REPORT #638

TAX SECTION

New York State Bar Association

REPORT ON PROPOSALS FOR TREASURY REGULATIONS

UNDER SECTION 337(d) RELATING TO

SECTION 355 DISTRIBUTIONS

December 6, 1989

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COMMITTEE ON REORGANIZATIONS

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UNDER SECTION 337(d) RELATING TO

SECTION 355 DISTRIBUTIONS

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The purpose of this report[1] is to recommend proposals for adoption in the Treasury regulations to be promulgated under section 337(d),[2] to prevent the use of section 355 distributions to circumvent the repeal of General Utilities.[3]

The first part of this report discusses section 337(d) and its legislative history. The second part discusses the interaction of the repeal of General Utilities and section 355. The third part summarizes the report’s conclusions and recommendations as to the application of the section 337(d) regulations to spin-offs, split-offs and split-ups. The fourth part discusses alternative approaches for the application of the section 337(d) regulations to split-offs and split-ups. The fifth part discusses in detail the conclusions and recommendations summarized in the third part. The appendix examines the current requirements with respect to distributions under section 355.

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[1] This report was prepared by a subcommittee consisting of Randolph G. Abood, Andrew H. Braiterman, Jonathan S. Brenner, Anthony J. Carbone, Ralph A. Gerra, Jr., Kenneth H. Heitner, Diana M. Lopo, Paul W. Markwardt, Matthew A. Rosen, Stanley I. Rubenfeld and Jodi J. Schwartz. Kenneth H. Heitner and Stanley I. Rubenfeld coordinated the preparation of the report. Helpful comments were received from Renato Beghe, Peter C. Canellos and Irving Salem.

[2] All references herein to sections are to the Internal' Revenue Code of 1986, as amended (the “Code”), unless otherwise noted.

[3] General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

I. Section 337(d) Regulatory Authority.

Congress enacted section 337(d) in the Tax Reform. Act of 1986, as part of its repeal of General Utilities.[4] Section 337(d) provides:

> The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by subtitle D of title VI of the Tax Reform Act of 1986, including--
>
> (1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter) or through the use of a regulated investment company, real estate investment trust, or tax exempt entity, and
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> (2) regulations providing for appropriate coordination of the provisions of this section with the provisions of this title relating to taxation of foreign corporations and their shareholders.

The reference to “subtitle D of title VI” is to sections 631 through 634 of the Tax Reform Act of 1986, in which Congress repealed General Utilities. The reference to “part III of this subchapter” is to sections 351 through 368, including section 355. As a result, the statutory language authorizes the Secretary to issue regulations to prevent the use of section 355 distributions to circumvent the repeal of General Utilities.

The legislative history of section 337(d) does not expressly refer to section 355 distributions, but it does

[4] Pub. L. No. 99-514, §§ 631-34, 100 Stat. 2085, 2269-82.

support a broad grant of authority as to the types of transactions that the section 337(d) regulations may address. The conference report states:

> The repeal of the General Utilities doctrine is designed to require the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context. The conferees expect the Secretary to issue, or to amend, regulations to ensure that the purpose of the new provisions is not circumvented through the use of any other provision, including the consolidated return regulations or the tax-free reorganization provisions of the Code (part III of Subchapter C).

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 11-204 (1986).[5]

The reference to "through the use of any other provision" would include section 355 distributions within the scope of the grant of regulatory authority. Moreover, the reference to "the tax-free reorganization provisions of the Code" would encompass section 355 distributions that occur as part of a tax-free reorganization, which, in addition to certain distributions of stock or securities of a controlled corporation, are the types of section 355 distributions that otherwise are not subject to the repeal of General Utilities.[6] Additionally, the language of the conference report indicates that any

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[5] See also Staff of Joint Comm, on Tax'n, General Explanation of the Tax Reform Act of 1986, at 345 (1987) (containing language similar to the conference report).

[6] See I.R.C. §§ 355(c), 361(c). Congress added section 355(c) and amended section 361 in 1988, but both are effective as if they had been included in the Tax Reform Act of 1986. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, §§ 1018(d)(5)(A), 1018(d)(5)(C), 1019(a), 102 Stat. 3342, 3578, 3580, 3593.

regulations promulgated pursuant to section 337(d) should affect only corporate-level taxation and not shareholder-level taxation.

In 1988, Congress enacted technical amendments to section 337(d).[7] In 1987, the House of Representatives had passed identical technical amendments both as amendments to section 337(d) and, alternatively, as part of a technical amendment to recodify section 337(d) in section 336 in connection with a proposed repeal of section 337.[8] Neither alternative was enacted as part of the Revenue Act of 1987. However, the language of the House report that discussed the grant of regulatory authority in connection with the proposed recodification of section 337(d) also would support a broad grant of regulatory authority, as it stated:

> The bill also expressly provides that Treasury's regulatory authority extends so that the purposes of these provisions may not be circumvented by any other transactions. The purposes of these provisions include clarification that a current corporate level tax is to be paid when an appreciated subsidiary or other property is effectively disposed of outside of the group, and a reiteration that acquirors of a corporation should not be favored over the original owners in the tax consequences of a sale of subsidiaries or other assets of that corporation. It is intended that transactions that have this effect, regardless of their form, will result in the payment of the tax.

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7 Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1006(e)(5)(A), 102 Stat. 3342, 3400-01. The legislative history of the Technical and Miscellaneous Revenue Act of 1988, in its discussion of the amendments to section 337(d), does not contain any language regarding section 355 distributions.

8 H.R. 3545, 100th Cong., 1st Sess. S§ 10139(a)(5)(A), 10206(e)(5) (1987).

H.R. Rep. No. 391, 100th Cong., 1st Sess. 1084 (1987).

Of special interest in the House report is its reference to the imposition of a corporate-level tax where an appreciated subsidiary is effectively disposed of outside of the group. The House obviously was concerned about transactions that effectively are sales or dispositions of a subsidiary to a third party. Additionally, the report states that the corporate-level tax will apply to "transactions that have this effect, regardless of their form." Accordingly, the Secretary should have the authority to promulgate section 337(d) regulations to impose a corporate-level tax on transactions that take the form of a section 355 distribution, but effect a disposition of the controlled corporation outside of the distributing corporation group.[9]

[9] In the Tax Equity and Fiscal Responsibility Act of 1982, Congress provided that General Utilities generally would not apply to partial liquidations. See Pub. L. No. 97-248, §§ 222-23, 96 Stat. 324, 478-85. It also amended section 346(b) of the Internal Revenue Code of 1954, as amended, to grant the Secretary the authority to promulgate regulations to ensure that the repeal of. General Utilities as to partial liquidations "may not be circumvented through the use of section 355, 351, 337, or any other provision of law or regulations (including the consolidated return regulations)." I.R.C. § 346(b) (1985). The corresponding legislative history discussed the use of section 355 distributions to avoid the repeal of General Utilities as to partial liquidations. S. Rep. No. 494, 97th Cong., 2d Sess. 11-187 to -188 (1982).

The majority of the Committee believes that the Secretary has the authority under section 337(d) to promulgate regulations to prevent the use of section 355 distributions to circumvent the repeal of General Utilities. A majority of the Committee also believes that the Secretary has the authority to promulgate regulations that impose a corporate-level tax even though the distribution otherwise would be tax-free under section 355 at the shareholder level. A minority of the Committee believes that Congress did not intend for the Secretary, under section 337(d), to promulgate regulations that would impose a corporate-level tax on distributions which otherwise would qualify as section 355 distributions, and that even if Congress did provide the Secretary with such authority, it should not be exercised.

II. The Problem Regarding the Interaction of the Repeal of General Utilities and Section 355.

Spin-offs, split-offs and split-ups under section 355 traditionally have permitted a corporation to distribute assets without a corporate-level tax. However, the recent repeal of General Utilities was designed to require corporate-level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating or nonliquidating context. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 11-204 (1986). There is an obvious tension between these two approaches.

The Committee believes that Congress intended that the Secretary issue regulations under section 337(d) to prevent “abusive” situations as they might arise through the use of section 355. An abusive situation would arise if an acquiring corporation[10] and a target corporation (the distributing corporation) used section 355 to avoid a corporate-level tax in connection with an acquisition by the acquiring corporation of either the target corporation (without the controlled corporation) or a controlled corporation of the target corporation. For example, if target corporation T has two businesses operated by subsidiaries X and Y,[11] each representing 50 percent of the value of T, acquiring corporation A might try to acquire X in the following ways:

1. T spins off X. A acquires the stock of X in a taxable transaction.

2. T spins off Y. A acquires the stock of T in a taxable transaction.

3. T spins off X. A acquires X in a tax-free section 368(a)(1)(A), (B) or (C) reorganization.

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[10] This discussion is in the context of an acquisition by a corporation, but it also might involve an acquisition by two or more corporations or by a person other than a corporation.

[11] These situations also would arise where T operates the two businesses through divisions, and one or both divisions are incorporated prior to the section 355 distribution.

4. T spins off Y, A acquires T in a tax-free section 368(a)(1)(A) or (B) reorganization,[12]

5. A acquires 50 percent of the stock of T for cash. T exchanges its X stock with A for T stock in a split-off.

6. A acquires 50 percent of the stock of T for cash. T exchanges its Y stock with its shareholders other than A for their T stock.

