

# **Ch.10 §355 & §368(a)(1)(D)**

## **Corporate Divisions**

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**Objective: Divide corp. on tax-free basis.**

**Alternative formats for corporate divisions:**

- 1. Spinoff – prorata share distribution; cf., §301 dividend.**
- 2. Splitoff – sub stock to one shareholder for share cancellation; cf., redemption - §302.**
- 3 Split-up – stock of two corporations distributed; cf., liquidation - §331.**

# Structure & Objectives



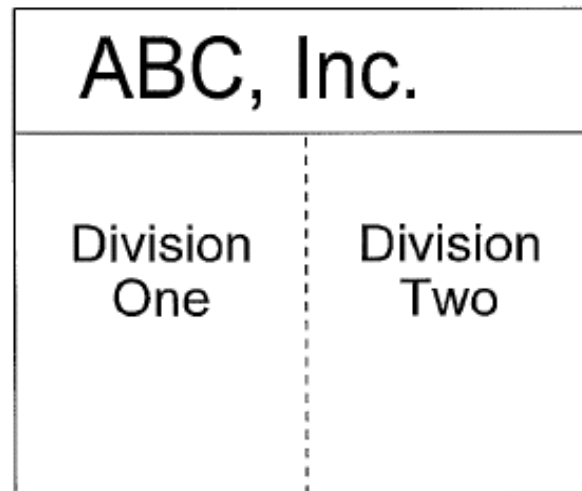
Tax-free divisions may be:

1. Prorata or non prorata.
2. Preceded by a drop-down into subsidiary.
3. In exchange (or not in exchange) for parent stock.

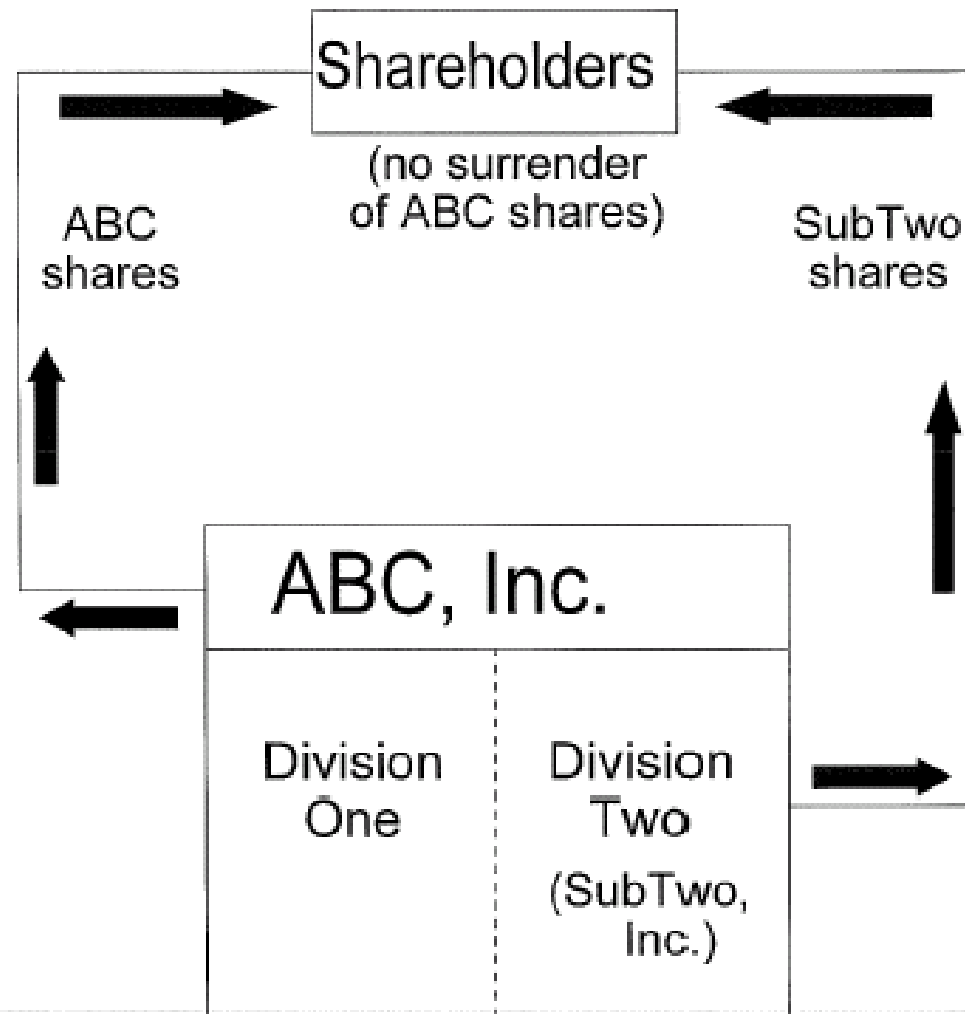
Objectives when implementing a spinoff:

1. Increased market recognition.
2. Parts are worth more than the whole.
3. Possible option for “tracking stock.”

# PRIOR TO DEMERGER, TWO UNINCORPORATED DIVISIONS OR BRANCHES

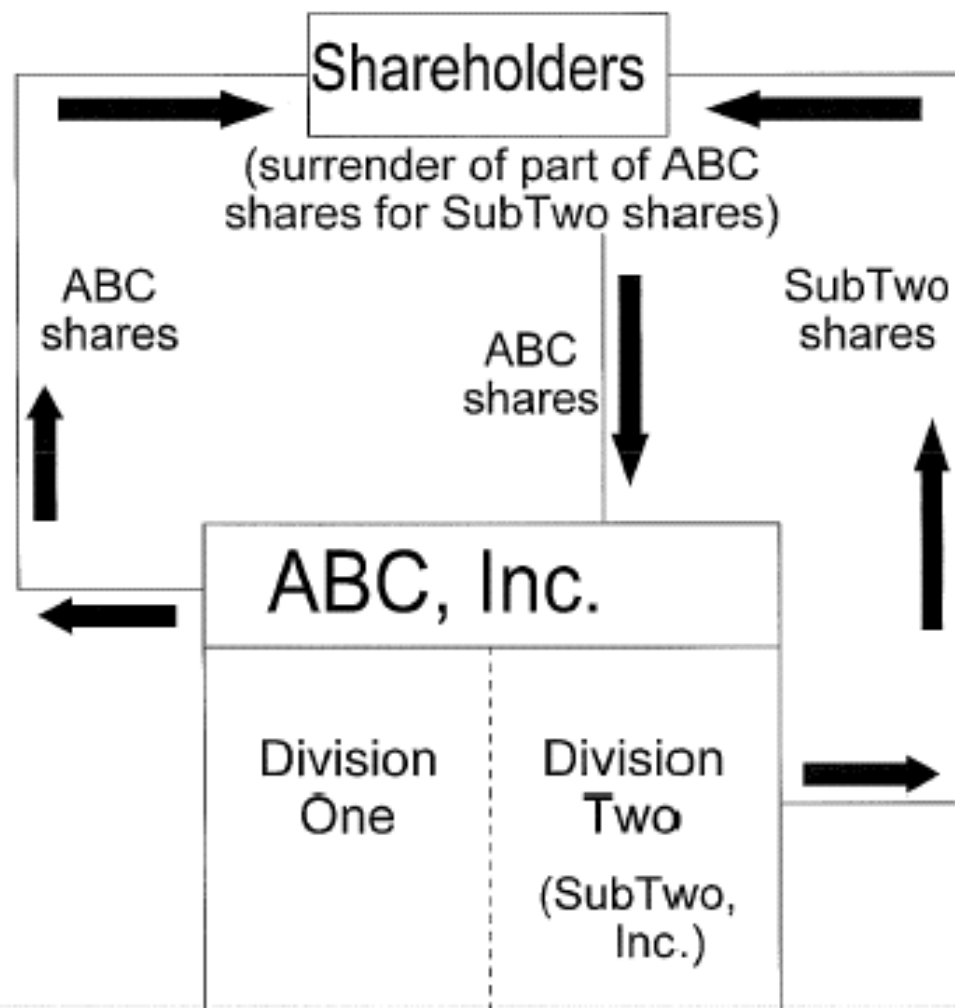


# SPINOFF



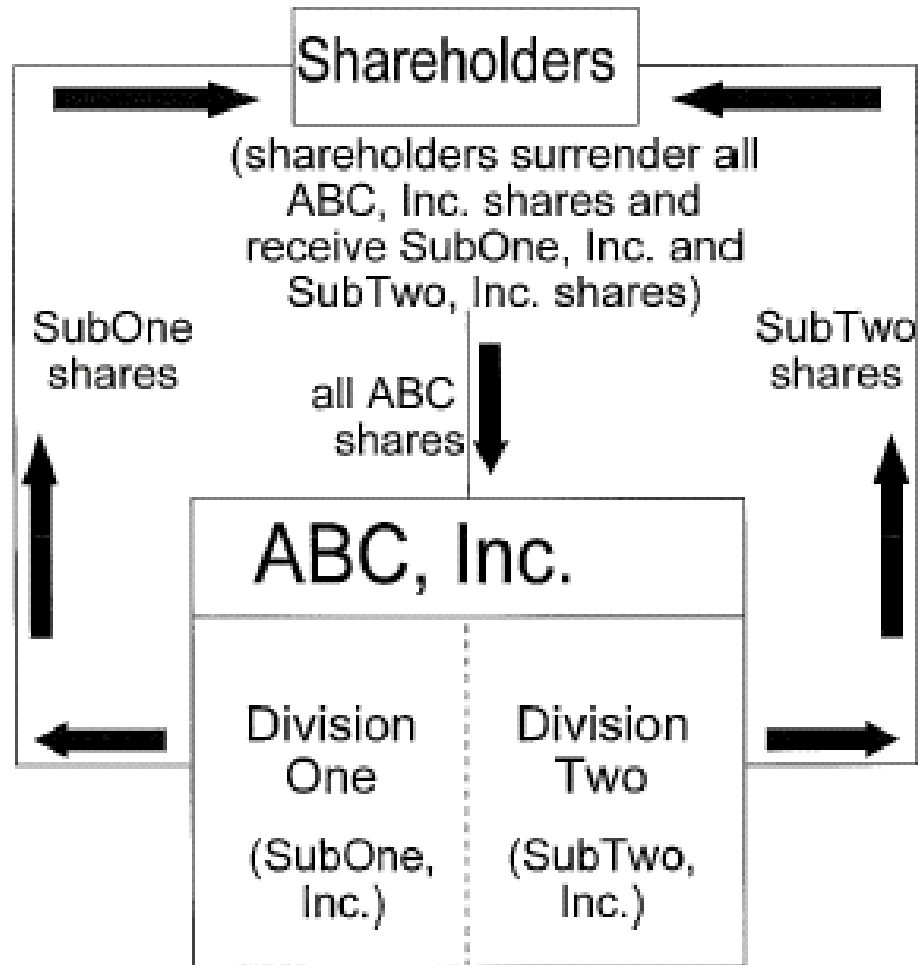
Note: similar to dividend

# SPLITOFF



Note: similar to redemption

# SPLITUP



Note: similar to liquidation

# **Collateral Effects for Spinoffs, etc.**

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- 1) Allocation of recipient shareholder's tax basis among shares of several companies.**
- 2) Holding period for all shares.**
- 3) Allocation of tax attributes to several corporations, including earnings and profits account.**
- 4) Tax treatment of boot received in the distribution.**

# **Gregory v. Helvering, p.461**

## **Disguised Dividend**

Averill created by United Mortgage to receive Monitor shares & then:

- 1) Transfer of Monitor shares to Averill;
- 2) Averill shares are distributed to Taxpayer; and,
- 3) Averill is liquidated with Monitor shares distributed to Shareholder.

