

**After the Spin: Preserving Tax-Free Treatment
Under Section 355**

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After the Spin: Preserving Tax-Free Treatment Under Section 355

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This article examines the principal issues that can arise under Section 355 of the Internal Revenue Code in connection with various transactions and other developments following a spin-off or other form of corporate separation. The article also discusses the process for obtaining a supplemental IRS ruling on such matters.

I. BACKGROUND

The ability to achieve a tax-free separation of a controlled subsidiary under Section 355 is one of the few bright spots remaining for corporate tax planners since repeal of the so-called *General Utilities* doctrine in the mid-1980s. Under the rationale of *General Utilities & Operating Co. v. Helvering*,¹ a corporation could make a liquidating or nonliquidating distribution of appreciated property to shareholders without incurring a corporate-level tax. The Internal Revenue Code generally embraced such treatment for nonliquidating distributions until 1984, and for liquidating distributions until 1986. The statutory reversal of *General Utilities* in those years (through amendments to Sections 311, 336 and 337) spared only complete liquidations of controlled subsidiaries (under Section 332) and qualifying distributions of controlled subsidiary stock (under Section 355).

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¹ 296 U.S. 200 (1935).

A. Section 355 Transactions.

All Section 355 transactions involve the distribution by a corporation (“Distributing”) of an 80% or more controlling interest in the stock of a subsidiary (“Controlled”). The distributed stock must constitute “control” within the meaning of Section 368(c), *i.e.*, 80% of voting power and 80% of each class of nonvoting stock. In most instances, Distributing owns and distributes 100% of the Controlled stock. Any retention of Controlled stock must be supported by a good business reason, and the retained stock must be disposed of within 5 years under IRS ruling guidelines.²

A Section 355 distribution typically is either pro rata to all of the Distributing shareholders (a “spin-off”) or non-pro rata to some shareholders in redemption of their Distributing stock (a “split-off”). Another, less frequent, variation (a “split-up”) involves the complete liquidation of Distributing, with its shareholders receiving the stock of one or more controlled subsidiaries. (The term “spin-off” or “spin” is used in this article as a reference to Section 355 distributions generally, *i.e.*, whether or not pro rata.) If, prior to the spin-off, Distributing transfers an active business or other assets to a newly-formed or previously existing Controlled, the Section 355 distribution is generally considered part of a tax-free divisive reorganization under Section 368(a)(1)(D).

Apart from the “distribution of control” requirement, all spin-offs must meet several other requirements in order to qualify under Section 355. These include the statutory “device” and “active business” requirements, and the nonstatutory “business purpose,” “continuity of interest,” and “continuity of business enterprise” requirements. Section 355 qualification results in tax-free treatment to the Distributing shareholders on their receipt of the Controlled stock, and to Distributing as well on any gain inherent in the distributed stock.³ However, in certain circumstances involving significant pre- or post-spin changes in the stock ownership of

² See Rev. Proc. 96-30, App. B, 1996-1 C.B. 696 (“Rev. Proc. 96-30”).

³ I.R.C. §§ 355(a); 355(c); and 361(c).

Distributing or Controlled, corporate-level gain inherent in the distributed Controlled stock may be subject to tax under Section 355(d) or Section 355(e).

B. Post-Spin Developments.

The satisfaction of one or more of the Section 355 requirements can sometimes be affected by transactions or other events that occur after the spin-off. Total acquisitions of Distributing or Controlled by unrelated parties typically carry the greatest risk in this regard, especially if the acquisition occurs soon or relatively soon after the spin. More limited changes in the stock ownership or asset composition of Distributing or Controlled can also be problematic, as can changes in business plans or operations that might be viewed as contradicting the asserted business purpose for the spin-off.

The analysis as to the impact of post-spin developments is largely fact-intensive and tends to focus on two main inquiries: (i) How soon after the spin-off did such developments occur? and (ii) Were such developments planned or otherwise contemplated at the time of the spin-off?

In many instances, the risk of undoing otherwise available Section 355 treatment is serious enough to dictate not going forward with a proposed post-spin transaction, or at least postponing the transaction. However, if a Section 355 ruling was obtained on the spin-off, it often is possible to obtain a supplemental IRS ruling to the effect that a contemplated transaction or other post-spin development will not adversely affect any of the prior favorable rulings.

II. TAXABLE STOCK ACQUISITIONS

Following a spin-off, another corporation or entity may acquire all of the outstanding Distributing or Controlled stock for cash or other nonstock consideration in a taxable transaction. This typically is done through a negotiated purchase, a reverse cash merger or a tender offer (coupled, if necessary, with a minority squeeze-out merger). Such a transaction could render the spin-off taxable at both the shareholder and corporate levels on device or continuity of interest grounds, or result in partial taxation at the corporate level under Section 355(e).

A. Device.

Section 355(a)(1)(B) precludes tax-free treatment for spin-off transactions used principally as a “device” for the distribution of the earnings and profits of Distributing or Controlled. The device restriction is intended mainly to prevent shareholder “bailouts” of corporate ordinary income through sales or other capital gain dispositions of stock which allow for recovery of tax basis.⁴

1. Post-spin stock dispositions.

The statute states that “the mere fact” that stock in either Distributing or Controlled is sold or exchanged by all or some of the shareholder-distributees subsequent to the spin-off, “other than pursuant to an arrangement negotiated or agreed upon prior to the (spin-off) shall not be construed to mean that the transaction was used principally as a . . . device.” According to the underlying Treasury regulations (which look to an overall “facts and circumstances” test in applying the device requirement), stock sales or exchanges that are not prearranged are nonetheless considered “evidence of device.” Prearranged stock dispositions are considered “substantial evidence.”⁵

In general, the greater the percentage of stock disposed of, and the closer in time to the spin-off the disposition occurs, the greater the weight that will be accorded the disposition as a factor indicative of device.⁶ A post-spin stock disposition may be treated as having been effectuated “pursuant to an arrangement negotiated or agreed upon before the distribution,” even though enforceable rights to buy or sell did not exist at the time of the spin-off.⁷ It is sufficient

⁴ See Treas. Reg. § 1.355-2(d)(1).

⁵ See Treas. Regs. §§ 1.355-2(d)(2)(iii)(A) and (B).

⁶ Treas. Reg. § 1.355-2(d)(2)(iii)(A).

⁷ Treas. Reg. § 1.355-2(d)(2)(iii)(D).

in this regard that the sale was discussed before the spin-off and was “reasonably to be anticipated” by both parties.⁸

2. Non-device factors.

By reason of certain “non-device” factors in the regulations, the disposition may not trigger a device problem even where all or most of the Distributing or Controlled stock changes hands soon after the spin-off. For example, a strong corporate business purpose for the spin-off is generally evidence of non-device.⁹ Indeed, doing a spin-off for the express purpose of facilitating an acquisition of Distributing or Controlled has long been an acceptable corporate business purpose under Section 355.¹⁰ The 1997 enactment of Section 355(e), however, rendered most such transactions unfeasible due to stiff corporate-level tax consequences.

Other non-device indicators include the fact that (i) Distributing is publicly traded and widely held;¹¹ or (ii) the Distributing shareholders consist of one or more domestic corporations that could otherwise exclude the distributed Controlled stock from income as an intercorporate dividend.¹² Moreover, apart from these specific regulatory aids, in private letter rulings the Service has blessed post-spin sales of all the stock of Controlled where the decision to sell stemmed from significant changes in business circumstances that arose after the spin-off.¹³

⁸ *Id.*

⁹ Treas. Reg. § 1.355-2(d)(3)(ii).

¹⁰ Rev. Proc. 96-30, App. A, § 2.07.

¹¹ Treas. Reg. § 1.355-2(d)(3)(iii) [no beneficial owner of more than 5% of any class of stock].

¹² Treas. Reg. § 1.355-2(d)(3)(iv).

