ward off hostile takeovers

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

(a) In PLR 8819075, 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 takeover participation suggesting that a takeover was imminent.

(b) The Service approved of a distribution that allegedly would make the distributing corporation less vulnerable to such a takeover attempt.

6. The continuity of interest requirement

The final 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 (viz., Rev. Rul. 69-293, 1969-1 C.B. 102 and Rev. Rul. 79-293, 1979-2 C.B. 125).

a. In general

(1) Historically, tax practitioners viewed the continuity of interest requirement 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.

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

The continuity of interest requirement can be broken down into several key aspects as follows:

(a) Degree of continuity;
(b) Post-distribution continuity;
(c) Pre-distribution continuity, i.e. historic continuity; and
(d) Continuity in both the distributing and the controlled corporations.

These are discussed below.

b. Degree of continuity

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

(1) 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. Reg. § 1.355-2(c)(1).

(2) 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. Reg. § 1.355-2(c)(2) exs. 1-4.
c. Post-distribution continuity

(1) 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.

(a) 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.

(b) 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.

(c) 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").

i) 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. See also 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.

ii) The courts, however, 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).

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

(d) 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.

(e) Query: To what extent should the actions of some shareholders affect the tax consequences of unrelated shareholders. For example, if a 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

(f) 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.

(2) 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.

(a) 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.

(b) 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 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.

(c) 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.

(d) It is not clear how the Service would rule if the ownership of the parent’s stock changed or minority shareholders were present in the corporate chain.

(3) 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.

(a) 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.

i) 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.

ii) 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's stock.

(b) 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).

(4) Subsequent transactions involving the spun-off corporation

In contrast to (3) above, disastrous consequences may result if, following a section 355 transaction, the shareholders of the controlled corporation exchange their newly received stock in such corporation for stock in another corporation in a purported reorganization.

(a) For example, in Rev. Rul. 70-225, 1970-1 C.B. 80, a corporation transferred the assets of a separate trade or business to a newly-formed corporation and distributed the stock of such subsidiary to its shareholders. Pursuant to an integrated plan, the shareholders then exchanged the newly-acquired subsidiary stock for stock in another corporation.

i) The Service ruled that the transaction did not constitute a B reorganization because neither the distributing corporation or its shareholders controlled the subsidiary after the transaction. Since the subsequent exchange
of stock was pursuant to a plan, control was not obtained by the shareholders.

ii) The Service viewed the transaction as if the distributing corporation transferred its assets to the acquiror in exchange for acquiring corporate stock, followed by a distribution of such stock to the shareholders. Accordingly, the receipt of such stock did not qualify under section 355.

(b) However, 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.

i) 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.

ii) The Service stated that ownership of the subsidiary's stock was "real and meaningful" since the shareholders were free to vote their shares.

(c) The different results in these two rulings can be explained by the fact that in 75-406 the requirement for control in a D reorganization did not have to be satisfied.

(d) However, it is understood that the Service will not rule on a Rev. Rul. 75-406 situation that does not involve a publicly-held corporation.
i) Given the analysis in Rev. Rul. 70-225, the Service could recharacterize a distribution of the stock of a pre-existing subsidiary, followed by an exchange of such stock for stock in another corporation as a reorganization at the distributing corporation level, followed by a distribution of the stock of the acquiring corporation.

ii) If such a transaction is recharacterized, it will likely result in gain to the distributing corporation under section 311(b) and dividend income to the distributing corporation's shareholders.

d. Pre-distribution continuity, i.e. historic continuity

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.

(1) 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. 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.)

(a) 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.
(b) Tax practitioners commonly view a shareholder of a corporation 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.

(c) 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."

(2) 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.

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

(a) 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.

(b) 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.

e. Continuity in both the distributing and the controlled corporations

(1) 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. Reg. § 1.355-2(c)(2) ex. 3.

(2) 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.

7. Continuity of business enterprise requirement

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

b. It is not clear how this requirement is applied to a section 355 transaction, and how it interacts with the other requirements of section 355.