Distribution as a capital gain event? No.

Petitioner still owned the United Mortgage shares.

Held: Equivalent of a dividend distribution.

No business or corporate level purpose.

**Only a distribution from the corporation.**



# **Code §355 Requirements**

## **p. 465**

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- 1) Parent must control (i.e., at least 80%) the subsidiary before distribution of all of its sub stock. §355(a)(1)(A).**
- 2) Post-distribution active conduct of two or more businesses. §355(b)(1).**
- 3) Five year pre-distribution rule—**  
**Each trade or business must have been actively conducted during the five year period ending on the acquisition date and not acquired within the five year period. §355(b)(2)(C).     *Cont.***

# **Section 355 Requirements, cont. P.466**

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- 4) Distribution of all the stock and securities of the controlled corporation. §355(a)(1)(D).
- 5) Arrangement must not be principally a "device" for the distribution of earnings and profits of distributing corporation or a controlled corporation. §355(a)(1)(B).
- 6) Judicial requirements must be satisfied: (a) business purpose, and (b) continuity of interest.

# Taxation of the Parties

## P.467

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- 1) No shareholder level recognition on distribution of the stock of the controlled corporation.
- 2) Distribution of boot causes gain recognition (including distribution of “hot stock,” i.e., acquired within five years).
- 3) Distributing corporation does not recognize gain on the stock distribution (except for the distribution of appreciated boot).

# **Advance IRS PLRs**

**p. 468**

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**Rev. Proc. 2013-32 - limitation on issuance of PLRs.**

**Rev. Proc. 2017-38 – removal of no-rule position.**

**Rev. Proc. 2017-52 – pilot program for rulings on overall federal income tax consequences of spinoffs, etc.**

**Rev. Proc. 2018-53 – specifies procedures for requesting rulings in certain situations (i.e., assumption of distributing corporation's obligations).**

**Subsequent issuance of PLRs (with various Rev. Proc. 2017-52 representations).**

# **“Active Trade or Business” Requirement**

**p. 468**

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**§355(a)(1)(C) & (b).**

**Lockwood’s Estate; Spinoff of a corporation holding the Maine business – was separately incorporated for purposes of the stock spin-off.**

**Query: Satisfy the five year active business rule?**

**Held: Ok to divide a single business into two corporations. Spin-off segment was part of the business that Lockwood had always performed. Not a newly acquired business.**

**Tax Court was reversed; holding for the taxpayer.**

## **Expansion to Internet**

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“Bricks & mortar” business and then the creation of an internet business for selling the same product.

**Facts:** Dropdown of an internet business into a sub and the distribution of that sub stock within two years after organization and capitalization of the subsidiary.

**Held:** The internet site is (1) an expansion of current retail business, and (2) not a new or different business.

Change in any business must be anticipated.

E.g., suburban store; expansion to another product.

# **Rev. Rul. 2007-42** **p. 476**

## **Active Business through LLC?**

Corp. D owns minority interest in LLC engaged in office building leasing and management enterprise (for more than five years).

Corp. D also holds stock in Corp. C which has an unrelated business – proposed to be distributed.

Code §355(a)(1)(C) and §355(b) require two corps to be engaged in active business for prior five year period. Owner must perform significant services concerning operation and management of property.

Can a partner be so engaged? yes, if owning  $33\frac{1}{3}$  “significant interest” but not if owning 20%.

# Issues Concerning Business Requirement

## p.480

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- 1) Factual issue re continued conduct of two active businesses with a five year history.
  - 2) Consider the relative size of the active trade or business (compared to total business) as whether a “device” for E&P distribution exists.
  - 3) Holding real estate does not constitute active trade or business – unless significant services provided by the owner. Possible spinoff and then REIT status? See §355(h)(1); p. 482, fn. 58. Not for ten years after spinoff. Example: Restaurant chains.
- continued*



# Issues Concerning Business Requirement

## p.482

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4) Vertical division of single integrated business is acceptable, e.g., based on geographical separation.