¹³ *See, e.g.*, Ltr. Rul. 199914003 (Dec. 15, 1998), *supplementing* Ltr. Rul. 9730024 (Jul. 25, 1997) [Controlled suffered significant unanticipated reversals due to litigation losses and poor operating results; sale did not affect earlier Section 355 rulings]; Ltr. Rul. 9630033 (Apr. 30, 1996), *supplementing* Ltr. Rul. 9427010 (Apr. 6, 1994) [several unforeseen changes in Controlled’s business had adversely affected its ability to compete; sale pursuant to unsolicited offer].

B. Continuity of Interest.

The continuity of interest (“COI”) requirement is an independent requirement for Section 355 qualification. However, like the device restriction, it also can be breached by a post-spin disposition of Distributing or Controlled stock. The regulations state that “Section 355 applies to a separation that effects only a readjustment of continuing interests in the property of the distributing and controlled corporation.”¹⁴ This requires that, after the spin-off, “one or more persons who, directly or indirectly, were the owners of” Distributing before the spin-off “own, in the aggregate, an amount of stock establishing a continuity of interest in each of” Distributing and Controlled.¹⁵ “Indirect” COI can exist, for example, where a lower-tier subsidiary is spun to a parent corporation and then spun again to the parent company shareholders.¹⁶

1. How much?

Examples in the regulations indicate that 50% continuing stock ownership is an acceptable COI threshold, but that 20% is too low.¹⁷ The 50% continuing ownership test applies for advance ruling purposes. Distributing generally must represent in Section 355 ruling requests that its management is not aware of any plan or intention on the part of the Distributing shareholders (or any 5% shareholder if Distributing is a public company) to dispose of their stock in Distributing or Controlled.¹⁸ This representation relates as well to the device requirement, which can be triggered by dispositions of far less than 50% of the Distributing or Controlled stock.

¹⁴ Treas. Reg. § 1.355-2(c)(1).

¹⁵ *Id.*

¹⁶ *See* Rev. Rul. 62-138, 1962-2 C.B. 95.

¹⁷ Treas. Reg. § 1.355-2(c)(2), Exs. (2) and (4).

¹⁸ *See* Rev. Proc. 96-30, at §§ 4.06 and 4.05(1)(a).

In acquisitive reorganization contexts (which also have a 50% advance ruling threshold), the courts have accepted lower COI percentages.¹⁹ Absent a ruling, however, most practitioners are generally uncomfortable opining that COI is satisfied at levels below 40%. In any event, only shareholder stock dispositions should affect the measurement of continuity. Any reduction in the historic shareholders' aggregate percentage interest by reason of an issuance of new stock by Distributing or Controlled (*e.g.*, in a public offering or an acquisition) ought not be taken into account.

2. How long?

The more difficult prong of the COI requirement relates to how long after the spin-off the requisite amount of stock in Distributing and Controlled must continue to be held by the persons who were the Distributing shareholders at the time of the spin. There are no hard and fast rules in this regard. Most practitioners feel very confident about dispositions occurring more than two years after the spin. Most also believe that earlier dispositions ought not break continuity if de-linkage from the spin-off distribution can be established under conventional “step-transaction” principles. Thus, even where an acquisition of the Controlled or Distributing stock occurs soon after the spin, *i.e.*, within a few months, the critical focus for COI purposes should be on whether that acquisition (or, possibly, another like it) was committed to or otherwise contemplated at the time of the spin.²⁰ In this regard, a prearranged post-spin stock disposition is an adverse and potentially fatal fact in connection with both the “continuity” and “device” determinations.

It remains to be seen whether Treasury and the IRS will ultimately decide to liberalize the post-spin COI requirement – including perhaps dispensing with it altogether, as was done in

¹⁹ See, *e.g.*, *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) [38%]; *Miller v. Commissioner*, 84 F.2d 415 (6th Cir. 1936) [25%].

²⁰ See Ltr. Ruls. 199914003 and 9630033, *supra* n.13. Cf. *Penrod v. Commissioner*, 88 T.C. 1415 (1987) and *Est. of Christian v. Commissioner*, 57 TCM 1231 (1989) [post-reorganization stock sales after 9 and 7 months, respectively, did not violate Section 368 continuity requirement]. See also, Official IRS Summary of Ltr. Rul. 9637043 (Jun. 17, 1996), 2000 TNT 250-35 [5 years unrestricted ownership sufficient for Section 355 COI even though stock thereafter redeemable].

1998 amendments to the COI regulations for acquisitive reorganizations.²¹ The preamble to those amendments indicates that Treasury continues to study the role of the COI requirement in divisive “D” reorganizations and Section 355 transactions. Whether or to what extent the COI requirement applies to “D” reorganizations generally (*i.e.*, acquisitive or divisive) remains unclear.²²

C. Section 355(e).

If both the device and COI hurdles can be cleared, and the qualification requirements for Section 355 treatment are otherwise met, there is yet another potential fly in the ointment where substantial stock dispositions occur fairly soon after a spin-off – namely, Section 355(e). This controversial provision was enacted in 1997 to thwart long sanctioned transactions patterned after the decision in *Commissioner v. Morris Trust*,²³ which held that a tax-free spin-off could be followed by a planned tax-free merger between Distributing and an unrelated corporation. However, the actual sweep of the anti-*Morris Trust* provision extends far beyond the fact pattern of that case.

1. Corporate-level tax.

The main thrust of Section 355(e) is to impose a corporate-level tax on Distributing on any gain inherent in the distributed stock. The provision applies if the spin-off is “part of a plan (or series of related transactions)” pursuant to which a 50% or greater stock interest in either Distributing or Controlled (measured by vote or value) is directly or indirectly acquired by one or more persons.²⁴

²¹ See Treas. Reg. § 1.368-1(e)(1)(i).

²² See Treas. Reg. § 1.368-1(a) [third sentence, parenthetical]; and Beller, “D” Reorganizations and Dropdowns: An Uneasy Match, 26 J. Corp. Tax 177, 191-92 (1999).

²³ 367 F.2d 794 (4th Cir. 1966). See: Rev. Rul. 68-603, 1968-2 C.B. 148; Rev. Rul. 70-434, 1970-2 C.B. 83; and Rev. Rul. 78-251, 1978-1 C.B. 89 [all confirming the *Morris Trust* result].

²⁴ IRC § 355(e)(2)(A)(ii).

It is irrelevant whether the stock acquisition occurs incident to a taxable or a tax-free transaction. However, Section 355(e)(3)(A) cleanses certain types of “acquisitions,” including, for example, Distributing’s acquisition of Controlled stock. Section 355(e)(2)(C) excepts situations where, after the acquisition, Distributing and Controlled are members of the same affiliated group. Although tax-free treatment at the shareholder level is not disturbed when Section 355(e) applies, the distributee-shareholders do not get a basis increase in their Controlled shares for the taxed corporate-level gain.

2. Rebuttable “plan” presumption

Section 355(e)(2)(B) provides a rebuttable presumption that an acquisition that occurs during the 4-year period beginning two years before, and ending two years after, the date of the spin-off is presumed to have occurred pursuant to a proscribed plan or series of related transactions. An acquisition that falls outside this 4-year window can still be tainted for purposes of Section 355(e) if it is in fact sufficiently linked to the spin-off. In many instances, it may be possible to establish that a sale of all the stock of Distributing or Controlled within two years after the spin is not part of a Section 355(e) plan.

Under proposed regulations (as re-proposed at the end of last year),²⁵ the “plan” determination is generally based on a case-by-case weighing of all the facts and circumstances. In the case of a post-spin acquisition, the critical inquiry is whether “Distributing, Controlled, or any of their respective controlling shareholders intended, on the date of the distribution, that the acquisition or a similar acquisition occur in connection with the distribution.”²⁶ To aid in this process, the proposed regulations include two nonexclusive lists of “plan” and “nonplan” evidentiary factors that should be considered.²⁷ The proposed regulations also contain various “safe harbor” rules, three of which provide automatic protection from Section 355(e) for certain

²⁵ Prop. Treas. Reg. § 1.355-7 (Dec. 29, 2000), replacing earlier proposed regulations issued on August 24, 1999.

²⁶ Prop. Treas. Reg. § 1.355-7(b)(1).