7. A together with Company B acquires all of the stock of T. Neither A nor B acquires 80 percent of the stock of T. T exchanges its X stock with A for T stock in a split-off.

8. A together with Company B acquires all of the stock of T. Neither A nor B acquires 80 percent of the stock of T. T exchanges its Y stock with B for T stock in a split-off.

9. A together with Company B acquires all of the stock of T. Neither A nor B acquires 80 percent of the stock of T. T liquidates--exchanging its X stock with A for T stock and its Y stock with B for T stock in a split-up.

In each of the above transactions, A directly or indirectly has acquired X without T's incurring a corporate-level tax if the transactions otherwise meet the requirements of

[12] It seems likely that a stock-for-asset acquisition would not qualify as a tax-free section 368(a)(1)(C) reorganization because of a failure to meet the “substantially all” requirement.

section 355. Most practitioners would agree that, under current section 355, there would be a likelihood of a corporate-level tax in examples 1 and 2 if the transactions were part of an overall plan or arrangement between A and T. In contrast, practitioners would agree that no corporate-level tax should be imposed in examples 3 and 4. If there is a passage of time sufficient to satisfy the continuity-of-interest requirement of section 355, then it is not clear what the result would be in the split-off and split-up distributions m examples 5, 6, 7, 8 and 9.[13]

III. Summary of Conclusions and Recommendations.

1. The current section 355 regulations adequately protect against abusive spin-offs, although it would be useful if examples were added that address the effect of certain unsolicited taxable acquisitions following a section 355 spin-off distribution.

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[13] In Rev. Rul. 83-38, 1983-1 C.B. 76, the Internal Revenue Service (the "Service") held that pre-TEFRA section 311(d)(2)(B) did not apply when an acquiring corporation had purchased its T stock as part of a prearranged plan between it and T to exchange the acquiring corporation's T stock for the stock of a controlled subsidiary of T. In a similar situation, in Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd per curiam, No. 88-3073 (7th Cir. released Sept. 15, 1989) (Westlaw, 89 TNT 192-16), the Tax Court and the Seventh Circuit held that no corporate-level tax was imposed on Esmark, Inc. ("Esmark") when Mobil Oil Corporation ("Mobil") entered into a tender offer/redemption agreement with Esmark by which Mobil acquired 54 percent of Esmark's outstanding stock, and Esmark immediately redeemed that stock in exchange for 97.5 percent of the stock of Vickers Energy Corporation ("Vickers"), a controlled subsidiary of Mobil. The Tax Court rejected the Service's attempt to recast the transaction as a sale of Vickers to Mobil and its claim that Mobil's ownership of Esmark stock was too transitory to be recognized for tax purposes.

2. The current section 355 regulations do not focus on and adequately protect against the use of split-offs and split-ups to circumvent the repeal of General Utilities.

3. The section 337(d) regulations should apply the following “binding agreement” and “plan/five-year holding period” tests to all split-offs and split-ups to determine whether the distributing corporation should incur a corporate-level tax:

a. If the acquiring corporation enters into a binding agreement with the distributing corporation, other shareholders of the distributing corporation with or through whom it will have control of the distributing corporation or a third person with or through whom it will have control of the distributing corporation to cause the split-off or split-up, the distributing corporation would incur a corporate-level tax when the distribution occurred, regardless of when it occurred. Control for this purpose would mean ownership of more than 50 percent of the voting power of all classes of stock of the distributing corporation entitled to vote or of the total value of all classes of stock of the distributing corporation.

b. If the acquiring corporation has a plan of acquisition and distribution when it acquires control of the distributing corporation or if a joint plan of acquisition and distribution exists between the acquiring corporation and the distributing corporation, other shareholders of the distributing corporation with or through whom it will have control of the distributing corporation or a third person with or through whom it will have control of the distributing corporation, the distributing corporation would incur a corporate-level tax when the distribution occurred, unless the distribution occurred more than five years before the acquiring corporation's acquisition of stock of the controlled corporation or more than five years after its acquisition of stock of the distributing corporation. Control for this purpose would mean ownership of more than 50 percent of the voting power of all classes of stock of the distributing corporation entitled to vote or of the total value of all classes of stock of the distributing corporation.

IV. Alternative Approaches for the Application of the Section 337(d) Regulations to Split-Offs and Split-Ups.

The Committee has considered various alternatives as to the application of a corporate-level tax to split-up and split-off distributions that otherwise would qualify as tax-free distributions under section 355 at both the corporate and shareholder levels. At one end of the spectrum, the position might be taken that nothing need be done now; abusive transactions are adequately addressed by section 355 and the section 355 regulations. At the other end, the regulations might take a very restrictive approach to split-ups and split-offs by taxing all of them at the distributing corporation level. Because a split-up is a complete liquidation of the distributing corporation, imposing a tax on the distributing corporation might be viewed as being especially appropriate for a split-up.

Other alternatives falling between either end of the spectrum may be more appropriate. Assuming again that target corporation T has two businesses operated by subsidiaries X and Y, each representing 50 percent of the value of T, and acquiring corporation A wants to acquire X, a corporate-level tax might be imposed where A and T, other shareholders of T or a third person had a binding agreement when A acquired T stock to cause the subsequent split-off or split-up.

Alternatively, a corporate-level tax might be imposed where T, other shareholders of T or a third person participated in a preconceived plan pursuant to which A acquired T stock, and thereafter, as part of the preconceived plan, T distributed the stock of X to A in a split-off, the stock of Y to the shareholders of T other than A in a split-off, or the stock of X to A and the stock of Y to the shareholders of T other than A in a split-up. A broader variation of the preconceived plan standard would be to apply a corporate-level tax on T's distributions to A of the stock of X if, at the time A acquired the stock of T, A without the participation of any other person had a plan to acquire the stock of X.

Another alternative would be to impose a requirement that A hold T stock for a specified minimum period of time prior to any split-up or split-off. A final alternative would be to combine a plan standard with a holding-period requirement, after the expiration of which a split-off or split-up could occur without a corporate-level tax.

A. Deference to Section 355 and Accompanying Regulations.

It might be argued that the final regulations under section 355 provide an effective means for preventing the “abusive” use of split-offs and split-ups to circumvent the repeal of General Utilities, and therefore, that additional regulations are not required.

This argument is based on the view that the section 355 regulations contain broad requirements regarding device, business purpose, and continuity of interest. These requirements are flexible in their applicability to various transactional structures, and thus, they could provide the Service with effective weapons for attacking abusive transactions. The presence of these requirements in the section 355 regulations and the applicability of either section 311 or section 336 to any subsequent partial or complete liquidations arguably should adequately protect against abusive transactions.

However, the Committee does not believe that the foregoing argument is well founded. The section 355 regulations, in setting forth the broad requirements regarding device, business purpose, and continuity of interest, are drafted from the standpoint of taxing distributions of earnings and profits to shareholders (a shareholder-level tax on distributions) rather than taxing end-runs of the repeal of General Utilities (a corporate-level tax oh gains), although, of course, the. failure to meet the section 355 requirements will trigger a tax at the distributing corporation's level. The section 355 regulations do not address the application of these requirements to situations in which the distributing corporation enters into an agreement, or participates in a plan, pursuant to which an acquiring corporation acquires stock of the distributing corporation, and thereafter, pursuant to the agreement or plan, the distributing corporation distributes a controlled corporation in a split-off or a split-up to the acquiring corporation (or to the other shareholders of the distributing corporation).

Additionally, although the requirement of continuity of interest would limit the use of some split-offs and split-ups as a means to circumvent the repeal of General Utilities, the Committee perceived it as being inadequate to prevent many potentially abusive split-offs and split-ups. Moreover, the device requirement focuses on spin-offs, rather than on split-offs or split-ups, and does not adequately consider the use of split-offs and split-ups to circumvent the repeal of General Utilities. Accordingly, the Committee believes that the use of split-offs and split-ups to avoid a corporate-level tax should be addressed in regulations — preferably by regulations promulgated under section 337(d), rather than under section 355.

B. Binding Agreement Standard.

A second alternative would be to impose a corporate-level tax on any split-off or split-up pursuant to a binding agreement between the acquiring corporation and the distributing corporation or the other shareholders of the distributing corporation which the parties had entered into on or before the acquiring corporation's acquisition of distributing corporation stock. The rationale for this approach is that, whatever the section 355 tax consequences, because the distributing corporation is bound, either directly or indirectly, to make the distribution, it is effectively the same as if the distributing corporation had sold the controlled corporation to a person who was not a historical shareholder of the distributing corporation. In effect, the distributing corporation has sold the stock of the controlled corporation to a person who, as part of the binding agreement, is to become a shareholder of the distributing corporation for the specific purpose of exchanging its distributing corporation shares for the controlled corporation shares.

If this were not the rule, the acquiring corporation, pursuant to a binding tender offer/redemption agreement with the distributing corporation, could acquire stock of the distributing corporation not constituting control and two years thereafter exchange its distributing corporation shares for shares of the controlled corporation without a corporate-level tax. The binding agreement standard would eliminate the use of section 355 distributions in Esmark-type transactions, which the Committee believes would be an abusive use of section 355 to circumvent the repeal of General Utilities.