(1) 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 34238; PLR 8712019. Nevertheless, it is not clear whether the continuity of business enterprise requirement would prevent a distribution by the corporation from qualifying under section 355.

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

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

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

C. Planning Transactions

As a result of 1986 Act, the ability of a corporation to dispose of assets without triggering current tax has become an important planning objective. Significant attention has turned to section 355 as a device for disposing of assets in this manner. In the examples below, it is assumed that the active trade or business and the business purpose tests are met. The focus in these examples is on the continuity of interest and device requirements.

1. Mirror substitute transaction

a. Individual A owns all of the stock of T. T owns all of the stock of T-1. The combined value of T and T-1 is $200, $80 of which is attributable to T-1. P is interested in acquiring T, but not T-1. However, A will only sell T stock. Accordingly, P buys all of the T stock for $200.

b. This transaction closely resembles the one depicted in Rev. Rul. 74-5, 1974-1 C.B. 82. Unfortunately, as part of the 1987 Act, Congress amended section 355(b)(2)(D) to legislatively overrule Rev. Rul. 74-5.

(1) New section 355(b)(2)(D) applies to distributions after December 15, 1987. See 1987 Act § 10223(d)(1). However, a generous grandfather provision generally applies if 80 percent or more of the stock of the distributing corporation (i.e., control) was acquired by the distributee corporation before December 15, 1987, and the distribution occurs before January 1, 1993. See 1987 Act

(2) Therefore, if control of T was acquired by P prior to December 15, 1987, a distribution of the T-1 stock to P before January 1, 1993, will be governed by old section 355(b)(2)(D).

(3) If control of T was acquired by P before December 15, 1987, but the distribution of T-1 stock to P occurs after December 31, 1992, new section 355(b)(2)(D) will apply.

(4) If control of T was acquired by P after December 15, 1987, new section 355(b)(2)(D) will apply.

(5) Finally, if control T was acquired by P on December 15, 1987, and a distribution of the T-1 stock to P occurred on the same day, neither new section 355(b)(2)(D) nor the grandfathered old section 355(b)(2)(D) apparently would apply. Compare 1987 Act § 10223(d)(1) with 1987 Act § 10223(d)(2)(A).

(6) New section 355(d)(2)(D), if applicable, would require T to wait five years before distributing the T-1 stock to P.

c. Assume that old section 355(b)(2)(D) is applicable to a distribution of the T-1 stock (so that the five-year holding period of new section 355(b)(2)(D) does not apply). If P causes T to immediately distribute the T-1 stock, section 355 will not apply to the distribution because there is not historic continuity of interest as is now explicitly required by the final regulations. P would have to wait until its interest in T became old and cold (so that P becomes the historic shareholder) before distributing the T-1 stock. A two-year period should be ample. See Rev. Rul. 74-5, 1974-1 C.B. 82.

d. Assume that P holds the T stock for the following period after the purchase of T -- five years if new section 355(b)(2)(D) applies, or until P's interest becomes "old
and cold* if old section 355(b)(2)(D) applies. P then causes T to distribute the
T-1 stock, and P sells the T-1 stock immediately after its receipt.

(1) Historic shareholder continuity should not be an issue in this situation.
However, post-distribution continuity in each of the corporations is not satisfied.

(2) The transaction should not be viewed as a device because: (1) no earnings have
passed out of corporate solution as a result of the distribution, and (2) the
distribution to P, a corporation, is evidence of nondevice. However, the
post-distribution sale is evidence of a device.

(3) If P waited two years before selling the
T-1 stock, the continuity of interest test would appear to be satisfied
(unless the subsequent sale can be linked to the distribution under step
transaction principles) and the sale should not be considered a device.

(a) Under section 358, P's basis in the
T stock would be allocated between
the T stock and the T-1 stock
received in the distribution.