²⁷ Prop. Treas. Regs. §§ 1.355-7(b) and (d).

acquisitions of Distributing or Controlled stock that occur more than 24 months (“Safe Harbor III”) or more than six months (“Safe Harbors I and II”) after the spin-off.

3. Acquisitions after two years.

Under Safe Harbor III, an acquisition that occurs more than two years after the spin-off will not be considered part of a Section 355(e) “plan” if, at the time of the spin-off and throughout the first six months thereafter, (i) there was no “agreement, understanding or arrangement” (“AUA”), and (ii) “substantial negotiations” did not occur, as to such acquisition.²⁸

Thus, the parties apparently can start talking and negotiating at any time after six months, so long as the acquisition is not consummated until after the 24-month mark. Moreover, the mere fact that some discussions or other contact may have taken place within six months after the spin should not necessarily foreclose the availability of Safe Harbor III – provided that such discussions or other contact did not rise to the level of substantial negotiations or result in an AUA.

The proposed regulations do not comprehensively define the AUA or substantial negotiations concepts. They do indicate, however, that such concepts contemplate something short of a binding contract or complete agreement as to all terms of an acquisition.²⁹ Accordingly, the cleanest case for applying Safe Harbor III will exist where there is absolutely no contact at all between the parties or their representatives (*e.g.*, attorneys or investment bankers) prior to the 6-month mark.

4. Acquisitions after six months.

Safe Harbor I and II may come into play for acquisitions of Distributing or Controlled that occur during the 6 to 24-month period following the spin-off. Under Safe Harbor I, a

²⁸ Prop. Treas. Reg. § 1.355-7(f)(3).

²⁹ Prop. Treas. Reg. § 1.355-7(k)(1).

Section 355(e) plan will not be found if two prerequisites are met: (i) there was no AUA or substantial negotiations concerning the acquisition during the first six months; and (ii) the spin-off was motivated “in whole or *substantial part* by a corporate business purpose *other than* a business purpose to facilitate an acquisition.”³⁰

Safe Harbor I could apply, for example, if the spin-off was done solely to accomplish one or more of the following “non-acquisition” corporate business purposes: (i) to achieve cost savings; (ii) to insulate Distributing from liability exposure in connection with a risky business conducted by Controlled; (iii) to achieve expanded or more cost-effective debt financing; or (iv) to separate two businesses that lack managerial or operational synergies (*i.e.*, a so-called “fit and focus” purpose). Each of these purposes, if adequately substantiated, is acceptable for Section 355 advance ruling purposes.³¹

Other acceptable business purposes for a the spin-off may be “acquisition” related – for example, to set the stage for a post-spin acquisition by Distributing or Controlled (using their stock), or a public offering by Distributing or Controlled.³² If both acquisition and non-acquisition purposes are present, the application of Safe Harbor I turns on whether the spin was motivated “in substantial part” by the non-acquisition purpose. It is unclear whether a legitimate non-acquisition business purpose can be considered “substantial” even though it is not the principal or primary purpose for the spin; or whether the taxpayer must show that the spin-off would have gone forward based solely on the non-acquisition purpose. In other Code contexts, the term “substantial part” has been interpreted as encompassing quantitative thresholds well below 50 percent.³³ The final “plan” regulations hopefully will confirm a similar interpretation for Section 355(e) purposes.

³⁰ Prop. Treas. Reg. § 1.355-7(f)(1)(i)(B) (emphasis added).

³¹ See Rev. Proc. 96-30, App. A, §§ 2.03, 2.04, 2.05, and 2.09.

³² See Rev. Proc. 96-30, App. A, §§ 2.08 and 2.02.

³³ See Rev. Rul. 72-48, 1972-1 C.B. 102 [realization of one-third of the taxable income from corporate property constituted “a substantial part of the taxable income to be derived from such property” for purposes of old section 341(b)(1)(A); and GCM 34410 (Jan. 22, 1971) [“[A]ny revenue ruling that would interpret the statutory

Safe Harbor II covers certain situations in which there is no AUA or substantial negotiations during the first six months, but a substantial non-acquisition purpose did not motivate the spin. There are two other prerequisites: (i) the spin-off was motivated in whole or substantial part by a business purpose to facilitate an acquisition of no more than 33% of the stock of either Distributing or Controlled; and (ii) no more than 20% of such stock was in fact acquired or the subject of an AUA or substantial negotiations within the first six months after the spin-off.³⁴ Safe Harbor II could apply, for example, if (i) the spin was done solely to facilitate a 15% public offering by Controlled two months after the spin; and (ii) ten months after the spin-off Controlled is acquired pursuant to an unsolicited offer by a company with which it had had no prior contact.

5. Facts and circumstances test.

If none of the safe harbors apply, it still may be possible to avoid treatment of the acquisition as part of a Section 355(e) “plan” based on an overall facts and circumstances determination. The original version of the proposed regulations did not permit a facts and circumstances fall-back. Moreover, the earlier version included fewer safe harbors which were considerably more difficult to meet.

Many of the “plan” v. “non-plan” factors described in the proposed regulations reflect “step-transaction” overtones. For example, the fact that a post-spin acquisition resulted from “an identifiable, unexpected change in market or business conditions,” and was not otherwise contemplated at the time of the spin, indicates that the acquisition was not part of a proscribed plan.³⁵ Absence of a plan is also suggested by the fact that the spin “would have occurred at

phrase ‘substantial part’ to mean more than one-third would not be defensible as a matter of law.”]. *See also*: Treas. Reg. §1.368-1(e)(1)(i) [a “substantial part” of consideration issued in a tax-free reorganization must be an equity interest in the acquiring corporation; 38% equity held sufficient in John A. Nelson v. Helvering, 296 U.S. 374 (1935)]; Treas. Reg. §1.170-9(e) [“substantial part” generally means one-third, but can mean as little as 10 percent, for purposes of public charity “support” requirements].

³⁴ Prop. Treas. Reg. § 1.355-7(f)(2).

³⁵ Prop. Treas. Reg. § 1.355-7(d)(3)(iii).

approximately the same time and in similar form regardless of the acquisition or a similar acquisition (including a previously proposed similar acquisition that did not occur).”³⁶

On the other hand, the fact that discussions regarding the acquisition (or a similar transaction) occurred prior to the 6-month mark (including prior to the spin-off) will generally be considered a negative factor. However, where the acquisition is pursuant to an auction process, the tainted discussions are limited to those occurring with an investment banker or other outside adviser.³⁷

Another adverse factor is the existence of a substantial business purpose to facilitate an acquisition of stock in Distributing or Controlled.³⁸ The proposed regulations warn that purely internal management discussions regarding an acquisition may be considered indicative of a business purpose to facilitate an acquisition.³⁹ Moreover, in some instances, an acquisition-related business purpose may be found to exist even in the absence of discussions or negotiations. That would be so, for example, if, due to a “hot market” or other external factors, there was at the time of the spin-off a “reasonable certainty” that within six months (i) an acquisition would occur; (ii) an AUA concerning an acquisition would exist; or (iii) substantial negotiations would occur regarding an acquisition.⁴⁰

6. Interface with COI/device.

The Section 355(e) “facts and circumstances” analysis is likely to dovetail closely with the COI and device analyses in the context of a post-spin taxable acquisition of all the stock of Distributing or Controlled. It seems unlikely that a proscribed Section 355(e) plan would be found to exist if neither the COI or device requirements were violated by a post-spin stock sale.

³⁶ Prop. Treas. Reg. § 1.355-7(d)(3)(vii).

³⁷ See Prop. Treas. Regs. §§ 1.355-7(d)(2)(i) and (ii).

³⁸ See Prop. Treas. Reg. § 1.355-7(d)(2)(vii).

³⁹ See Prop. Treas. Reg. § 1.355-7(e)(2).

⁴⁰ Prop. Treas. Regs. §§ 1.355-7(e)(1)(i) and (m), Ex. (5).

However, if the acquisition was already committed to or otherwise clearly prearranged, both the COI and the device requirements probably would be failed. In that event, the Section 355(e) plan determination would become academic.