There is the issue of defining or determining what is a binding agreement. The term has been used most frequently with respect to effective date provisions for recently enacted legislation. In this area, the term generally is defined by what constitutes a valid, enforceable agreement under the applicable state law, although other requirements or exceptions may be incorporated into the definition.[14]

C. Subjective Standard of Preconceived Plan.

Another approach would be to apply a subjective standard to the acquiring corporation. If the acquiring corporation had a

14 See Edgar & Banoff, When Will a “Binding Contract” Secure Transitional Relief Under New Tax Laws?, 63 J. of Tax'n 234 (1985).

preconceived plan at the time it acquired stock of the distributing corporation to have the controlled corporation distributed either to it or to the other shareholders of the distributing corporation, then any subsequent split-off or split-up pursuant to the plan would be subject to a corporate-level tax.

This approach would offer at least two advantages. The first advantage would be the wide reach of its applicability. If the concern of Congress was the potential planning techniques that taxpayers might develop to circumvent the repeal of General Utilities, this preconceived plan standard would allow the Service to attack as abusive all transactions that it believed involved preconceived acquisition and distribution plans. The regulations might provide that any subsequent distribution of stock of a controlled corporation would be evidence that the acquiring corporation had a plan to cause the distribution of the controlled corporation at the time of the acquisition.

A second, related advantage would be the flexibility offered by this approach. The Service would be able to promulgate a general standard that would not restrict the types of transactions that it could review. Moreover, it would offer flexibility to the taxpayer that a standard based wholly or partially on the time period following the acquisition would not offer. As long as the acquiring corporation did not have a preconceived plan at the time of the acquisition and as long as it satisfied the other requirements of section 355, such as continuity of interest, a section 355 distribution could be nontaxable even if it occurred, for example, two years after the acquisition.[15] This flexibility[16] could be very beneficial to taxpayers where, after the acquisition, an unexpected, drastic change in business or market conditions occurred or where a shareholder conflict arose between the acquiring corporation and the other shareholders of the distributing corporation.

On the other hand, the preconceived plan standard also would have disadvantages. A primary disadvantage would be uncertainty. The existence or nonexistence of a preconceived plan would be difficult to establish, particularly if the plan need only be the plan of the acquiring corporation. Even if an acquiring corporation had no preconceived plan at the time of the

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15 However, such distribution might be taxable pursuant to other Code provisions, such as the “greenmail” excise tax imposed by section 5881.

16 This flexibility would be restricted to acquisitions by the acquiring corporation of less than 80 percent of either the voting power of the stock of the distributing corporation entitled to vote or the total number of shares of all other classes of stock of the distributing corporation. An acquisition by the acquiring corporation of 80 percent or more of both the voting power of stock entitled to vote and the total number of shares of all other classes of stock of the distributing corporation would require a five-year holding period prior to a tax-free distribution. See Code § 355(b)(2)(D). This restriction applies only to acquirors that are corporations.

acquisition, it never could be certain that the Service would not challenge a subsequent split-off or split-up, asserting that such plan existed. Given the uncertainties that distributing corporations and distributees already face as to section 355 distributions, it may not be constructive to add a possible corporate-level tax on a section 355 distribution based solely on the application of a preconceived plan standard to the acquiring corporation, particularly if the regulations provided that the subsequent split-off or split-up itself was evidence of a preconceived plan. Additionally, the Service would likely have greater difficulty in administering a preconceived plan standard.

Moreover, the wider-reaching applicability of a preconceived plan standard that focuses on a preconceived plan of the acquiring corporation only may penalize the distributing corporation and its other shareholders unfairly. Because this preconceived plan standard would not require the participation of the distributing corporation or the other shareholders of the distributing corporation in such plan, the distributing corporation would be subject to a corporate-level tax even though it was not part of any preconceived plan at the time of the acquisition of its stock. It is likely that, where there would be any doubt about the existence of a preconceived plan, distributing corporations would require indemnification agreements from controlled corporations, acquiring corporations, or both. This concern also might be addressed by narrowing the applicability of the rule by requiring the preconceived plan to be a joint plan of the acquiring corporation and the distributing corporation or the other shareholders of the distributing corporation.

D. Objective Holding-Period Standard.

Another alternative would be to impose an objective standard that would tax distributions that occur within a specified time period after the acquisition. The advantages and disadvantages associated with this standard generally would be the opposite of those concerning the preconceived plan standard.

The primary advantages of this standard would be certainty and simplicity. A specified time period would establish a clear line between corporate-level taxable and nontaxable distributions. If the distribution occurred prior to the expiration of the time period, the distribution would be subject to corporate-level tax, while if it occurred after the expiration of the time period, it would not be subject to corporate-level tax as long as it otherwise met the requirements of section 355. Thus, as long as the acquiring corporation and the other shareholders of the distributing corporation waited until after the specified time period, they could be certain that the distribution would not be subject to corporate-level tax under the section 337(d) regulations.

The standard would also be much easier for the Service to administer. The Service and taxpayers would avoid extended controversies, which likely would be involved in applying a preconceived plan or other more complex standard to split-off or split-up distributions.

However, this approach may not be acceptable since there would be the potential for taxpayers to structure transactions that would circumvent the repeal of General Utilities. For example, an acquiring corporation might have an agreement, option or other arrangement, such as a voting trust or dividend restrictions, to acquire the controlled corporation after the expiration of the specified holding period. A fixed-holding period standard allows acquiring corporations to enter into transactions on a tax-free basis if they wait a specified period of time before acquiring the controlled corporation in a split-up or split-off distribution. However, the Committee believes that acquiring corporations would be unlikely to use this approach, particularly in the face of an extended holding period. Few acquiring corporations would wait five years after an acquisition of stock of the distributing corporation to acquire stock of the controlled corporation.

There would be another disadvantage to the acquiring corporation and the other shareholders of the distributing corporation. Even if a preconceived plan to make a distribution did not exist at the time of the acquisition, the section 355 distribution could not occur prior to the expiration of the specified holding period. However, valid business reasons or changed circumstances could arise before the expiration of the holding period which would support the business purpose of such distribution and its lack of any tax-avoidance purpose.

If this objective standard were adopted, the question of the specified time period to use for the standard would need to be addressed. One choice might be a five-year time period. A five-year period would discourage acquiring corporations from acquiring stock of a distributing corporation in order to obtain stock of a controlled corporation. Additionally, under current law, a five-year time period applies to distributions to the acquiring corporation where it acquires at least 80 percent of the voting power of the stock of the distributing corporation entitled to vote and of the total number of shares of all other classes of stock of the distributing corporation. A five year time period is used in an example to the continuity-of-interest requirement in the section 355 regulations,[17] although this is more likely a result of the subsidiary's being wholly owned in the example than a decision by the Service to establish five years as the standard for continuity of interest. The examples also show that an acquisition of the distributing corporation stock followed by an immediate distribution clearly would not satisfy the continuity-of-interest requirement.

Alternatively, a specified time period of less than five years may be more appropriate where the acquiring corporation does not acquire control. A logical choice would be the two-year time period which the Service used in Revenue Ruling 74-5.[18] A two-year time period might offer sufficient discouragement to the acquisition of distributing corporations for immediate split-ups or split-offs. It would require an acquiring corporation to make a longer-term investment in the distributing corporation. Moreover, it would be consistent with other Code provisions that address distributions or redemptions with respect to stock

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17 See Treas. Reg. § 1.355-2(c)(2) ex. 2. See also Rev. Proc. 83-59, § 4.023(a)(8)(f), 1983-2 C.B. 575, 578 (requiring' in a ruling request where a section 351 transfer is part of a larger acquisitive reorganization a representation that no significant changes in the stock ownership of the acquired corporation has occurred in the last five years so that continuity of interest would not be met).

18 For a discussion of Revenue Ruling 74-5 and related materials, see the appendix at 18 to 21.

acquired in a distributing corporation. See, e.g., Code § 1059 (extraordinary dividends on stock not held for more than two years); § 5881 (“greenmail” payments on stock acquired in connection with an actual or threatened public tender offer). The choice of a two-year period, in effect, would be an adoption of what we believe most tax practitioners view as the current law, subject to the promulgation of the section 337(d) regulations. However, a disadvantage of a two-year period would be that corporations more likely would be willing to acquire stock of the distributing corporations and wait two years, rather than five years, in order to acquire the controlled corporation.

E. <u>Combination Standard</u>.

Another alternative would be a combination standard. This combination standard would tax any distribution that occurs pursuant to a preconceived plan at the time of the acquisition, except if a specified period of time has passed since the acquisition.

Advantages to a combination standard include, first, the flexibility that it gives the Service in challenging transactions that, in its view, circumvent the repeal of <u>General Utilities</u>. Because the Service might view different types of transactions or certain facts in combination with transactions as more likely indicating a preconceived plan, it would be able to address problem areas more readily. From the taxpayer's standpoint, a combination standard offers the flexibility that, if the acquisition and distribution were not pursuant to a preconceived plan, then a distribution could occur before the expiration of the specified time period.

A second advantage of this standard is the termination, after a specified period of time, of the uncertainties associated with only a preconceived plan standard. Although the taxpayers would face possible challenge by the Service of the distributions that occur within the specified time period, once that time period had expired and as long as the requirements of section 355 otherwise were met, distributions could be made without concern as to corporate-level tax.