(b) This allocation should give a basis
in the T-1 stock approximately
equal to its value at the time of
P's acquisition of T (ignoring
post-purchase adjustments to the
basis of P's stock in T).

(c) Thus, P would be able to sell T-1
without recognizing gain (other
than post-purchase appreciation).

e. If section 355 does not apply to the
distribution of T-1, the distribution will be
a taxable dividend. P should be able to
defray the tax cost of the distribution by
a dividends-received-deduction. However,
gain (but not loss) will be recognized by
T under section 311(b).
2. **Partnership transaction**

   a. The facts are the same as in example 1, above, except that P is a partnership.

      (1) In this case, section 355(b)(2)(D) would not apply since that provision refers to a corporate distributee that acquired control.

      (2) If the partners were members of the same affiliated group, it appears that the acquisition of T stock still would not trigger new section 355(b)(2)(D).

   b. Because historic continuity is required under the final regulations, T could distribute T-1 to P once P's interest in T became "old and cold" (e.g., two years).

   c. Assume that P's interest becomes "old and cold," and that T distributes T-1 to P.

      (1) If P sells T-1 immediately upon receipt, the distribution may fail the continuity of interest and device requirements.

      (2) If P waits until its interest in T-1 becomes "old and cold" (e.g., two years), a sale of the T-1 stock should not affect the application of section 355 to the distribution.

3. **Split-off to non-historic shareholders**

   a. The facts are the same as in example 1, above, except that P is interested in T-1, not T. Accordingly, P acquires 40 percent of the T stock from A for $80. A retains the remaining 60 percent. Subsequently, P redeems its interest in T in exchange for all of the T-1 stock.

   b. Since P did not acquire control of T, section 355(b)(2)(D) does not apply. However, there is not historic shareholder continuity of interest in T-1 which is required by the final regulations. P must wait a sufficient period of time (e.g., two years) before having its interest in T redeemed for T-1 stock in order to have section 355 apply to the transaction.
c. Suppose that after P purchased its T stock, P acquired from T an option, exercisable in two years, to acquire the T-1 stock in exchange for its T stock. Query whether the distribution of the T-1 stock upon exercise of the option would be treated as a section 355 transaction?

d. Since A sold his T stock prior to the split-off, the transaction may be viewed as a device. See Rev. Rul. 59-197, 1959-1 C.B. 77.

e. This transaction is suggested by Esmark v. Commissioner, 90 T.C. 171 (1988). Under the authority of the Esmark case, the transaction would not be viewed as a sale of T-1 stock by T to P. Compare Rev. Rul. 83-38, 1983-1 C.B. 76.

4. Split-off to historic shareholder

a. The facts are the same as in example 1, above, except that P buys only 60 percent of the T stock for $120. A retains the remaining 40 percent. A redeems his T stock immediately after the purchase by P in exchange for all of the stock of T-1.

b. Since P only acquired 60 percent of T, section 355(b)(2)(D) is not implicated. However, the continuity of interest requirement of the final regulations is not satisfied and additionally the transaction may be considered a device.

c. Historic continuity of interest has only been maintained in T-1. P, as a new shareholder, is not a historic shareholder of T. However, if the split-off occurred after P's interest in T became "old and cold" then continuity of interest should be satisfied.

d. A's sale of 60 percent of his stock to P, followed by a split-off may be viewed as a device. Had A spun-off T-1 first, then sold T to P, the sale would be evidence of a device. Query whether a different result should occur where the sale occurs before the purported section 355 transaction. See Rev. Rul. 59-197, 1959-1 C.B. 77.
5. **Purchase followed by a recapitalization**

a. The facts are the same as example 3, above, except that after P acquires 40 percent of T, T is recapitalized with two classes of stock — voting preferred stock and voting common stock. The preferred stock represents only 20 percent of the total voting power of the T stock, but 60 percent of the total value of T. P receives 100 percent of the common stock of T, and A receives 100 percent of the preferred stock of T. The values of the new stock interests received equal those of the old stock interests exchanged. T-1 is also recapitalized so that 60 percent of its total equity is represented by preferred stock having terms similar to the T preferred stock. T distributes the T-1 preferred stock to A and the T-1 common stock to P.