7. Reliance on proposed regulations.

Although the proposed “plan” regulations are not technically effective until finalized,⁴¹ it seems safe to assume for planning purposes that situations that meet the criteria of one of the proposed safe harbors will not run afoul of Section 355(e). The National Office has been accepting ruling requests relating to the Section 355(e) plan requirement. However, until the proposed regulations are finalized, or become effective earlier via designation as temporary regulations or other administrative action, ruling letters probably will be based on a general facts and circumstances analysis rather than specific safe harbors.

In some instances, taxpayers may seek to avoid potentially adverse interpretations of the proposed regulations (*e.g.*, the “reasonable certainty” and “internal discussions” aspects) on the ground that the regulations are not yet final. At least in a ruling context, however, the IRS would likely resist any such assertion. If a Section 355(e) plan issue were litigated, it remains to be seen whether, or to what extent, a court would look to and embrace specific principles of the proposed regulations in deciding the case.

III. TAX-FREE STOCK ACQUISITIONS

Post-spin dispositions of all the outstanding stock of Distributing or Controlled may also occur pursuant to acquisitions structured as tax-free reorganizations under Section 368. In such transactions, the target company shareholders exchange their stock for stock in the acquiring corporation (or its parent), and also may receive cash or other nonstock consideration. The target corporation may stay alive -- as in a stock-for-stock type-“B” reorganization or a reverse

⁴¹ Prop. Treas. Reg. § 1.355-7(n) [distributions occurring after publication as final regulations].

triangular merger under Section 368(a)(2)(E). Alternatively, the target may transfer its assets to the acquiring corporation and go out of existence -- as in a two-party type-“A” statutory merger or forward triangular merger under Section 368(a)(2)(D). In general, these tax-free acquisitions cause less pressure on the device and COI requirements than do taxable stock acquisitions. The Section 355(e) risk, however, is generally the same for taxable and tax-free acquisitions.

A. Device.

The Section 355 regulations provide that if a post-spin exchange of stock occurs incident to a Section 368 reorganization involving no more than an “insubstantial” amount of taxable “boot,” the exchange will not be considered evidence of “device.”⁴² Any boot gain that is treated as a “dividend” under Section 356(a)(2) is disregarded for purposes of applying the “insubstantial boot” rule. However, in most acquisitive reorganizations involving boot, the Supreme Court’s decision in *Commissioner v. Clark*⁴³ dictates taxation as capital gain. In private letter rulings, the IRS has extended the Section 368 device exception to post-spin Section 351 transfers of Controlled stock into an existing or new corporation controlled by the transferor-shareholder.⁴⁴ The same result presumably obtains whether or not the stock transfer also constitutes a type-“B” reorganization.

If a transaction does involve boot, the line between “substantial” and “insubstantial” is unclear. The IRS might consider problematic an amount representing as low as 5 or 10% of the total consideration. In any event, the existence of substantial boot gain would be only one factor to consider, and could be outweighed by traditional non-device factors such as a strong business purpose or widely-held Distributing stock.

⁴² Treas. Reg. § 1.355-2(d)(2)(iii)(E).

⁴³ 489 U.S. 726 (1989).

⁴⁴ See, e.g., Ltr. Rul. 200109031 (Nov. 30, 2000) [contribution of 100% of Controlled stock following a split-off]; Ltr. Rul. 9301007 (Oct. 2, 1992) [multiple Section 351 dropdowns of Controlled stock by parent following internal spin].

B. Continuity of Interest.

The exchange of all the stock of Distributing or Controlled pursuant to a tax-free reorganization should not cause the earlier spin-off to violate the Section 355 COI requirement. This result follows because the exchanging shareholders will maintain an indirect equity interest of equal value in the target company (or its assets) through the stock received in the acquiring corporation. This core principle is reflected in the *Morris Trust* decision and also in published rulings.⁴⁵ Moreover, as is true for purposes of the Section 368 COI requirement, the exchanging shareholders need not end up with at least 50% of the acquiring corporation's stock. COI should thus be preserved even though the new stock interests collectively represent only a very small percentage of the acquiring corporation stock. For similar reasons, continuity should be preserved in the case of a contribution of Distributing or Controlled stock to a controlled subsidiary corporation, or a downstream merger of Distributing or Controlled into a subsidiary.⁴⁶ While a dropdown to a partnership in exchange for a 50 percent or greater interest ought to yield the same result, technical application of the "indirect" continuity concept in that context may be more difficult.

C. Section 355(e).

In contrast to the COI rules, the amount of acquiring corporation stock received by exchanging shareholders of Distributing or Controlled in a subsequent tax-free reorganization is critical for Section 355(e) purposes. Again, that provision comes into play only if the spin otherwise continues to qualify for tax-free treatment under Section 355. Section 355(e) is not

⁴⁵ See: Rev. Rul. 78-251, 1978-1 C.B. 89 [subsequent "B" reorganization]; Rev. Rul. 75-406, 1975-2 C.B. 125, *declared obsolete on other grounds* by Rev. Rul. 98-27, 1998-1 C.B. 1159 [subsequent merger]; and Ltr. Rul. 200109045 (Dec. 6, 2000), *supplementing* Ltr. Rul. 9649040 (Sept. 10, 1996) [acquisition of Controlled via (a)(2)(E) merger].

⁴⁶ Ltr. Rul. 9841016 (Jul. 7, 1998), *supplementing* Ltr. Rul. 9750059 (Sept. 16, 1997) [contribution of Distributing to newly-formed holding company did not affect earlier Section 355 rulings]; Ltr. Rul. 199948032 (Sept. 2, 1999) [Section 332 liquidation]; Ltr. Rul. 9445015 (Aug. 11, 1994), *supplementing* Ltr. Rul. 9422016 (Feb. 25, 1994) [downstream merger].

triggered if the exchanging shareholders receive, in the aggregate, a 50% or greater equity interest in the acquiring corporation.⁴⁷ (Somewhat ironically, that was the situation in the *Morris Trust* case, where the Distributing shareholders ended up with 54% of the acquiring corporation's stock.) If the 50% threshold is breached, Section 355(e) will apply unless it can be shown that the requisite "plan" is lacking.⁴⁸ The "plan" determination requires the same factual analysis in reorganization contexts as it does with respect to taxable stock acquisitions.

IV. OTHER POST-SPIN STOCK TRANSACTIONS

The device, COI and/or Section 355(e) requirements may also have to be revisited in connection with partial post-spin dispositions or transfers of Distributing or Controlled stock, as well as new issuances of such stock in public or private offerings. The risk of jeopardizing the Section 355 treatment of the spin-off is generally much lower in these scenarios, at least where relatively small stock interests are involved. Representations in Section 355 ruling requests commonly acknowledge that minor transfers (including by way of family gifts) will or may occur. Problems can arise, however, when the percentage of stock disposed of or issued begins to move into double-digit territory, particularly if the transactions were prearranged or can otherwise be factually linked to the spin-off.

A. Third-Party Sales.

Where Distributing and Controlled are publicly-held, stock market trades by less than 5% shareholders are generally disregarded by the IRS for device, COI and Section 355(e) purposes.⁴⁹

⁴⁷ See Ltr. Rul. 200018035 (Feb. 4, 2000), *supplementing* Ltr. Rul. 9732026 (May 13, 1997) [merger of Controlled more than 2 years after spin-off would not jeopardize Section 355 rulings where sole shareholder of Controlled received more than 50% of the acquiring company stock].

⁴⁸ Cf. 200115001 (Feb. 4, 2000), *supplementing* Ltr. Rul. 200004035 (Aug. 3, 1999) [more than 50% change in indirect ownership of Distributing prior to split-off not part of plan].

⁴⁹ See Treas. Reg. § 1.355-2(d)(3)(iii) [publicly traded Distributing with no less than 5% shareholders "nondevice" factor]; Prop. Treas. Regs. §§ 1.355-7(e)(4), (f)(5) (Safe Harbor V) and (k)(5) [non-impact of active trading and definition of 5% shareholder for Section 355(e) purposes].