A disadvantage to this standard would be the difficulty of establishing the existence of a preconceived plan of the acquiring corporation. Another disadvantage would be the possibility that the interests of the other shareholders of the distributing corporation could be adversely affected if the distributing corporation were subject to corporate-level tax on a distribution prior to the expiration of the specified time period. As stated previously, these problems could be lessened by narrowing the preconceived plan part of the standard to require a joint plan of both the acquiring corporation and the distributing corporation or the other shareholders of the distributing corporation.

As to the question of what would be the appropriate. specified time period for the holding period, the most appropriate choices would be either a five-year period or a two-year period. The arguments in favor and against each choice would be the same as discussed above with regard to the objective standard.

F. All-Inclusive Standard.

Another alternative would be a standard which would tax all split-ups or split-offs that occur following an acquisition of any amount of stock of a distributing corporation, regardless of the time period that had passed since the acquisition. The theory for this approach is that the distributing corporation in effect has sold a controlled corporation to a shareholder (albeit a less-than-80-percent shareholder) in exchange for its own stock. Economically, this is not much different than the distributing corporation's selling the stock of the controlled corporation for cash and using the cash to redeem its stock.

Although this standard would offer certainty to both the taxpayer and the Service as to the treatment of section 355 distributions, the Committee believes that it would be neither a reasonable approach to this area nor consistent with Congressional policy regarding the interaction between the repeal of General Utilities and section 355.

First, to impose a corporate-level tax on all split-ups or split-offs would restrict transactions that clearly would have neither the intent nor the effect of circumventing the repeal of General Utilities. For example, an acquiring corporation might acquire a 50-percent interest in a distributing corporation with the intent of having an ongoing “joint venture” with the other distributing corporation shareholders. However, because of an unanticipated subsequent shareholder conflict or a dispute between the distributing corporation and its other shareholders, it might become necessary or desirable to the success of the distributing corporation to resolve the conflict by means of a split-up or split-off. Because the split-up or split-off would have a valid business reason, it would be inappropriate to impose a corporate-level tax on the distribution.

More importantly, recently enacted section 355(c), with its carve-out for distributions of stock or securities of a controlled corporation, supports the view that Congress did not intend an automatic application of section 336 to split-ups or split-offs. Additionally, because the grant of regulatory authority in section 337(d) addresses transactions that would circumvent the repeal of General Utilities, it is clear that Congress did not believe that all split-ups or split-offs should be subject to a corporate-level tax.

Accordingly, the Committee believes that section 337(d) does not give the Secretary the authority to issue regulations that would impose a corporate-level tax on all split-offs or split-ups.

V. Recommended Approaches for Section 337(d) Regulations.[19]

A. Application to Spin-Offs.

1. Introduction.

The Committee considered the possible application of the section 337(d) regulations to spin-offs that otherwise would qualify as tax-free distributions under section 355. The Committee concluded that the continuity of interest, device and business purpose tests of section 355 generally serve as adequate safeguards against disguised sales. While there are certain section 355 transactions, such as those immediately preceding unsolicited tender offers (which may or may not be hostile) or acquisitions following the threat of a hostile tender offer, that are not addressed explicitly in the regulations under section 355, they should be dealt with by adding examples to those regulations rather than by promulgating regulations under section 337(d).

The device test that applies to spin-offs (as opposed to split-offs and split-ups) is intended to preclude the transfer

[19] The following proposals are not intended to affect or to change what otherwise constitutes a closed sale for tax purposes under current law. The finding of a closed sale and the tax consequences of such finding will continue to be determined under current law.

from corporate solution of earnings and profits of the distributing or the controlled corporation. The business purpose test serves to assure that the spin-off occurs only for reasons that are important to the continued operation of the businesses and not for purposes related to the disposition of a business, as well as a "backstop" to the device test. In a sense, these two tests operate jointly -- a strong business purpose will sometimes override evidence of a device. The continuity of interest test assures that the historical shareholders continue to have a proprietary interest in both the distributing and controlled corporations. These tests are adequate determinants of when a spin-off should be treated as a taxable transaction. The section 337(d) regulations are intended to prevent de facto sales from avoiding taxation by fitting into the mold of section 355 transactions. Transactions in which the historical shareholders retain an interest in both the distributing and controlled corporations, that are done for purposes consistent with retaining ownership in an altered form and are not susceptible to being used to bail out earnings and profits, are not the equivalent of sales. Thus, further limitations imposed under section 337(d) would serve only to interfere with legitimate business operations.

2. Tax-Free Acquisitions Following Spin-Offs.

a. In General.

The Committee considered tax-free acquisitions of both the distributing corporation and the controlled corporation following a spin-off. The Committee determined that section 337(d) serves the same purposes as are served by the device and the continuity of interest tests of section 355 and considers the application of section 337(d) in such context unnecessary.

b. The Tax-Free Acquisition of the Distributing Corporation.

Under present law, the post spin-off disposition, pursuant to a prearranged plan, of the stock of a distributing corporation by its shareholders in a tax-free reorganization (in which no boot is distributed) does not disqualify the spin-off from being tax-free under section 355.[20] The shareholders of the distributing corporation retain the requisite continuity of interest in the distributing corporation through their ownership of stock in the corporation resulting from the tax-free reorganization. Because continuity of interest is maintained, the transaction is not akin to a sale and section 337(d) should not convert the spin-off into a taxable transaction.

This result should obtain regardless of whether the consideration received in the reorganization by the shareholders of the distributing corporation consists of common stock or preferred stock. Preferred stock has historically provided sufficient continuity of interest for purposes of a

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[20] Treas. Reg. § 1.355-2(d)(2)(iii)(E); Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966).

reorganization,[21] and section 337(d) should not impose a higher standard of continuity. The result should not change even if the preferred stock has a mandatory redemption feature, so long as it is properly classified as equity rather than debt. Mandatorily redeemable preferred stock, however, could be viewed as evidence of a device.

c. Nontaxable Transactions Involving the Controlled Corporation.

Section 337(d) should not apply to tax-free transactions involving the controlled corporation after the spin-off distribution. In Revenue Ruling 75-406, 1975-2 C.B. 125, the Service ruled that the merger of a controlled corporation immediately following a spin-off was not taxable, as there was an independent vote by the shareholders of the controlled corporation. The Service focused on the fact that the ownership by the shareholders of the controlled corporation was real and meaningful as the shareholders were free to vote their stock for or against the merger. The Committee believes that Revenue Ruling 75-4 06 is correct and represents the proper analysis of the transactions described therein. Section 337(d) does not add any safeguards not provided by this continuity of interest approach.

3. Taxable Acquisitions Following Spin-Off Distributions.

The Committee considered whether the section 337(d) regulations should set forth guidelines further limiting post

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[21] John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935).

spin-off taxable acquisitions of either the controlled or the distributing corporation. The Committee determined that, under these circumstances, the purposes of section 337(d) are served by the business purpose and device tests of section 355. These tests prevent the use of spin-offs as preludes to taxable sales. While the current section 355 regulations may not address the fact patterns of certain unsolicited acquisitions that precede spin-offs, the Committee believes that such transactions should be analyzed under the existing section 355 framework of business purpose and device contained in the existing section 355 regulations without the need to rely on section 337(d). Accordingly, the Committee recommends that the section 337(d) regulations not apply to spin-off distributions under section 355, but that the section 355 regulations be amended to include additional. examples:

The Committee examined a variety of approaches in determining the potential application of section 337(d) to spin-offs followed by taxable transactions. The Committee considered whether the section 337(d) regulations should adopt a rule pursuant to which any taxable acquisition of the distributing corporation or the controlled corporation within a fixed period of time (e.g., one or two years) after a spin-off would render the spin-off taxable. Such a rule, however, would prevent a corporation from responding to changes in its business or to market conditions. In addition, any such rule would tend to entrench management of the post spin-off controlled and distributing corporations in the event of an unsolicited takeover attempt. The current business purpose and device tests of section 355 prevent a post spin-off taxable acquisition absent a substantial change in circumstances and serves as an adequate check on prearranged two-step transactions.

The Committee also considered and rejected a rebuttable presumption regarding the effect of a taxable acquisition following a spin-off. A rebuttable presumption was viewed as posing the same problem as a bright-line test, as presumptions tend to become de facto limitations due to the in terrorem effect of presumptions on cautious counsel.

The Committee next considered the effect of an unsolicited post spin-off taxable acquisition of the distributing corporation or the controlled corporation and concluded that such an unsolicited transaction should not render the spin-off taxable. For an acquisition to be considered unsolicited for this purpose, the spin-off must not have been undertaken to facilitate the acquisition and there must not have been prior discussions between the parties. A target corporation should not be required to resist an unsolicited offer so as to protect its tax position.