5) Functional/horizontal division – supply corp.; research corp., may be OK; e.g., where doing contract research (but not required).

6) Expansion of trade or business ok – e.g., suburban store. New activity/situs in the same line of business is acceptable.

Limitation: No taxable acquisition within five-year pre-distribution period. §355(b)(2)(C).

# **Affiliated Group Treatment**

## **SAG rules**

**p. 485-6**

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**When can the active trade or business test be satisfied through a holding of a subsidiary?**

**See Code § 355(b)(3) enables all members of the corporations' separate affiliated group ("SAG") to be treated as one corporation for purposes of making this determination.**

**This necessitates the parent corporation's ownership of 80 percent of each affiliated corporation (i.e., 80 percent of voting power and 80 percent of value).**

# **Problem 1(a) Active Trade or Business Requirement p. 486**

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Lemon contributes assets and research of Boston division to Peach, Inc. & distribution of all Peach stock to Mr. Chips in redemption of his Lemon stock. Ms. Micro as sole shareholder of Lemon.

This split-off satisfies the §355(b) active business requirement. Each entity is engaged in active conduct of computer business after distribution.

A vertical division of an integrated business. Two separate predistribution businesses not required.

# Problem 1(b) – Three year Activity

p. 487

Should the Boston branch be regarded as a separate pre-distribution trade or business, causing the splitoff to flunk the §355(b)(2)(B) five-year pre-distribution business history requirement?

This new activity is in the same line of business actively conducted by the distributing corp. for a 5 year pre-distribution period and is not a separate trade or business. Reg. § 1.355-3(b)(3)(ii).

Similar to the Lockwood case.

# Problem 1(c) Taxable Acquisition

p. 487

Acquisition of stock of Peach (Boston) three years earlier for cash. See §355(b)(2)(C) - re acquisition in a transaction where gain or loss recognized in whole or in part. Lemon will contend that a single computer business was conducted for more than five year period & expanded.

Yes: Prop. Reg. §1.355-3(b)(1)(ii). Acquisition of Peach treated as an expansion of Lemon's active trade or business. Prop. Reg. §1.355-3(d), Ex. 20.

# **Problem 1(d) Taxable Acquisition**

**p. 487**

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Similar to Problem 1(c), but Peach stock only acquired to enable control (§368(c)), but not “separate affiliated group” (SAG) status (under §1504(a)(2) – when measured by voting power and value). E.g., failure to acquire 80% of the total value of Peach stock.

IRS position: Prop. Reg. §1.355-3(d), Example 21, specifies that §355(b)(3) is not satisfied.

# **Problem 1(e)**

## **Divestiture Order**

**p. 487**

**Horizontal/functional division of a single business.**

**Reg. §1.355-3(b)(2)(ii) - "trade or business" must consist of a specific group of activities carried on for purpose of earning income.**

**Regulations do not require that the activity must independently produce income, i.e., from outside sources. See Reg. §1.355-3(c), Ex. 9.**

**Note: Functional divisions also must withstand scrutiny under §355(a)(1)(B) "device" limitation (see later problem). Reg. §1.355-2(d)(2)(iv)(C).**

# **Problem 1(f)**

**p. 487**

## **New Business? Expansion?**

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Three years ago Lemon purchased stock of Floppy Disk, Inc. (software co.) in a taxable transaction.

Pursuant to a regulatory decree Lemon distributes Floppy Disk stock to its shareholders pro rata.

Floppy Disk fails to qualify as an active business - acquisition within 5 year period.

Software and hardware are different and, therefore, not expanding an existing business.

Rev. Rul. 2003-38 (p.474) is not helpful here.



# Problem 1(g)

## Tax-free Acquisition

p. 487

Floppy Disk merged into Lemon three years ago in an "A" reorganization for nonvoting preferred stock (80 percent) and Lemon short-term notes (20 percent) (i.e., "boot") (& transaction not an expansion of the Lemon trade or business).