For advance ruling purposes, a representation is required to the effect that 5% or more shareholders do not intend to dispose of stock in either Distributing or Controlled, or that Distributing's management is not aware of any such intention.⁵⁰ More substantial sales will not be problematic from a COI or Section 355(e) standpoint if they result (either alone or in conjunction with other such transactions) in a less than 50% stock ownership shift. The device threshold, however, is certainly lower, with many practitioners believing that 20% is the Service's maximum tolerance level.⁵¹

B. Redemptions.

1. Device.

Where stock of Distributing or Controlled is redeemed or repurchased by the corporation after a spin-off, the initial focus is typically on the device requirement. Again, the less stock redeemed, and the further in time from the spin, the better. Although no clear guidelines exist, many practitioners believe that a redemption that was not prearranged and that occurs more than two years after the spin should have no device implications.

An administrative safe harbor may apply to nullify any device concern as to post-spin stock repurchases by publicly-held corporations.⁵² This safe harbor imposes four requirements, all of which must be satisfied:

- There must be a sufficient business purpose for the stock repurchase.
- The stock to be repurchased must be widely-held.
- The stock repurchase must be made in the open market.

⁵⁰ See Rev. Proc. 96-30, § 4.05(1)(a).

⁵¹ *But see, Pulliam v. Commissioner*, 73 TCM 3052 (1997), *nonacq.* 1998-2 C.B. xix [prearranged sale of 49% of spun-off corporation's stock to key employee not a device].

⁵² Rev. Proc. 96-30, § 4.05(1)(b).

- There must be no plan or intention that the aggregate amount of stock repurchases will equal or exceed 20% of the outstanding stock of the corporation.

Section 355 ruling requests by public companies typically include a representation to the effect that any subsequent redemptions by Distributing or Controlled will meet all of the safe harbor requirements. The National Office normally will rule on a case-by-case basis where the safe harbor does not or may not apply. In one recent letter ruling, the IRS concluded that open market repurchases include “block trades” over an exchange in brokered transactions where the corporation is not made aware of the seller’s identity.⁵³ The ruling indicates that the open market requirement may be satisfied in such cases even though the sale is made at a negotiated price or following a direct unsolicited offer to the corporation from the seller’s broker. In another ruling, the IRS approved combined open market and tender offer repurchases of less than 20%.⁵⁴

2. COI/Section 355(e).

The impact of redemption transactions on the COI and Section 355(e) requirements is less clear. It is arguable that redemptions should not count against continuity at all where remaining historic shareholders continue to own collectively enough of the post-redemption outstanding stock to satisfy continuity. Nonetheless, the Section 355 advance ruling guidelines specifically state that repurchases of stock by a widely-held corporation that satisfy the device safe harbor may still be taken into account for COI purposes.⁵⁵ Any COI risk is likely to loom larger in closely-held contexts, where redemptions at or near the 50% level are not uncommon. However, in such circumstances a serious device problem will probably surface as well.

⁵³ Ltr. Rul. 199914028 (Jan. 8, 1999); *see also*, Ltr. Rul. 200039032 (Jun. 30, 2000), *supplementing* Ltr. Rul. 200029037 (Aug. 3, 1999) [no device where Distributing repurchased less than 2% of its stock from an unrelated financial institution that had purchased such shares on the open market].

⁵⁴ Ltr. Rul. 200017035 (Feb. 1, 2000), *supplementing* Ltr. Rul. 199943030 (Aug. 2, 1999); *see also*, Ltr. Rul. 199941027 (Jul. 15, 1999) *supplementing* Ltr. Rul. 199940003 (Apr. 14, 1999) [represented there was no plan or intention to purchase shares pursuant to tender offer from any Controlled officer or director].

⁵⁵ Rev. Proc. 96-30, § 4.05(1)(b).

As to Section 355(e), there is a threshold question whether a post-spin cash redemption can give rise to a tainted “acquisition” of stock for purposes of that provision and, if so, by whom.⁵⁶ Proposed regulations on the “acquisition” requirement of Section 355(e) may be issued later in 2001, and hopefully will provide clear guidance on the treatment of redemptions.

C. Stock issuances.

1. Device/COI.

Spin-offs are often effectuated in order to facilitate an initial public offering or a private placement of the stock of Distributing or Controlled. This motivation is an acceptable corporate business purpose under the Section 355 advance ruling guidelines.⁵⁷ Whether or not pre-planned, the magnitude of any such offerings should have no adverse device or COI ramifications.⁵⁸ In this regard, the issuance of new stock by the corporation is a nontaxable transaction and does not alter the aggregate value of the equity interests that continue to be owned by the corporation’s historic shareholders. Thus, there is no capital gain “bailout” by such shareholders, and no transformation of any of their existing stock interests into cash or other nonstock property. The same analysis holds for post-spin acquisitions by Distributing or Controlled using newly-issued stock as the acquisition currency.

2. Section 355(e).

Post-spin stock issuances by Distributing or Controlled can have Section 355(e) implications. An IPO is an “acquisition” for purposes of that provision. Moreover, the fact that

⁵⁶ See Trier and Ferrell, “Section 1012 of 1997 Act: The Application of Section 355(e) to Distributions in Connection With Acquisitions,” 2000 *Tax Strategies for Corporate Acquisitions (PLI)*, Vol. 9, at 419, 445-47.

⁵⁷ See Rev. Proc. 96-30, App. A, § 2.02.

⁵⁸ See Official Summary of Ltr. Rul. 9637043 (Jun. 17, 1996), 2000 TNT 250-35 [COI]; Treas. Reg. § 1.355-2(d)(2)(iii)(A) [device evidence flows from shareholder-level “sale or exchange” of Distributing or Controlled stock].

a public offering was discussed before the spin with an investment banker or other outside adviser tends to show that the spin and the offering are part of a proscribed plan.⁵⁹ As a result, a 50% offering would alone trigger the application of Section 355(e), as could a lower-sized offering in conjunction with other tainted stock acquisitions.⁶⁰

Stock issued as consideration for acquisitions by Distributing or Controlled also may be subject to Section 355(e). Under a somewhat controversial example in the proposed regulations, stock acquisitions of target companies not identified until more than six months after a spin-off may be aggregated with an acquisition occurring during the first six months for purposes of the 50 percent threshold.⁶¹

As noted earlier, Safe Harbor II of the proposed regulations may apply if –

- the spin was done to facilitate one or more offerings or other stock issuances totaling no more than 33%;
- no more than 20% of the shares are in fact issued during the initial 6-month period; and
- there was no AUA or substantial negotiations during that period as to issuances in excess of 20%.

In addition, under Safe Harbor I, an offering or other stock issuance that occurs more than six months after the spin-off (no matter how large) should not be considered part of a Section 355(e) plan, if –

- the spin was motivated at least in part by a substantial “non-acquisition” purpose; and
- the issuance was not the subject of an AUA or substantial negotiations at any time prior to the close of the first six months after the spin.

⁵⁹ See Prop. Treas. Regs. §§ 1.355-7(d)(2)(iii) and (iv); - 7(d)(3)(ii); and Official Summary of Ltr. Rul. 9747021 (Aug. 21, 1997), 1999 TNT 182-16.

⁶⁰ *But see*, Ltr. Rul. 200118050 (Feb. 6, 2001), *supplementing* Ltr. Rul. 199926017 (Mar. 30, 1999) [post-spin stock offering of less than 20 percent of Controlled stock not part of section 355(e) plan].

⁶¹ Prop. Treas. Reg. §1.355-7(m), Ex. (7).

Finally, stock issued to employees or directors of Distributing or Controlled may not be considered part of a Section 355(e) plan if the conditions of Safe Harbor VI are met. This safe harbor rule is available only if (i) Section 83 applies to the transaction in which the stock is issued; and (ii) the stock does not constitute excessive compensation for the particular services rendered.⁶²

3. “D” reorganizations.