The Committee considered whether section 337(d) should prevent a tax-free spin-off in those circumstances in which the distributing corporation considered several options with respect to the controlled corporation, including the sale or spin-off of the controlled corporation or a recapitalization of itself, and then distributed the controlled corporation in a transaction intended to qualify under section 355, followed by the acquisition of the controlled corporation in a taxable transaction. In this context, the Committee considered whether an acquisition by a person who expressed an interest in purchasing the controlled corporation prior to the spin-off automatically should cause the spin-off to be rendered taxable. The Committee concluded that such a subsequent acquisition is best analyzed under the present tests of section 355. Although it is quite likely that an acquisition by a previously interested person would render the spin-off taxable, it is possible, as a result of intervening circumstances, for the acquiror to abandon its plans to acquire the controlled corporation and later. reinstate those plans. The facts and circumstances approach of the device and business purpose tests under section 355 is the best gauge of the tax consequences of the subsequent acquisition, For any test devised under section 337(d) to operate properly, such test would have to rely on the same facts and circumstances as the tests under section 355 and, consequently, there is no need for additional regulations under section 337(d).

However, the Committee supports the amendment of the current section 355 regulations to address situations where recapitalizations are utilized to facilitate subsequent sales of controlled corporations. This might occur where an acquiror

Acquires an interest in a distributing corporation, and the distributing corporation then recapitalizes, pursuant to which the acquiror receives the distributing corporation common stock and the historical shareholders of the distributing corporation receive the distributing corporation preferred stock. Subsequently, the distributing corporation spins-off a controlled corporation, distributing the controlled corporation common stock to the acquiror and the controlled corporation preferred stock to the historical shareholders. The acquiror then sells its controlled corporation common stock.[22]

The section 355 regulations should provide that, after an acquisition of stock of a distributing corporation, a combination of the three factors -- a recapitalization, a spin-off and a subsequent taxable acquisition -- is a higher level of evidence of a device than merely a spin-off and a subsequent

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22 As an example of this situation, T has two subsidiaries -- T1 and T2. T has one outstanding class of common stock. A wishes to acquire T and believes that the value of the two subsidiaries can be enhanced if T does not own the stock of both. Accordingly, pursuant to a plan, A purchases 60 percent of the T stock. T then recapitalizes with the 40-percent minority shareholders exchanging their T common stock for T nonvoting preferred stock. T then spins-off T2 (which either has recapitalized to add a class of nonvoting preferred stock or has an existing class of such stock) to A and the minority shareholders, with A receiving the T2 common stock and the minority shareholders receiving the T2 nonvoting preferred stock. A subsequently sells its T2 common stock to a third party. This example is based on an example by Jerred G. Blanchard, Jr. in his article Tax Considerations in Structuring Leveraged Buyouts, Practising Law Institute (Tax Series) No. 294, at 339, 423-24 (1989).

taxable acquisition. In such situations, the Committee believes that the distributing corporation is recapitalizing to facilitate the acquiror's investment and the subsequent spin-off and disposition of the controlled corporation. As such, the recapitalization provides additional, objective evidence of a device.

The Committee also considered the extent to which section 355 or section 337(d) should require the controlled corporation to have charter and by-law provisions, such as poison pills, super-majority provisions or other shark repellants, that indicate an unwillingness to be acquired in order for a subsequent taxable acquisition of the controlled corporation not to taint the previous spin-off. In today's business climate, the spin-off of a controlled corporation without such devices could give the impression that the controlled corporation was inviting a purchaser to come forward. Such devices, however, are frequently intended to increase the purchase price of the controlled corporation rather than to prevent it from being acquired. Furthermore, it is inappropriate for the tax laws to dictate that a corporation must adopt protective measures in order to protect a tax-free spin-off in the event of a subsequent taxable acquisition. Matters -such as these are best decided on the basis of nontax considerations, such as fiduciary duty and business judgment. Furthermore, the adoption of protective measures is likely to evidence the intent of the distributing corporation’s board of directors, rather than that of the newly independent board of the controlled corporation. Accordingly, the facts and circumstances approach of the device and business purpose tests is the best analytic framework in which to assess the effect of a subsequent acquisition of the controlled corporation.

There is some concern that the subjective nature of some of the section 355 tests could result in abuse. The subjective business purpose and device tests of section 355, however, best serve the objective of preventing the removal of assets from corporate solution in transactions that are equivalent to taxable sales. The subjective nature of these tests should not cause undue concern, inasmuch as the subjective intent that is the focus of these tests is the intent as evidenced by facts, and not the state of mind of the parties..

The Committee recommends that amendments of the section 355 regulations be issued concurrently with the section 337(d) regulations regarding split-offs and split-ups.

B. Application to Split-Offs and Split-Ups.

The Committee believes that the section 337(d) regulations should apply a two-prong approach by adopting the binding agreement standard and the combination standard of a plan/five-year holding period. This approach would protect against abusive transactions while providing flexibility to taxpayers. Under this approach, if the acquiring corporation enters into a binding agreement to cause the subsequent split-off or split-up with the distributing corporation, other shareholders of the distributing corporation with whom it will have control of the distributing corporation or a third person with whom it acquires control of the distributing corporation, the distributing corporation would incur a corporate-level tax when the subsequent distribution occurred, regardless of when it occurred. Additionally, if the acquiring corporation has a plan of acquisition and distribution when it acquires control of the distributing corporation or if a joint plan of acquisition and distribution exists between the acquiring corporation and the distributing corporation, other shareholders of the distributing corporation with whom it will have control of the distributing corporation or a third person with whom it acquires control, a corporate-level tax would be imposed on any subsequent section 355 distribution by the distributing corporation pursuant to the plan, unless at least five years had elasped after the acquiring corporation's acquisition of the distributing corporation stock.[23]

[23] This discussion is in the context of a split-off or split-up distribution of a controlled corporation to the acquiring corporation. However, the same standard would apply to a split-off distribution of a controlled corporation to the other shareholders of the distributing corporation and the acquiring corporation's continued ownership of the distributing corporation. Moreover, it would apply where a person other than a corporation acquires stock of the distributing corporation. Additionally, the standard would apply where, pursuant to a binding agreement or a joint plan, there was a split-off or a split-up, followed by the acquiring corporation's acquisition of stock of the distributing corporation or the controlled corporation.

This two-prong approach would apply even though the subsequent distribution otherwise meets the requirements of section 355 and, therefore, is tax-free at the shareholder level. If the subsequent distribution fails to meet the requirements of section 355 and, therefore, is taxable at the shareholder level, then either section 311 or section 336, rather than this two-prong approach, would apply to the distributing corporation. Thus, for the distribution to be tax-free at the corporate level, it would have to pass muster under both section 355 and the two-prong approach.

Pursuant to the first prong of this approach, if the acquiring corporation enters into a binding agreement to cause the subsequent split-off or split-up with the distributing corporation, other shareholders of the distributing corporation with whom it will have control of the distributing corporation or a third person with whom it acquires control of the distributing corporation, a corporate-level tax would be imposed when the subsequent split-off or split-up occurred. The binding agreement prong would apply, and a corporate-level tax would be imposed, regardless of when the subsequent split-off or split-up occurred (i.e., there would be no holding-period exception to the application of a corporate-level tax).

The question arises as to what a binding agreement is for this purpose. As stated previously, the term binding agreement is used most frequently in statutory provisions with regard to effective date provisions. Although specific requirements or exceptions may be provided, the effective date provisions generally look to applicable state law to determine what constitutes a binding agreement. The concept of a binding agreement also has been applied in other areas of tax law, such as the step-transaction doctrine.[24] In these other areas, the courts and the Service appear to look to applicable state law to determine what constitutes a binding agreement. For this purpose, the Committee believes that the binding agreement prong should apply to agreements that contain customary closing conditions, financing conditions, or similar conditions.

It should be recognized that, if an agreement were not a binding agreement for this purpose, it likely would be a plan of acquisition and distribution for purposes of the recommended second prong to the section 337(d) regulations.

The binding agreement prong also would apply where two or more corporations enter into a binding agreement to acquire all of, or at least a controlling interest in, the stock of a distributing corporation and to divide the businesses of the distributing corporation. Here, it may be cogently argued that the distributing corporation's entering into the binding agreement is not relevant since after the acquisition the distributing corporation will be under the control of the

[24] See, e.g., Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1975); Rev. Rul. 79-70, 1979-1 C.B. 144.

acquiring corporations, and a corporate-level tax should be imposed when the controlled corporation or corporations subsequently are distributed in a split-off or split-up. This approach would be based on the view that the transaction in its entirety was an acquisition by the acquiring corporations of, rather than the ongoing participation by the historical shareholders of the distributing corporation in, the controlled corporation or corporations.

A second question to be addressed concerning the binding agreement prong is what level of stock ownership should constitute control when the binding agreement is between the acquiring corporation and either other shareholders of the distributing corporation or a third person. One alternative would be that control for this purpose means ownership by the acquiring corporation and either other shareholders of the distributing corporation or a third person of at least 80 percent of the distributing corporation stock entitled to vote and at least 80 percent of the total number of shares of all other distributing corporation stock. This definition of control parallels the definition that applies for purposes of section 355. Accordingly, to adopt this same definition for purposes of the section 337(d) regulations would maintain a degree of consistency between the two sections.

A second alternative would be to apply the percentage of voting stock and of other stock that would be required pursuant to applicable state law to be able to cause the subsequent split-off or split-up. The argument in favor of this alternative is that it recognizes that effective control of the distributing corporation can occur, and likely will occur, at ownership levels of less than 80 percent.