b. Section 355(b)(2)(D) does not apply because P acquired control in a reorganization (i.e., the recapitalization).

c. There is historic shareholder continuity of interest in both entities because A continues to hold a 60 percent equity interest in both T and T-1. Preferred stock qualifies as an equity interest for purposes of the continuity of interest requirement.

d. The transaction may constitute a device due to the prior sale of stock by A.

e. Query whether the Service will impose corporate level tax at the T level under its section 337(d) authority.

(1) Under section 337(d), Treasury has authority to promulgate regulations to prevent circumvention of the General Utilities repeal.

(2) Treasury officials have indicated that the authority under section 337(d) might be used to combat transactions that otherwise fall within section 355.
6. **Additional split-off transaction**

a. Individual A owns all of the stock of T. T owns all of the stock of T-1. The total value of T is $100, $20 of which is attributable to T-1. P corporation is interested in T, but not T-1. X corporation is interested in T-1, but not T. P and X purchase all of the T stock from A -- P acquiring 80 percent and X acquiring 20 percent.

b. Since P acquired control of T, amended section 355(b)(2)(D) will prevent a distribution to P from qualifying under section 355 if made within five years.

c. However, section 355(b)(2)(D) does not apply to X. T may distribute the T-1 stock to X after P’s and X’s interests have become old and cold so that continuity as required by the final regulations is satisfied.

7. **Holding company break-up**

a. T corporation’s assets consist solely of the stock of three subsidiaries -- T-1 (fair market value $50), T-2 (fair market value of $30), and T-3 (fair market value of $20). The total value of the T stock is $100. Corporations A, B, and C are interested in T-1, T-2, and T-3, respectively. However, T and its shareholders are not willing to sell T or its assets in piecemeal fashion, especially where corporate tax would be incurred. Accordingly, the following plan is devised. A, B, and C buy all of the T stock in the following proportions: A-$50; B-$30; C-$20. T subsequently redeems A’s, B’s, and C’s stock in exchange for the stock of T-1, T-2, and T-3, respectively.

b. Section 355(b)(2)(D) does not apply to this transaction since no corporate distributee acquired control of the distributing corporation. Therefore, a split-up of T can qualify under section 355 once A’s, B’s, and C’s interests have become old and cold as required by the final regulations.

c. The split-up transaction should not be taxable to T. § 336(c). Query whether
Treasury will seek to impose gain recognition at the T level under section 337(d).

8. **Subsidiary tracking stock**
   
a. 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.
   
b. An immediate distribution of the T-1 stock does not qualify under section 355 because historic continuity of interest is not satisfied.
   
c. Suppose P cannot wait until its interest in T becomes "old and cold" before the distribution of T-1 stock is made.

   (1) 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.

   (2) 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.

   d. 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."

9. **Transaction to thwart hostile takeovers**
   
a. 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.
   
b. 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 so, 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.

c. 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.

d. Query whether a hostile takeover of a corporation subsequent to a transaction which was intended to qualify for tax-free treatment under section 355 should be rendered taxable by the subsequent acquisition of the corporation’s stock?
THIRTY-FIFTH WILLIAM AND MARY TAX CONFERENCE
SELECTED TAX PROBLEMS AND ISSUES

APPENDIX TO OUTLINE
ON
CORPORATE DIVISIONS UNDER SECTION 355

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Types of Tax-Free Divisions (p. 5)

### Spin-Off
1. Corporation D spins-off the stock of C to A.
2. A does not surrender any stock.

### Split-Off
1. Corporation D splits-off the stock of C to B.
2. B surrenders its stock in D.

### Split-Up
1. Corporation D distributes the stock of C-1 to A and C-2 to B in complete liquidation.
2. A and B surrender their stock in D.
Spin-off by Newly-Acquired Parent (p. 30)

1. P acquires all of the X stock. Two years later, X distributes the Y stock to P (first distribution).

2. One year after the first distribution, P distributes the Y stock to its shareholders.

3. Under old section 355(b)(2)(D), the first distribution qualified as a spin-off, but the second did not. Rev. Rul. 74-5.