§ 355(b)(2)(C) permits the acquisition of business in a tax-free transaction as meeting 5 year rule.

The use of boot means that gain is recognized in the transaction. §361. No tax-free qualification.

# **Problem 2(a)**

## **Rental Real Property**

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**p. 487**

DC transfers 10 story building to a new corporation, Rental, Inc. and distributes Rental stock pro-rata to shareholders.

DC leases the six floors that it occupies.

Rental employees actively manage the building.

Does the real estate activity constitute a "trade or business"? Yes, if significant management activities are being conducted concerning the property.

See Reg. §1.355-3(c), Example 12.

## **Problem 2(b)**

**p. 487**

## **Mostly Independent Rentals**

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DC occupies only one floor and the remaining space is leased to unrelated tenants.

Real estate rental activities will likely qualify as an active trade or business – premised upon Rental employees engaged in the active management of the business.

See Reg. §1.355-3(c), Example 12.

# Problem 2(c)

## Long-term Lease

p. 487

Nine floors are rented to outsiders on a long term lease. Not an active business? A long term net lease arrangement is not an active business for §355 purposes.

This rental probably means no performance of any significant services concerning the operation and maintenance of the building and, therefore, not satisfying the active business test.

## **Problem 2(d)**

**p.487**

## **Distribution of Properties**

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The stock of Properties, Inc. is distributed to the DC shareholders on a prorata basis.

Assume the terms of the long-term net lease do not require Properties to engage in any significant activities other than the collection of rent.

Then, unlikely that the active business test is satisfied even though the buildings are rented to outsiders.

# Judicial & Statutory Limitations

p. 488

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Business Purpose See Reg. §1.355-2(b), including (b)(1), which indicates that the business purpose requirement is independent of other §355 requirements.

**Examples:** Resolution of shareholder disputes; reduction of state and local tax, etc.

Can the objective be met through an alternative to a stock distribution? P.490. E.g., drop to sub?

“Fit and focus” analysis is applicable. P.491.

# Judicial & Statutory Limitations

p. 488

## Business Purpose Requirement

What if continuing relationships occur? See Rev. Rul. 2003-75 (p. 491, fn. 109).

Consider agreements for:

- 1) Tax allocations
- 3) IP sharing
- 3) Headquarters and back-office support

# Judicial & Statutory Limitations

p.491

Continuity of Interest (COI) Reg. §1.355-2(c).

Old shareholders must own 50% of each corporation after the division of the several corporations. A limit applies on rearranged post-distribution sales arrangements.

But, can have a division of ownership among old shareholders to enable the break-up of the enterprise.

Continuity of interest must also be maintained after the distribution. P. 492. Cf., acquisitive reorganizations requirement as modified.



# The “Device” Limitation

**Reg. §1.355-2(d)**

**p.493**

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Code §355(a)(1)(B) provides that a corporate division is not to be “used principally as a device for the distribution of the earnings and profits” of the distributing corporation.

Device factors (p. 495):

- (1) pro rata distribution;
- (2) subsequent stock sale (evidence of bailout?);
- (3) nature and use of the corporate assets after the division (e.g., excess cash is transferred) (p. 497).

# **The Device Limitation**

## **Non-Device Factors**

See pages 494 & 498.

Reg. § 1.355-2(d)(2) identifies non-device factors:

- 1) Corporate business purpose.
- 2) Wide stock distribution & publicly traded.
- 3) Distributions to domestic corporations which are entitled to the dividends received deduction under Code § 243.

# Cash-Rich Split-offs

## Code §355(g)

P.498

No §355(g) qualification if:

- 1) After the distribution either distributing or controlled corporation is a “disqualified investment corporation.”
- 2) A person holds a 50 percent or greater interest in a disqualified investment corporation (assuming no such ownership before).

Definition of “disqualified investment corporation”: investment assets as 2/3rds + of FMV of all assets.