The argument against this alternative is that it lacks uniformity. No clear rule would be provided as the level of ownership for control would vary from state to state. Additionally, it could vary from corporation to corporation incorporated in the same state, depending on voting provisions included in the articles of incorporation, bylaws and other corporate documents. Additionally, this type of control test has not been used previously in either the Code or Treasury regulations, and the section 337(d) regulations should not adopt it without clear Congressional guidance or support. A uniform rule of control at a specified level of ownership seems more desirable.

A third alternative would be to define control as the ownership of more than 50 percent of the total voting power of all classes of stock of the distributing corporation entitled to vote or of the total value of all classes of stock. This alternative is the same as the definition of control for purposes of section 304, except that it substitutes an ownership threshold of “more than 50 percent” for the ownership threshold of “at least 50 percent” in section 304. This alternative would apply the most restrictive definition of control and, accordingly, would result in the broadest application of the section 337(d) regulations to potentially abusive section 355 distributions. Additionally, it would avoid an end-run of the section 337(d) regulations through the acquiring corporation's failure to acquire a single class of distributing corporation stock, such as a class of newly issued preferred stock, which would be available under the first alternative. The arguments against this approach are that it is not consistent with the ownership requirement under section 355, and since it depends on a requirement of more than 50 percent of the vote or value of the distributing corporation stock, it may be a level of ownership that is higher or lower than effective control under state law.

A fourth alternative would be to apply the third alternative's control test of vote or value but to use a threshold of 80 percent or more. This alternative, in comparison to the third alternative, would narrow the application of the control test, but it would not necessarily result in the ability of a large number of transactions to avoid the application of the section 337(d) regulations. An acquiring corporation that acquires more than 50 percent, but less than 80 percent, of the vote or value of the distributing corporation stock would be subject to corporate fiduciary obligations to the minority interest and other nontax restrictions in attempting to complete the split-off or split-up. Thus, as a practical matter, there might be few transactions where an acquiring corporation would acquire more than 50 percent, but less than 80 percent, of the vote or value of stock of a distributing corporation with the intent of causing the split-off or split-up, without otherwise having some type of binding agreement or plan with the distributing corporation, other shareholders of the distributing corporation or a third person. This alternative still would protect against end-runs of the section 337(d) regulations through the acquiring corporation's failure to acquire a single class of stock of the distributing corporation. An argument against this alternative is that, since it depends on a requirement of 80 percent or more of the vote or value of the distributing corporation stock, it likely is a level of ownership that is higher than effective control under state law.

The majority of the Committee supports the adoption of a control test requiring ownership of more than 50 percent- of the voting power of all classes of stock of the distributing corporation entitled to vote or of the total value of all stock of the distributing corporation. The majority prefers the broad application of this alternative and the corresponding increased protection against the use of abusive transactions to circumvent the repeal of General Utilities. A minority of the Committee supports the adoption of the “vote or value” control test but with an ownership threshold of 80 percent or more, rather than more than 50 percent.

The second prong of the section 337(d) regulations -- the plan/five-year holding period standard -- would examine whether there was a plan of acquisition and distribution of the acquiring corporation when it acquires control of the distributing corporation or a joint plan of acquisition and distribution between the acquiring corporation and the distributing corporation, other shareholders of the distributing corporation with whom it will have control of the distributing corporation or a third person with whom it acquires control of the distributing corporation prior to or contemporaneously with its acquisition of the distributing corporation stock. The plan would need to include the subsequent distribution. If a plan existed at the time of the acquisition, the distributing corporation would be taxed on any subsequent distribution pursuant to the plan, unless the subsequent distribution occurred more than five years after the acquiring corporation's acquisition of the distributing corporation stock.[25]

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[25] It should be noted that, in a situation where an acquiring corporation, pursuant to a plan of acquisition and distribution, acquired at least 80 percent of both the voting power of all classes of stock of the distributing corporation entitled to vote and the total number of shares of all other classes of stock of the distributing corporation, the five-year holding period requirements of both section 355 and this prong of the section 337(d) regulations would apply to the acquiring corporation. However, as to individuals, partnerships or other noncorporate taxpayers, only this prong of the section 337(d) regulations would apply.

The difficult question under the plan/five-year holding period standard prong would be what would qualify as a plan of the acquiring corporation or a joint plan between the acquiring corporation and the distributing corporation, other shareholders of the distributing corporation or a third person. Although various Code provisions regarding the taxation of corporations and shareholders use the word "plan,"[26] these provisions do not provide any guidance as to what constitutes a plan for their purposes. Additionally, Congress usually has not offered any significant guidance in legislative history as to the factors to examine in determining the existence of a plan. As such, there is flexibility as to the determination of the factors that either would indicate, or be conclusive as to, the existence of a plan for purposes of this standard.

The existence or nonexistence of a plan of the acquiring corporation would be difficult to establish. The inquiry effectively would focus on the intent of the acquiring corporation in acquiring the distributing corporation. Such intent could be established by letters, memoranda, internal corporate documents, press releases, or other documents, such as filings with the Securities and Exchange Commission.

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[26] See, e.g., Code §§ 302(b)(2)(D), 306(b)(4), 332(b), 354(a), 361(a). See also H.R. 3150, 101st Cong., 1st Sess. § 11203(a) (1989) (proposed amendment of section 351 regarding the use of securities in section 351 transfers).

Additionally, the acquiring corporation's active involvement in the management of the controlled corporation but not the distributing corporation, or vice versa, during the period prior to the section 355 distribution might indicate a plan of acquisition and distribution. Because of the subjectivity associated with a unilateral plan, substantial, objective evidence should exist to support a finding of a plan of acquisition and distribution of the acquiring corporation.

As to the existence or nonexistence of a joint plan, a binding agreement between the parties clearly would be covered by the first prong. However, an agreement between the parties that was not a binding agreement likely would be a joint plan. Accordingly, a letter of intent between the parties would be a joint plan.

If the parties had discussions or negotiations, this fact would be evidence of a joint plan but would not automatically result in the finding of the existence of a joint plan. Whether the discussions or negotiations were, or became, a joint plan would depend on the extent and the nature of the discussions or negotiations. It also would depend on how close in time the discussions or negotiations occurred to the subsequent transaction. If a significant time period elapsed between the discussions or negotiations and the subsequent transaction, it would be less likely that the discussions or negotiations would have focused on the subsequent transaction. If the discussions or negotiations resulted in some type of arrangement that effectively shifted the benefits of ownership and the risk of loss with respect to either the controlled corporation or the distributing corporation to the acquiring corporation, such arrangement would be substantial evidence of the existence of a joint plan. Additionally, discussions or negotiations involving representatives of the parties (e.g., bankers, lawyers, accountants, or other advisors) would be evidence of a joint plan. Moreover, options, puts and similar arrangements would be viewed as a joint plan.

The plan of acquisition and distribution would need to exist prior to or contemporaneously with the acquiring corporation's acquisition of the distributing corporation stock. If the plan regarding the distribution were to develop after the acquisition, a plan would not exist for purposes of this combination standard. However, in this situation, the Service likely would question when the plan actually developed and might assert that the plan existed at the time of the acquisition. The regulations should provide that changed circumstances (e.g., shareholder disputes or the lapse of time) are evidence to support the absence of a plan at the time of the acquisition.

If the acquiring corporation does not have a binding agreement or a plan at the time of the acquisition, then a subsequent split-off or split-up would be tax free as to the distributing corporation and the acquiring corporation if the requirements of section 355, including continuity of interest, otherwise would be satisfied. The acquiring corporation presumably would satisfy the continuity-of-interest requirement if it had held the stock of the distributing corporation for at least two years.

Additionally, even if the acquiring corporation alone has a plan or the acquiring corporation has a binding agreement or a joint plan with either other shareholders of the distributing corporation or a third person, the distributing corporation would not incur a corporate-level tax on a subsequent split-off or split-up if the requisite control[27] of the distributing corporation did not exist subsequent to or contemporaneously with the binding agreement or plan. Of course, both conclusions assume that the subsequent distribution otherwise would satisfy the requirements of section 355. However, if the acquiring corporation, the other shareholders of the distributing corporation or the third person subsequently were to acquire additional distributing corporation stock so as to gain

[27] Control would exist if the acquiring corporation alone or together with the other shareholders of the distributing corporation or the third person joining in the plan own more than 50 percent of the voting power of all classes of stock of the distributing corporation entitled to vote or of the total value of all stock of the distributing corporation.

control of the distributing corporation while the acquiring corporation still had a plan or while the parties still had a binding agreement or joint plan, the distributing corporation would incur a corporate-level tax on a subsequent distribution (at any time if there were a binding agreement or if it occurred within five years after the acquisition if there were a plan).