4. Under new section 355(b)(2)(D), the first distribution does not qualify for section 355 treatment unless P waits the required five year period.
Restructuring of Holding Company to Satisfy Active Business Requirement

Liquidation of Subsidiary in Active Business(p. 35)


2. U, V and W are actively engaged in a trade or business. X and Y are not.

3. In order to satisfy the active business requirement, P liquidates V so that P is directly engaged in an active business and substantially all its assets need not be stock and securities of corporations so engaged.

4. P can then distribute the stock of U to A in a section 355 transaction.
Restructuring of Holding Company to Satisfy Active Business Requirement

Contribution of Non-Qualifying Subsidiaries to Qualifying Subsidiaries (p. 35)

2. U, V, and W are actively engaged in a trade or business. X and Y are not.
3. In order to satisfy the active business requirement, P contributes X and Y to V so that substantially all of P's assets are stock in corporations engaged in the active conduct of a trade or business.
4. P can then distribute the stock of U to A in a section 355 transaction.
1. Parent owns all of the stock of Distributing.

2. Distributing transfers the assets of a trade or business to Newco and distributes the Newco stock received to Parent.

3. Parent distributes the Newco stock to its shareholders.

Subsequent Transactions Involving the Distributing Corporation (p. 63)

1. Acquiring corporation is interested in buying T, but T has unwanted assets.

2. T contributes the unwanted assets to a newly formed subsidiary (Newco) and distributes the Newco stock to its shareholders.

3. The T stock is then exchanged for Acquiring corporation stock in a B reorganization.

4. The subsequent reorganization involving T does not break continuity of interest. The T shareholders continue their interest in T through their interest in Acquiring. Rev. Rul. 70-434.
1. Corporation transfers the assets of a trade or business to Newco and distributes the Newco stock to its shareholders.

2. The shareholders exchange such Newco stock for Acquiring corporation stock in a B reorganization.

3. The transaction is not a D reorganization because control is lacking.

4. The Service treats the transaction as a transfer of assets by Corporation to Acquiring in exchange for Acquiring stock which is distributed to Corporation's shareholders.

1. Distributing is publicly held. Distributing distributes all of the stock of Sub, a pre-existing corporation, to its shareholders.

2. Shortly after the distribution, the public shareholders vote to merge Sub into Acquiring corporation for Acquiring corporation stock.

3. In Rev. Rul. 75-406, the spin-off and merger were both tax-free.

4. It is understood that the Service will not rule on this transaction if the distributing corporation is not publicly held.
1. Individual A owns all of the stock of T corporation. T owns all of the stock of a subsidiary, T-1.

2. P is interested in acquiring T, but not T-1. Since A will only sell T, P buys the T stock for $200.

3. This transaction is similar to a Rev. Rul. 74-5 transaction. Congress amended section 355(b)(2)(D) to overrule Rev. Rul. 74-5.

4. New section 355(b)(2)(D) applies to distributions after December 15, 1987. Old section 355(b)(2)(D) applies where control was acquired before 12/15/87 and the distribution occurs before 1/1/93.
   a. P acquires control of T before 12/15/87, distribution of T-1 before 1/1/93 -- old section 355(b)(2)(D) applies.
   b. P acquires control of T before 12/15/87, distribution of T-1 after 12/31/92 -- new section 355(b)(2)(D) applies.
   c. P acquires control of T after 12/15/87, new section 355(b)(2)(D) applies.

5. New section 355(b)(2)(D) requires T to wait five years before distributing the T-1 stock to P.

6. Assuming old section 355(b)(2)(D) applies, an immediate distribution of T-1 stock to P does not qualify for section 355 treatment because historic continuity of interest is required.