If §355(g) applies: tax at (1) corporate & (2) shareholder levels.

# Problem (a)

p. 502

## Two Equal Shareholders

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Distribution of all the stock of sub to one shareholder & the shareholder is completely redeemed for that shareholder's parent stock.

Resolution of a shareholder dispute is a recognized corporate business purpose.

Reg. § 1.355-2(b)(5), Example (2).

Not a prorata distribution; finding of “device” is unlikely.

## Problem (b)

p. 502

## Mother & son as shareholders

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Result should be the same as in (a) above.

A redemption would not qualify as a complete redemption without a waiver of family attribution under § 302(c)(2).

Reg. § 1.355-2(d)(5)(iv) says ten year look forward rule in Code § 302(c)(2)(A)(ii) and (iii) are not relevant in this context.

## Problem (c)

p.502

## Pre-distribution Stock Sale

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Ms. Micro sells Lemon stock to Mr. Modem.

Mr. Modem is not a historic shareholder for "continuity of interest" purposes.

The continuity of interest requirement would not be satisfied.

The historic shareholders must own at least 50 percent of both the distributing and the controlled corporations. Reg. §1.355-2(c)(2). Ex. 3.

Lemon has no historic shareholders.

## Problem (d)

p. 502

## Different Retirement Plans?

Lemon transfers research assets to Research, Inc.  
& distributes Research stock pro-rata.

Even assuming a valid business purpose, no  
purpose for the stock distribution.

Need not have a distribution to achieve this  
objective. Could be achieved merely through  
separate subsidiaries. See Reg. § 1.355-2(b)(5),  
Examples 3 & 4.

Further, §482 is an adequate protection mechanism  
in this context.

## **Problem (e)**

**p. 502**

## **Compliance with Decree**

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Spinoff made to comply with a regulatory decree.  
Business purpose is satisfied, but what about the  
“device” test?

Device factors include the prorata nature of the  
distribution.

Critical inquiry is whether Research could be sold  
without adversely affecting the business of Lemon.  
See Reg. § 1.355-2(d)(2)(iv)(C).  
See similar Problem 1(e) at p. 487.



# Problem (f)

p. 502

## Subsequent Stock Sale

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Issue: Do sales subsequent to the division constitute evidence of a device? See Code §355(a)(1)(B) indicating that the "mere fact" that a sale or exchange occurs is not construed as a "device."

But, see Reg. §1.355-2(d)(2)(iii)(A) re the sale of either distributing or controlled after the distribution is evidence of a device.

See Reg. §1.355-2(d)(2)(iii)(B) re sale as "substantial evidence" of a device.

# **Problem (g) p. 502**

## **Rejected Deal & Delayed Sale**

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**Lemon rejects Suitor offer. Prorata distribution of the Floppy stock. Subsequent sale to White Knight, Inc..**

**Not a prearranged sale and, therefore, protected by the Code §355(a)(1)(B) (parenthetical).**

**But, see Reg. §1.355-2(d)(2)(iii)(C) re subsequent sale as evidence of a device.**

## **Problem (h)**

**p. 502**

## **Subsequent Shareholder Sale**

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Do the regulations not presume that the subsequent sale had been negotiated or agreed upon prior to the distribution?

Sale as "evidence" of a device? Reg. § 1.355-2(d)(iii)(A).

In this situation was an understanding reached to first distribute the Floppy Disk stock?

Also a violation of the continuity of interest rule in this situation?

# **Tax Treatment of the Parties**

## **p. 503**

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**A corporate division may be preceded by a Type D reorganization – the formation of a corporation to facilitate the stock distribution.**

**Parent corporation treatment (§361(c)):**

- 1) has no gain (or loss) on an asset transfer to a new sub,**
- 2) takes an exchanged tax basis for the stock received, and**
- 3) tacks the holding period for the new stock received.**

# **Income Tax Consequences to the Shareholders**

## **p. 504**

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**Receipt of the distribution - no gain or loss to the shareholder - §355(a)(1).**

**The tax basis for the stock is allocated between two stocks based on relative fair market values.**

**Tacked holding period for stock.**

**Treatment of “boot”- does not invalidated the basic transaction as being tax-free; the tax status depends on distribution form.**

**Rev. Rul. 93-62**

**p. 507**

## **Cash boot as “dividend”?**

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Code §356(a)(2) – treatment of cash boot as a dividend if having the effect of a dividend (i.e., to the extent of the ratable share of accumulated earnings and profits).