The Committee considered providing an exception to both prongs if there was continuity of interest for purposes of section 355 as to both the distributing corporation and the controlled corporation after a split-off or as to each controlled corporation after a split-up. For purposes of determining whether there was continuity of interest, the acquiring corporation would not be included. Thus, even though the acquiring corporation had held its distributing corporation stock for the time period required for continuity of interest, it would not be treated as a historical shareholder for purposes of this exception.,

An example of this exception would be where an acquiring corporation A enters into a binding agreement with target corporation T and its two historical shareholders C and D pursuant to which A will acquire 25 percent of the T stock, and two years thereafter, T will exchange its stock of subsidiary X, which represents 50 percent of T's value with A and C for all of their T stock. Two years thereafter, the exchange occurs, and A and C each own 50 percent of the X stock. Because C has a 50-percent interest in X and D has a 100-percent interest in T, there is continuity of interest in both corporations after the exchange, and no corporate-level tax would be imposed by reason of this exception.[28]

Some members of the Committee believe that, in the situation where there is continuity of interest in each post-distribution corporation, it is not an abusive transaction that circumvents the repeal of General Utilities, and that it would be inappropriate to impose a corporate-level tax. Other members of the Committee, however, believe that, although the requisite continuity of interest may exist, there still is effectively a sale by the distributing corporation to the acquiring corporation that circumvents the repeal of General Utilities. These members believe that a sale exists because the acquiring corporation is not investing in the distributing corporation as a whole but is acquiring only the portion of the distributing corporation that it desires. As such, they would support the imposition of a

[28] A similar example is set forth in section 1.355-2(c)(2), example 2 of the Treasury regulations, except that the controlled corporation is distributed solely to a historical shareholder in a split-off while another historical shareholder retains a 50-percent interest in the distributing corporation. The example states that the split-off satisfies continuity of interest for section 355 purposes.

corporate-level tax on the subsequent section 355 distribution.[29] Applying the facts of the example in the preceding paragraph, in their opinion, T effectively has sold 50 percent of X to A, and thus, it should incur a tax on the subsequent exchange.

C. Examples of the Application of the Recommended Binding Agreement—Plan/Five-Year Holding Period Approach to Split-Offs and Split-Ups.

For purposes of the following examples, it is assumed that T operates two businesses through its wholly owned subsidiaries (or divisions) X and Y, each of which represents 50 percent of the value of T. T has one class of common stock. A wishes to acquire X.

The following examples illustrate situations which the Committee believes circumvent the repeal of General Utilities and would be subject to a corporate-level tax under the binding agreement--plan/five-year holding period approach:

1. A enters into a binding agreement or joint plan with T pursuant to which A will acquire 50 percent of the

[29] The members that support this treatment are divided as to the amount of the distribution that should be taxed. One group would impose a corporate-level tax on the entire distribution. The other group would impose a. corporate-level tax on the portion of the distribution to the acquiring shareholder and would examine the balance of the distribution to the historical shareholder to determine whether, treating it as a separate distribution, it otherwise would satisfy the requirements of section 355. If it did satisfy such requirements, the distributing corporation would not incur a corporate-level tax on the balance of the distribution. If it did not satisfy such requirements, the distributing corporation would incur a corporate-level tax on the balance of the distribution.

stock of T, and two years thereafter, T will exchange its X stock with A for T stock in a split-off. Two years thereafter, the exchange occurs.

2. A enters into a binding agreement or joint plan with all of the other shareholders of T pursuant to which A acquires 50 percent of the stock of T, and two years thereafter, T will exchange its Y stock with the T shareholders other than A for their T stock in a split-off. Two years thereafter, the exchange occurs.

3. A enters into a binding agreement or joint plan with B pursuant to which each acquires 50 percent of the stock of T, and two years thereafter, A and B will cause T to exchange its X stock with A for T stock in a split-off. Two years thereafter, the exchange occurs.

4. A enters into a binding agreement or joint plan with B pursuant to which each acquires 50 percent of the stock of T, and two years thereafter, A and B will cause T to exchange its Y stock with B for T stock in a split-off. Two years thereafter, the exchange occurs.

5. A enters into a binding agreement or joint plan with B pursuant to which each acquires 50 percent of the

stock of T, and two years thereafter, A and B will cause T to liquidate and distribute its X stock to A and its Y stock to B in a split-up. Two years thereafter, the liquidation occurs.

6. All prior assumptions are the same except that X represents 60 percent, instead of 50 percent, of the value of T. A, pursuant to its own plan of acquisition and distribution, acquires 60 percent of the stock of T. Pursuant to the plan, A will cause T either to exchange its X stock with A for T stock, to exchange T's Y stock with the other shareholders of T for their T stock, or to liquidate and to distribute T's X stock to A and its Y stock to the other shareholders of T in exchange for A and the other shareholders' T stock. Two years thereafter, anyone of these exchanges occurs.

In each of the above examples, the Committee believes that T should be treated as if it had sold its X or Y stock or both and that a corporate-level tax should be imposed on T, irrespective of whether the transaction would otherwise meet the requirements of section 355. In each example, A's binding agreement or joint plan with T, the other shareholders of T or a third person or its plan alone where it has control places it in a position to require T to transfer direct or indirect ownership of X to A.

In each of the above examples, if the exchange occurred more than five years after A's acquisition of its T stock, T still would incur a corporate-level tax if the exchange was pursuant to a binding agreement. However, if the exchange was pursuant to a plan, T would not incur a corporate-level tax if the requirements of section 355 otherwise would be met.

In contrast, the following examples illustrate situations which the Committee believes do not circumvent the repeal of General Utilities and would not be subject to a corporate-level tax under the binding agreement-- plan/five-year holding period approach, assuming that the requirements of section 355 otherwise would be met:

1. A acquires 50 percent of the stock of T with no binding agreement or joint plan existing between A and T or the other shareholders of T. Two years thereafter, T exchanges its X stock with A for A's T stock in a split-off.

2. A acquires 50 percent of the stock of T with no binding agreement or joint plan existing between A and T or the other shareholders of T. Two years thereafter, T exchanges its Y stock with the other shareholders of T for their T stock in a split-off.

3. A acquires 50 percent of the stock of T with no binding agreement or joint plan existing between A and T or

the other shareholders of T. Two years thereafter, T liquidates and distributes its X stock to A for A's T stock and its Y stock to the other shareholders of T for their T stock.

4. A and B pursuant to a binding agreement or a plan contemplating a subsequent distribution acquire 50 percent of the stock of T with no binding agreement or joint plan with T or the other shareholders of T. Two years thereafter, any of the above-described split-off or split-up distributions occur whereby A and B together own directly or indirectly X stock.

5. A acquires 25 percent of the stock of T pursuant to a binding agreement or plan contemplating a subsequent distribution with one other shareholder of T who owns 25 percent of the stock of T. Two years thereafter, any of the above-described split-off or split-up distributions occur whereby A and the other shareholder of T together own directly or indirectly X stock.

6. Pursuant to its own plan of acquisition and distribution, A acquires 50 percent of the stock of T with no binding agreement or joint plan with T, other shareholders of T or a third person. Two years thereafter, any of the above-described split-off or split-up distributions occur whereby A owns directly or indirectly X stock.

D. Prospective vs. Retroactive Application.

An additional issue is the prospective or retroactive application of the section 337(d) regulations. The first relevant question is whether the regulations must apply either retroactively or prospectively. If not, the second relevant question is which approach should the Secretary take.

As to the first question, neither section 337(d) nor the underlying legislative history mandates either a retroactive or prospective application. Absent congressional guidance, the Secretary generally may adopt regulations that apply retroactively. See, e.g., Manhattan General Equipment Co. v. Commissioner, 297 U.S. 129, 135 (1936); Anderson, Clayton & Co. v. United States, 562 F.2d 972, 984 (5th Cir. 1.977). Section 7805(b) actually creates a presumption of retroactive application of a regulation by authorizing the Secretary to prescribe to what extent, if any, a regulation will apply prospectively. Although this provision is a subsection of the section that generally authorizes the Secretary to issue “interpretative” as opposed to “legislative” regulations, the language of section 7805(b) is broad as it applies to “any . . . regulation, relating to the internal revenue laws.” Moreover, no distinction generally has been drawn between interpretative and legislative regulations concerning their retroactivity. See Gehl Co. v. United States, 795 F.2d 1324, 1332 n.9 (7th Cir. 1986); Anderson, Clayton & Co., 562 F.2d at 984. Therefore, the Committee believes that the Secretary has the discretion of applying the section 337(d) regulations retroactively or prospectively.

As to the second question, it clearly would be fairer to taxpayers if the Secretary were to apply the section 337(d) regulations prospectively to transactions where both the binding agreement or plan arises, and the section 355 distribution occurs, after their issuance. General Utilities was a long-standing doctrine on which taxpayers relied. More importantly, there are significant uncertainties as to the types of transactions to which the section 337(d) regulations might or should apply. The statutory language provides no guidance concerning, nor does the legislative history provide any clarification or examples of, transactions that would circumvent the repeal of General Utilities. As such, a retroactive application of the section 337(d) regulations could result in harsh consequences to unsuspecting taxpayers with respect to completed transactions. This is especially true where the stock of the other distributing corporation shareholders remains outstanding after a split-off distribution.

The Service has indicated that it will choose a prospective application. In Notice 89-37, 1989-13 I.R.B. 7, the Service stated that it will promulgate regulations under section 337(d) that would apply to transactions involving partnerships which hold or acquire stock of a corporate partner or an affiliate. The Service will apply these regulations prospectively to transactions occurring after the date of the notice.