7. Assume that P holds the stock of T for five years if new section 355(b)(2)(D) applies or until the interest is "old and cold" if old section 355(b)(2)(D) applies. T distributes T-1 to P, and P immediately sells T-1. Section 355 may not apply because of its subsequent sale by P.

8. a. If P waits two years before selling T-1, section 355 should apply to the distribution of T-1 stock to P.
   b. P's basis in T would be allocated to the T stock and T-1 stock, reducing P's gain on the sale.

9. If section 355 does not apply, P would be taxed under section 301 and T would recognize gain.
1. Same facts as in the diagram on page 9, except that P is a partnership, not a corporation. P's partners are unrelated.

2. New section 355(b)(2)(D) does not apply -- P is not a corporate distributee. If the partners were members of the same affiliated group, new section 355(b)(2)(D) apparently still would not apply.
1. Same facts as in the diagram on page 9, except that P is interested in T-1, not T.

2. P acquires 40 percent of the T stock from A.

3. Subsequently, P's interest in T is redeemed in exchange for all the T-1 stock.

4. Since P did not acquire control of T, new section 355(b)(2)(D) does not apply.

5. However, because historic continuity of interest is necessary in both entities, P would have to wait until its interest became old and cold (e.g., two years) for section 355 to apply to the split-off.
1. Same facts as in the diagram on page 9, except that P buys only 60 percent of the T stock. A retains the remaining 40 percent.

2. Since P only acquired 60 percent of T, section 355(b)(2)(D) does not apply.

3. A's stock in T is immediately redeemed in exchange for all of the stock of T-1.

4. Section 355 does not apply because historic continuity of interest is required in both T and T-1. If the redemption occurs two years later, section 355 should apply.
Purchase Followed by a Recapitalization (p. 74)

1. Same facts as in the diagram on page 12, except that after P acquires 40 percent of T, T recapitalizes its equity structure. The preferred stock represents 20 percent of the voting power of T, and 60 percent of the total value of T stock.

2. P receives 100 percent of the new common stock of T and A receives 100 percent of the new preferred stock of T. The values of the new stock interests received equal those of the old stock interests exchanged.

3. T-1 is also recapitalized in similar fashion. The T-1 stock is then distributed -- preferred stock to A and common stock to P.

4. Section 355 should apply.
1. Individual A owns all of the stock of T corporation. T owns all of the stock of T-1 corporation.

2. The total value of T stock is $100, $20 of which is attributable to the T-1 stock.

3. P corporation is interested in T, but not T-1. X corporation is interested in T-1, but not T.

4. P and X purchase all of the T stock from A — P acquiring 80 percent and X acquiring 20 percent.

5. Since P acquired control of T, amended section 355(b)(2)(D) will prevent a distribution to P from qualifying under section 355 if made within five years.

6. However, section 355(b)(2)(D) does not apply to X. Because historic continuity is required, T may distribute the T-1 stock to X after P and X’s interests have become old and cold.
1. T corporation's assets consist solely of the stock of three subsidiaries -- T-1, T-2, and T-3. The total value of the T stock is $100.

2. Corporations A, B and C are interested in T-1, T-2 and T-3, respectively.

3. A, B and C buy all the T stock as follows: A - $50; B - $30; C - $20.

4. T subsequently redeems A and B, and C in exchange for the stock of T-1, T-2 and T-3, respectively. In order for this to qualify under section 355, A, B, and C's interests must become "old and cold."
1. Individual A owns all of the T stock. T owns all of the T-1 stock. T has a value of $200, $80 of which is attributable to T-1.

2. P is interested in T-1, but not T. P buys 40 percent of T for $80.

3. An immediate distribution of T-1 would not qualify for section 355 treatment since historic continuity is required in both entities.

4. P exchanges its T stock for a new class of T stock that pays dividends based on T-1's earnings.

5. Once this subsidiary tracking stock becomes old and cold, P can exchange such stock for the T-1 stock under section 355.