The analysis as to post-spin stock offerings does not change where the spin is part of a “D” reorganization. Section 368(a)(1)(D) requires that Distributing shareholders hold 80% or more “control” of Controlled “immediately after” the transaction. However, under amendments to Section 368(a)(2)(H) that were enacted in conjunction with Section 355(e) (including related technical corrections), neither shareholder sales of outstanding stock nor corporate issuances of additional stock are taken into account for purposes of determining compliance with the 80% threshold. Thus, step-transaction risks are no longer a concern with respect to the “immediately after” requirement. Likewise, under a much welcomed 1998 published ruling,⁶³ the IRS no longer views prearranged post-spin issuances or dispositions of more than 20% of the Controlled stock as possibly violating the Section 355 “distribution of control” requirement.

V. POST-SPIN ASSET TRANSACTIONS

Section 355 issues can also surface by reason of post-spin transactions involving the assets of Distributing or Controlled. Asset transfers may occur in the context of certain tax-free reorganizations, or through sales or other transfers to unrelated parties or to subsidiaries or other entities with which Distributing or Controlled is affiliated. The particular aspects of Section 355

⁶² Prop. Treas. Reg. § 1.355-7(f)(6).

⁶³ Rev. Rul. 98-27, 1998-1 C.B. 1159.

that may need to be re-examined in these situations include the “active business,” “continuity of business enterprise” and Section 355(e) requirements.

A. Active Business Considerations.

Under the active business requirement, both Distributing and Controlled must be engaged, “immediately after” the distribution of the Controlled stock, in the direct or indirect conduct of a trade or business that has been actively conducted for at least five years.⁶⁴ In the indirect scenario, the stock or securities of 80% or more controlled subsidiaries that directly conduct qualifying active businesses must represent “substantially all” of the assets of the corporation seeking to satisfy the active business requirement.⁶⁵ Intermediate holding company subsidiaries must also satisfy the “substantially all” requirement through stock owned in lower-tier subsidiaries.

1. 90% test.

For advance ruling purposes, “substantially all” is defined as 90% of the fair market value of the corporation’s gross assets.⁶⁶ Lower thresholds are no doubt acceptable as a matter of law, but how low is unclear. Consistent with case law and administrative interpretations of the “substantially all” requirement in acquisitive reorganization contexts, relevant factors may include not only the value of the non-stock assets, but also their nature (*i.e.*, active v. passive) and whether their holding is merely temporary.⁶⁷

⁶⁴ IRC § 355(b).

⁶⁵ IRC § 355(b)(2)(A).

⁶⁶ Rev. Proc. 77-37, § 3.04, 1977-2 C.B. 568, 570; Rev. Proc. 96-30, § 4.03(5).

⁶⁷ *See generally*, Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, § 12.24[2][b] (7th ed. 2000).

2. 5% test.

Neither the Code nor the regulations contain provisions regarding what portion of a corporation's assets must be attributable to a directly conducted active business. Where the corporation also holds substantial non-active business assets, the IRS ordinarily not rule if the gross assets relied on to satisfy the active business requirement have a fair market value that is less than 5% of the total fair market value of the gross assets of the corporation directly conducting the business.⁶⁸ However, the IRS may rule in such cases if the taxpayer can show that, based upon all the relevant facts and circumstances, the trades or businesses relied upon are not *de minimis* compared with the other assets or activities of the corporation and its subsidiaries.

The alternative facts and circumstances test may be especially helpful for service-type businesses. A “not *de minimus*” showing might be based, for example, upon the number or relative percentage of employees engaged in the active business, or the percentage of gross revenues generated by the active business.⁶⁹ It is understood that, in applying the *de minimus* standard, the National Office may be willing to take into account an identifiable trend that suggests that the active business will likely reach a non *de-minimus* size within a relatively short timeframe.

3. “Immediately after” requirement.

In connection with any post-spin disposition or other transfer of assets that was relied upon to satisfy the active business requirement, the analysis typically focuses on –

- how soon after the spin the transfer occurs;
- whether the transfer was committed to or planned at the time of the spin; and
- whether retained assets continue to constitute a qualifying active business without regard to the transferred assets.

⁶⁸ Rev. Proc. 2001-3, § 4.01(31), 2001-1 I.R.B. 117.

⁶⁹ See Official Summary of Ltr. Rul. 9846028 (Aug. 17, 1998), 2000 TNT 250-66.

Relatively minor asset transfers generally are not problematic, particularly if they occur in the ordinary course of business. For more significant dispositions, the IRS is likely to apply conventional step-transaction principles in determining whether the transfer violates the “immediately after” requirement. As a result, a transfer that was contemplated at the time of the spin may carry risk even though it does not occur until several months or more after the spin. As a general rule, however, absent the existence of a legally binding commitment to make the transfer at the time of the spin, the longer the time gap, the lower the risk. Moreover, if it can be shown that the asset disposition was motivated by identifiable business circumstances or events that were not foreseen at the time of the spin, how soon the disposition occurs should be largely, if not entirely, irrelevant.⁷⁰

Post-spin sales of the stock of active business subsidiaries can also be problematic where Distributing or Controlled had relied upon that stock to meet the indirect active business test. Thus, compliance with the 90% “substantially all” threshold may be breached if the sale proceeds are retained or deployed into non-stock assets. If feasible from a business standpoint, a prompt transfer of the sale proceeds into another controlled subsidiary that conducts a qualifying active business may eliminate this risk, as might an acquisition of the stock of a new active business subsidiary.

It otherwise is unclear how long after the spin a corporation must continue the often burdensome and uncertain process of monitoring the composition of its assets in light of the “substantially all” requirement.⁷¹ Again, the statutory “immediately after” requirement

⁷⁰ See Ltr. Rul. 200019013 (Feb. 10, 2000), *supplementing* Ltr. Rul. 9821052 (Feb. 24, 1998) [discontinuance due to substantial and consistent decline in rate of return on business]; Ltr. Rul. 199922036 (Mar. 3, 1999), *supplementing* Ltr. Rul. 9651045 (Sept. 23, 1996) [sale due to industry consolidation]. See also, Ltr. Rul. 200109045 (Dec. 6, 2000), *supplementing* Ltr. Rul. 9649040 (Sept. 10, 1996) [transfer of one of Distributing’s businesses to new subsidiary more than 3 years after spin, preparatory to sale in response to changed market conditions]; Ltr. Rul. 200123030 (Mar. 7, 2001), *supplementing* Ltr. Rul. 199939040 (Jun. 30, 1999) [post-spin disposition of active business by Distributing; another qualifying active business retained].

⁷¹ See Ltr. Rul. 200113017 (Dec. 21, 2000), *supplementing* Ltr. Rul. 200018039 (Feb. 2, 2000) [sale of division by subsidiary of Distributing, a holding company, with proceeds used to expand retained division, did not invalidate prior Section 355 rulings]; Ltr. Rul. 200030007 (Apr. 24, 2000), *supplementing* Ltr. Rul. 199950032

presumably applies with reference to step-transaction principles. As a result, any dramatic change in asset composition relatively soon after the spin probably should be justified, if possible, by the demonstrated emergence of unforeseen circumstances.

4. Tax-free transfers.

Other post-spin scenarios may involve the transfer of entire active businesses pursuant to a tax-free reorganization or other nonrecognition transaction. No active business issue arises if the acquired corporation remains alive and continues to conduct an active business, as in a type-“B” or Section 368(a)(2)(E) reorganization. Likewise, where the reorganization involves a corporate-level asset transfer to the acquiring corporation, as in a type-“A”, “C”, “D” or Section 368(a)(2)(D) reorganization, the change in the identity of the corporation conducting the business should not cause a violation of the active business requirement even though the reorganization was planned at the time of the spin. That was precisely the situation in the *Morris Trust* case, the Section 355 qualification aspects of which (business purpose, device, COI and active business) clearly survive the enactment of Section 355(e).⁷²

The IRS has reached the same favorable conclusion in letter rulings involving Section 332 liquidations and downstream mergers of Distributing or Controlled.⁷³ Somewhat less clear, however, is the impact of a Section 351 transfer, soon after the spin, of an active business into a directly or indirectly controlled subsidiary of Distributing or Controlled. If this was the only directly conducted active business of the transferor corporation, the “substantially all” requirement of the indirect active business test may be violated depending on what other assets

(Sept. 13, 1999) [distribution of interest-bearing securities to Controlled, a holding company, did not invalidate prior Section 355 rulings].