Dividend equivalence test is applied by reference to §302 principles (i.e., a meaningful reduction of the shareholder's proportionate interest). Cf. , the Clark case in the reorganization - boot context.

# Consequences to Distributing & Control Corporation p.510

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## 1. Part of a "D" reorganization plan:

No recognition on distribution to shareholders of "qualified property." §361(c)(1) & (2); i.e., no corporate level gain.

§311(b) is not applicable to a spinoff - since not a dividend.

§336 is not applicable to the equivalent of a liquidating distribution when part of a tax-free reorganization.

# Consequences to Distributing and Controlled Corp., cont.

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## 2. No preliminary “D” reorganization.

§355(c) provides the distributing corporation recognizes no gain or loss on the distribution of qualified property, i.e., stock or securities of the distributing corporation.

Gain recognized, however, on distribution of other than “qualified property,” i.e., appreciated “boot.”  
§355(c)(2).

Receipt of the distribution - no gain or loss -  
§355(a)(1).



# Consequences to Distributing and Controlled Corp., cont.

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Earnings and profits are allocated between the several corporations.

Other Section 381 carryover rules are not applicable (the tax history of the distributing corporation remains intact).

# **Failed Divisions**

## **p. 549**

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**Tax consequences depend upon the form of the transaction:**

- 1) 1st segment as a qualifying Section 351 organization (if new corp. organized)?**
- 2) Distribution in a spin-off as §351 distribution.**
- 3) Split-off –tested under stock redemption rules.**
- 4) Split-up – examine under complete liquidation rules.**

# **Problem**

**p. 513**

## **Father's Estate Planning**

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**Father as sole shareholder in Store Corp.**

**\$200,000 basis and \$2 million FMV**

**\$400,000 accumulated e&p - Suburb store  
represents 25 percent of total FMV**

**Proposal to organize Branch Corp for stock & debt  
& distribute Branch stock & debt to Father who  
gives Branch stock to children.**

**Does the spin-off qualify as tax-free?**

# **§355 & Corporate Acquisitions**

## **p. 513**

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**Limitation on use of §355 in taxable acquisitions.  
§355(a)(2)(D) – dispositions of recently acquired businesses.**

**Five year holding period applies to enable satisfying active trade or business requirements.**

**Target recognizes gain on distribution of Sub stock to Purchaser – but DRD on distribution to corporate parent?**

# **Problem (a) p. 516**

## **Acquirer not Wanting Sub**

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- 1) T sells S stock to buyer – gain on the stock sale.
- 2) T's shareholders sell T stock to P – gain to be recognized on this stock sale.

A Section 338 election by P is not likely.

## **Problem (b)**

**p. 516**

## **Acquirer not Wanting Sub**

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**P's stock purchase of T stock from T shareholders.  
Shareholders have gain recognition.**

**Subsequently distribution of Sub stock to purchaser  
and then the purchaser sells the Sub stock to  
Buyer. Avoidance by P of shareholder level  
gain on Sub stock?**

**Does the distribution of the Sub stock violate 5 year  
active business rule?**

# **Problem (c)**

## **P as an individual**

**p. 516**



**[to come]**

**Problem (d)**

**p. 516**

**Stock acquired in B reorg.**



[to come]



# **Problem (e)**

## **Stock Purchase**

**p. 516**



**[to come]**

# **Divisive Transactions & Ownership Changes     p.516**



**[to come]**

# Disposition of Unwanted Assets

p.520



[to come]