⁷² See Rev. Rul. 68-603, 1968-2 C.B. 148 [merger of Distributing into another corporation]; Ltr. Rul. 200113019 (Dec. 27, 2000) [internal spin followed by merger of Controlled into another subsidiary in same group].

⁷³ See Ltr. Rul. 9416008 (Nov. 3, 1993) [liquidation of Controlled immediately following a Section 355 distribution]; Ltr. Rul. 9445015 (Aug. 11, 1994), *supplementing* Ltr. Rul. 9422016 (Feb. 25, 1994) [downstream merger of Controlled].

that corporation may then hold (*i.e.*, stock of other controlled subsidiaries v. non-stock assets). The best course may be to delay any such dropdowns for a while. Alternatively, the issue can be avoided by instead transferring the business into a single-member LLC which is treated for tax purposes as a “disregarded entity.”⁷⁴

Post-spin asset dropdowns by Distributing or Controlled into a partnership (or multiple-member LLC) may also be risky if the corporate transferor is left with no other qualifying active business. Under the rationale of a 1992 published IRS ruling, a corporate general partner may be viewed as directly engaged in the partnership’s active business for Section 355 purposes if its officers or other employees perform active and substantial management functions and exercise significant decision-making responsibility in connection with such business.⁷⁵ However, the parameters of this ruling are not entirely clear – especially if there are other general partners who share managerial responsibilities with Distributing or Controlled, or the transferred business represented only a small portion of the transferor corporation’s overall assets.⁷⁶

B. Continuity of Enterprise.

The nonstatutory “continuity of business enterprise” requirement (“COBE”) for spin-off transactions derives from a brief statement in the regulations that Section 355 “contemplates the continued operation of the business or businesses existing prior to the separation.”⁷⁷ This presumably means that both Distributing and Controlled must satisfy COBE for some continuing period of time after the spin-off. In contrast, the active business requirement must be satisfied “immediately after” the spin. Despite this apparent temporal difference, a post-spin asset

⁷⁴ See, e.g., Ltr. Rul. 200007005 (Nov. 1, 1999) [Controlled considered directly engaged in active business of partnership that it owned indirectly through two single-member LLCs]; Ltr. Rul. 199939040 (Jun. 30, 1999) [Distributing deemed to directly conduct active business through ownership of single-member LLC].

⁷⁵ See Rev. Rul. 92-17, 1992- C.B. 142 [20% corporate general partnership interest in real estate business].

⁷⁶ See Beller, *supra* n.22, 26 J. Corp. Tax at 207-09.

⁷⁷ Treas. Reg. § 1.355-2(b).

disposition or transfer that passes muster under the active business requirement should normally withstand any COBE challenge as well.

A separate COBE requirement applies in the context of tax-free reorganizations. The regulations under Section 368 give fairly extensive guidance on how to satisfy that requirement. The core test is that the acquiring corporation must “either continue the target corporation’s (T’s) historic business or use a significant portion of T’s historic business assets in a business.”⁷⁸ While this test does not technically apply for purposes of the Section 355 COBE requirement, it does apply to type-“D” reorganizations which include Section 355 distributions.⁷⁹ In the case of a divisive “D” reorganization, there is no requirement that Distributing transfer to Controlled the assets of a going business, a transfer simply of cash or other non-active assets will suffice. The historic business/business asset elements of the COBE regulations are therefore an awkward fit in such contexts.

In like fashion, Distributing and Controlled should each satisfy Section 355 COBE requirement if, at the time of the spin-off, both corporations intended to continue their respective historic businesses and (i) in fact do so for a reasonable period of time, or (ii) decide to discontinue such business due to unanticipated circumstances or events that arise after the spin-off.⁸⁰

Consistent with the *Morris Trust* decision, a planned post-spin transfer of Distributing’s or Controlled’s historic business assets pursuant to a statutory merger or other tax-free reorganization should not jeopardize the Section 355 treatment of the spin on COBE grounds. Nor should a planned dropdown of Distributing’s or Controlled’s business to an 80% or more controlled subsidiary undermine tax-free treatment. In the case of Controlled, such a transfer would preserve Section 368 COBE if Controlled had acquired the business from Distributing just

⁷⁸ Treas. Reg. § 1.368-1(d)(1).

⁷⁹ See Treas. Reg. § 1.368-1(b) [third sentence].

⁸⁰ See private letter rulings cited *supra*, at n.70. Cf. Treas. Reg. § 1.368-1(d)(5), Ex. (5) [pre-planned disposition of target assets immediately after a merger breaks COBE].

before the spin incident to a “D” reorganization.⁸¹ There is no apparent reason why Controlled’s indirect conduct of the business through a subsidiary ought not similarly suffice for Section 355 COBE purposes.

The Section 368 COBE rules also protect post-reorganization asset transfers into a partnership if the corporate transferor (*i.e.*, the acquiring corporation) retains “a significant portion” of the target corporation’s historic business assets, including assets retained indirectly through its partnership interest.⁸² Where the entire target business is transferred, COBE can still be preserved if: (i) the transferor and/or members of its affiliated group own “a significant interest” in the partnership; or (ii) one or more members of that group exercise “active and substantial management functions as a partner with respect to that partnership.”⁸³

Examples in the regulations indicate that a one-third interest without active management, or a 20% interest with active management, will be considered sufficient.⁸⁴ Again, similar principles ought to apply for purposes of the Section 355 COBE requirement. However, the precise boundaries of that requirement, including its relationship to the active business requirement, will remain murky absent new or clarifying guidance from the IRS.

C. Section 355(e).

The corporate-level tax risk of Section 355(e) generally exists only for transactions involving acquisitions of the stock of Distributing or Controlled. However, under Section 355(e)(3)(B), certain asset acquisitions may also be covered. In particular, and unless future Treasury regulations provide otherwise, if the assets of Distributing or Controlled are acquired by a successor corporation in a type-“A” (statutory merger), “C” (assets for stock) or “D” (also

⁸¹ See Treas. Regs. §§ 1.368-1(d)(4)(i) and (ii) [transfers to members of Controlled’s “qualified group,” *i.e.*, direct or lower-tier 80% owned subsidiaries, satisfy COBE].

⁸² Treas. Reg. § 1.368-1(d)(4)(iii)(A).

⁸³ Treas. Reg. § 1.368-1(d)(4)(iii)(B).

⁸⁴ Treas. Regs. §§ 1.368-1(d)(5), Exs. (7) and (9).

assets for stock) reorganization, the shareholders of the acquiring corporation will be treated as acquiring stock in the corporation from which the assets were acquired.

For example, if Distributing merges into unrelated P Corporation, the P shareholders will be considered to have acquired, as a group, all of the Distributing stock. That acquisition must then be tested against the relevant criteria to determine whether a proscribed Section 355(e) plan exists. The legislative history indicates that future regulations may identify other types of unspecified asset transfers that could be subject to Section 355(e).⁸⁵ Certain tax-free transfers into corporations or partnerships (under Sections 351 or 721) may be candidates for such treatment.

V. DEVIATION FROM BUSINESS PURPOSE

Apart from post-spin changes in the stock ownership or asset composition of Distributing and Controlled, other transactions or events may jeopardize Section 355 qualification because the IRS views them as inconsistent with the corporate business purpose(s) of the spin. The IRS has recognized, however, that the authenticity and importance of an asserted business purpose should be evaluated in light of the facts and circumstances existing and reasonably contemplated at the time of the spin-off. As a result, unforeseen deviations from such business purposes generally should not invalidate otherwise available Section 355 treatment.

A. Favorable Rulings.

The National Office has issued favorable supplemental rulings in a number of situations involving delays, reductions in size or cancellations of planned public offerings due to changes in market conditions or business circumstances.⁸⁶ It also has ruled that a spin-off done to

⁸⁵ Jt. Comm. on Taxation, General Explanation of Tax Legislation Enacted in 1977 (Dec. 17, 1997), at p. 199.

⁸⁶ See, e.g., Ltr. Rul. 200103054 (Oct. 23, 2000), *supplementing* Ltr. Rul. 199950032 (Sept. 13, 1999) [due to unexpected business difficulties and unfavorable market conditions, IPO could not be completed within one year of the distribution; later date set]; Ltr. Rul. 200009050 (Nov. 30, 1999), *supplementing* Ltr. Rul. 9841027

facilitate increased debt financing for use in future acquisitions was not jeopardized by a change in plans to use part of the borrowed funds for working capital needs.⁸⁷ And in another situation, where the principal purpose of the spin was to permit an IPO by Controlled, the IRS concluded that subsequent open market repurchases of Controlled stock did not affect Section 355 qualification.⁸⁸

B. Continuing Relationships.

In general, but especially where the purported business purpose for the spin-off is “fit and focus,” the Service will closely scrutinize any continuing post-spin relationships between Distributing and Controlled.⁸⁹ These relationships might include, for example, common directors or officers, the sharing of administrative personnel, office space or manufacturing facilities, or other joint business or financial arrangements. It often is represented in Section 355 ruling requests that any such continuing relationships are intended for only a specified transitional period. Any significant lengthening of that period, or other change in the nature of the relationship, may warrant a supplemental request, as might any new relationships that Distributing and Controlled may subsequently desire to enter.⁹⁰ In all such instances, it will be necessary to demonstrate that the new or revised relationships are in fact compatible with the fit and focus or other business purpose for the spin, or that identifiable changed circumstances have rendered such purpose or purposes less compelling.

(Jul. 13, 1998) and Ltr. Rul. 9841050 (Apr. 15, 1998) [indefinite delay in IPO due to unanticipated sustained unfavorable market conditions]; Ltr. Rul. 9709047 (Dec. 3, 1996), *supplementing* Ltr. Rul. 9610034 (Dec. 15, 1995) [issuance of lesser amount of stock due to changes in equity market].

⁸⁷ Ltr. Rul. 200104025 (Oct. 26, 2000), *supplementing* Ltr. Rul. 200011017 (Dec. 14, 1999).

⁸⁸ Ltr. Rul. 200036023 (Jun. 7, 2000), *supplementing* Ltr. Rul. 9821052 (Feb. 24, 1998).

⁸⁹ *See* Rev. Proc. 96-30, § 4.08(4) and App. A, § 2.05(5)(a).

⁹⁰ *See, e.g.*, Ltr. Rul. 200039032 (Jun. 30, 2000), *supplementing* Ltr. Rul. 200029037 (Aug. 3, 1999) [son of 5% shareholder of Distributing allowed to serve as outside director of both Distributing and Controlled].

VI. SUPPLEMENTAL RULINGS

The price of a busted Section 355 transaction is normally very high: Distributing's shareholders are taxed on the value of the distributed Controlled stock, and Distributing is taxed on its gain inherent in that stock. As a result, the parties typically have a strong interest in monitoring closely any post-spin transactions that could imperil Section 355 treatment.

A. Ruling or Opinion?

At least in public company spins where a Section 355 ruling was obtained, the tax sharing or other agreement between Distributing and Controlled normally prohibits Controlled from undertaking, during the two or three-year period following the spin-off, any transaction or other action that might jeopardize the tax-free treatment of the spin-off without first obtaining a favorable supplemental IRS ruling.

If Distributing agrees to forego a ruling, Distributing and Controlled may instead agree to secure a comparable "will not jeopardize" opinion from mutually acceptable outside tax counsel. An opinion, of course, does not bind the IRS, so there generally is little incentive for Distributing to allow Controlled's transaction to proceed on that basis. If the opinion turns out to be wrong, Controlled may still bear the tax burden under the tax sharing agreement, but a ruling enables Distributing to avoid any concern over Controlled's financial ability to discharge any such burden.

Distributing generally cannot be forced to seek a supplemental ruling to any post-spin transaction or other potentially jeopardizing action that Distributing might be contemplating. Nonetheless, Distributing often will seek a ruling unless the transaction is clearly safe or it can shift any tax risk to another party (*e.g.*, a corporation that proposes to acquire Distributing and is comfortable doing so without a ruling).

B. Ruling Request Content.

The supplemental ruling request should fully describe the proposed transaction or other developments that prompted the request. The request also should –

- identify any representations or factual statements in the original ruling request that may be impacted by such developments;
- provide any revised or new representations that may be necessary; and
- explain why, as a matter of law, the new information should not alter the Section 355 treatment of the spin-off or any other nonrecognition ruling that may have been issued as to internal restructuring transactions that preceded the spin-off.

Distributing will always be a party to a supplemental request. Controlled must also join as a party if it or its shareholders are involved in the proposed transaction or other developments. Officers of both corporations will have to provide perjury declarations as to representations and other information in the supplemental request to the extent such information relates to Distributing or Controlled. The IRS may also require perjury declarations from other involved parties (*e.g.*, a corporation that plans to acquire Distributing or Controlled).

The willingness of the IRS to rule favorably on a supplemental request is often based largely, if not entirely, on a representation that the proposed transaction or other developments were not contemplated at the time of the spin-off. The National Office's comfort level in this regard will generally be higher if a fairly substantial period of time has elapsed since the spin (two years is generally quite safe; less than six months generally suspect), or if relevant intervening events or circumstances can be demonstrated. Affidavits from corporate officers or external parties (*e.g.*, an investment banker or management consultant) can often be helpful in this regard.

C. Pre-filing Conferences.

In some cases, through a "pre-filing conference" in Washington, the taxpayer may be able to gain valuable insights as to how the National Office will react to the supplemental request. Based on the input of the IRS representatives at such a conference, the taxpayer may decide to

scrap the proposed transaction altogether, or may be able to alter the business terms of the transaction in ways that neutralize expressed concerns.

While requests for pre-filing conferences in Section 355 matters were encouraged and routinely granted by the National Office in past years, that is no longer so. The taxpayer must now make a compelling case, in writing, as to why a conference is necessary. If granted, the conference usually can be scheduled within a couple of weeks. If the National Office decides not to have a pre-filing conference, an IRS attorney typically will call the taxpayer's representative to explain why, and that discussion can often be as illuminating as an actual conference might have been.

D. Processing Time.

A supplemental ruling request can sometimes be processed more quickly than an initial request (*e.g.*, within 60-90 days), particularly if the new facts are uncomplicated and the same IRS attorney who handled the original ruling request is assigned responsibility for the supplemental request as well. While the National Office generally tries to honor a request that the same attorney be assigned to the supplemental request, current workloads may dictate directing the case to another attorney, including, possibly, one in a different branch of the Corporate Tax Division. However, if new IRS attorneys have to become involved, or if multiple or controversial issues need to be considered, the processing time can easily expand to 120 days or more.

E. Refusal to Rule.

If the IRS is ultimately unwilling to issue a favorable supplemental ruling, the request can be withdrawn and the ruling file closed. In that event, if the parties nonetheless proceed with the proposed transaction (based on opinion or otherwise), the spin-off will of course be subject to challenge on audit. The audit risk would be heightened if, as it may do, the National Office advises the IRS field office of the proposed transaction when the supplemental ruling request is withdrawn.

VII. CONCLUSION

Designing a spin-off transaction to qualify for tax-free treatment under Section 355 is often a difficult task, and one that does not necessarily end with the spin-off itself. Subsequent transactions or events involving Distributing or Controlled may raise thorny questions as to whether one or more of the relevant statutory or nonstatutory requirements continue to be satisfied. If a Section 355 ruling was obtained, it may be necessary or advisable to seek a supplemental ruling before implementing a proposed transaction or arrangement, in order to confirm the continuing validity of the prior rulings. Moreover, where at least 50% of the stock of Distributing or Controlled is to be acquired within two years of the spin, it becomes necessary to rebut the “plan” presumption of Section 355(e) in order to avoid a typically stiff corporate-level tax. In all events, the ability to preserve tax-free treatment under Section 355 will be greatly enhanced by, and may well require, a strong showing that the post-spin transactions or other developments were not contemplated at the time of the spin-off and arose in the context of unanticipated or externally imposed circumstances.

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