Given the uncertainties as to the types of transactions to which the section 337(d) regulations might or should apply and the potentially harsh consequences of a retroactive application, it would be unfair to taxpayers if the regulations applied retroactively. Therefore, consistent with the position in Notice 89-37, the Secretary is urged to treat all section 337(d) regulations as applying prospectively to transactions where both the binding agreement or plan arises, and the section 355 distribution occurs, after their issuance. Current law would apply to all other transactions.

APPENDIX

Distributions Under Section 355

Spin-offs, split-offs, and split-ups are tax-free to a shareholder (absent any boot in the transaction) if they meet the requirements of section 355. Additionally, under section 355(c), they are tax-free to a distributing corporation to the extent that it distributes only stock or securities in a controlled corporation. The following discussion examines the requirements under section 355 with respect to spin-off, split-off, and split-up distributions.

A. Current Requirements.

1. Control. The distributing corporation must own immediately before the distribution at least 80 percent of the total combined voting power of all voting stock and at least 80 percent of the total number of shares of all other classes of stock of the corporation to be distributed. Code §§ 355(a)(1)(A), 368(c).

2. Active Businesses. Both the distributing. corporation and each controlled corporation that is distributed must be engaged in the active conduct of a trade or business immediately after the distribution. Code § 355(b)(1)(A). Alternatively, if the section 355 distribution is a split-up, the distributing corporation must have owned no assets other than

stock of the controlled corporations immediately before the distribution, and each controlled corporation must be actively conducting a trade or business immediately after the distribution. Code § 355(b)(1)(B). Thus, under either alternative, section 355 requires the continuation of the predistribution business or businesses. Treas. Reg. § 1.355-l(b). Accordingly, this requirement generally prevents the separation of liquid assets into a controlled corporation, which then could be distributed to a shareholder who would sell the controlled corporation in an attempt to convert ordinary income into capital gain.

A corporation will be considered to be engaged in the active conduct of a trade or business if it is so engaged or substantially all of its assets are stock and securities of a controlled corporation that is so engaged. Code § 355(b)(2)(A). A trade or business is a group of activities that involves every operation toward the earning of income or profit, including the collection of income and the payment of expenses. Treas. Reg. § 1.355-3(b)(2). However, it does not include the holding of assets for investment purposes or the ownership or operation of trade or business property unless the taxpayer performs significant services with respect to such property. Treas. Reg. § 1.355-3(b)(2)(iv). As to this latter point, for example, the leasing of real estate pursuant to a triple-net lease (i.e., the lessee pays taxes, insurance and repairs or maintenance) would not be the performance of significant services. Treas. Reg, § 1. 355-3(c) ex. 13.

Generally, the performance of substantial services focuses on the active conduct of the trade or business. Whether a corporation is actively conducting a trade or business will depend on all facts and circumstances, but it assumes that the corporation will perform active and substantial management and operational functions. Treas. Reg. § 1.355-3(b)(2)(iii). Although the corporation cannot rely on the activities of outsiders to satisfy this test, such activities will not disqualify the corporation as long as it otherwise performs substantial functions. Id. The Treasury regulations also warn that the separation of real property occupied prior to the distribution by the distributing or controlled corporation from other trade or business assets will receive special scrutiny. Id.

The trade or business must have been actively conducted during the five-year period that ends on the date of distribution. Code § 355(b)(2)(B). Additionally, the trade or business could not have been acquired during such five-year period in a taxable transaction. Code § 355(b)(2)(C). Moreover, as to corporate distributees only, they could not have acquired direct or indirect control of the controlled corporation during such five-year period in a taxable transaction. Code § 355(b)(2)(D). Normal business expansion, contractions, or other changes during the five-year period will not violate this requirement as long as such changes are not to the degree to constitute a new trade or business. Treas. Reg. § 1.355-3(b)(3)(ii). Consistent with the rationale for the active business requirement overall, the five-year period requirement prevents a corporation's use of its earnings and profits to acquire a new trade or business, which it then distributes to its shareholders. If this transaction were allowed, it effectively would be a means by which the corporation could distribute earnings and profits to its shareholders without the receipt of a dividend by the shareholders. If the distributing corporation acquired stock of a controlled corporation in a taxable transaction during the five-year period, then such stock will be treated as other property for purposes of determining the amount of gain, if any, to be recognized because of the receipt of such stock. Code § 355(a)(3)(B).

3. Continuity of Interest. Because a section 355 distribution is viewed as a readjustment of an existing business, one or more persons who directly or indirectly owned the business prior to the distribution must own together stock that establishes a continuity of interest in each corporation after the distribution. Treas. Reg. § 1.355-2(c)(1). Based on the examples provided in the Treasury regulations, a 50-percent interest by one or more of the former shareholders in a corporation will satisfy the requirement, while a 20-percent interest will not. See Treas. Reg. § 1.355-2(c)(2) exs. 2, 4. The Treasury regulations do not state whether a 50-percent continuity

of interest is the minimum, although this threshold is generally the Service's ruling position with respect to reorganizations. See Rev. Proc. 77-37, 1977-2 C.B. 568.

4. Business Purpose. A section 355 distribution must have a corporate business purpose. If a section 355 distribution is motivated, at least substantially, by one or more corporate business purposes, it satisfies this requirement. Treas. Reg. § 1.355-2(b)(1). A "corporate business purpose" is defined as "a real and substantial non Federal tax purpose germane to the business of the distributing corporation, the controlled corporation, or the affiliated group ... to which the distributing corporation belongs." Treas. Reg. § 1.355-2(b)(2). However, the potential for federal income tax avoidance will also be considered in determining whether the distribution is motivated, at least substantially, by corporate business purposes. Treas. Reg. § 1.355-2(b)(1), (2). Moreover, a shareholder business purpose generally will not be a valid corporate business purpose. Treas. Reg. § 1.355-2(b)(2).

The distribution also must be carried out for a corporate business purpose. If another nontaxable transaction, which would not require the distribution of the controlled corporation, would accomplish the corporate business purpose without being impractical or unduly expensive, then the distribution does not have a corporate business purpose. Treas. Reg. § 1.355-2(b)(3).

The Treasury regulations add that the presence of a corporate business purpose or purposes for the distribution supports a determination that the distribution is not principally a device for the distribution of earnings and profits, which is another requirement concerning section 355 distributions. Treas. Reg. § 1.355-2(b)(4).

The Treasury regulations do not expressly list acceptable corporate business purposes for a section 355 distribution. However, the examples set forth in section 1.355-2(b)(5) of the Treasury regulations do provide some guidance as to what may be an acceptable corporate business purpose. Additionally, the courts and the Service have approved a variety of corporate business purposes.[1] At least as to private letter rulings, it is understood that, if the taxpayer cannot assert one of these traditional corporate business purposes as the business purpose for its distribution, the Service will not issue a favorable ruling.

It is in this context that the question arises whether the separation of two corporations and/or active businesses through a section 355 distribution to make each corporation or business more attractive as a takeover target and, thereby, to enhance shareholder value would be a valid corporate business

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[1] See Kaden & Wolfe, Spin-offs, Split-offs, and Split-ups: A Detailed Analysis of Section 355, 44 Tax Notes 565, 584 (1989) (setting forth a list of commonly approved business purposes).

purpose. Although the Service has not accepted the enhancement of shareholder value as a good business purpose, there does not seem to be any tax policy reason why it should not be a good corporate business purpose. Indeed, any board of directors of a public corporation which did not have as its primary goal the long-range enhancement of shareholder value would not be fulfilling its legal responsibilities under corporate law. However, there is tension between the use of section 355 to facilitate a sale of one corporation or business to a third party and the repeal of General Utilities.

The second example in section 1,355-2(b)(5) of the Treasury regulations involves the enhancement of shareholder value as a corporate business purpose. The example concerns a corporation with two unrelated businesses. One business was transferred to a new corporation, and the stock of the new corporation was distributed to one shareholder in a split-off. The business purpose was to enhance the operations of; each business, based on each shafeholder’s ability to devote his full attention to the business in which he had a greater interest and proficiency. The example concludes that, although the distribution has partially a shareholder business purpose, it is carried out for a corporate business purpose.

The example is support for the view that the enhancement of shareholder value through the enhancement of business operations is a valid corporate business purpose. However, the example also is distinguishable in that each shareholder continued one of the separate businesses. Neither business was sold to a third party, and thus, no possible conflict with the repeal of General Utilities could occur in the example.

The Service also has recognized the validity of a section 355 distribution of an unwanted subsidiary or business to make a corporation more attractive to an acquiror, as part of a tax-free reorganization. See, e.g., Rev. Rul. 86-125, 1986-2 C.B. 57; Rev. Rul. 78-251, 1978-1 C.B. 89. As such, it may be that a section 355 distribution to enhance the value of each corporation as a takeover target would be acceptable. However, if the subsequent transaction is taxable, such as a sale of the distributing or controlled corporation, the section 355 distribution likely will be viewed as violating the device factor. See, e.g., Rev. Rul. 55-103, 1955-1 C.B. 31.

The Service likely will accept the enhancement of shareholder value as a valid corporate business purpose only where it is being done as a defensive measure to avoid or to discourage a takeover. The Service has expressed its concern privately that the enhancement of shareholder value is too easy to assert and too difficult to disprove as a corporate business purpose. It feels that, because it can be stated as a purpose for most, if not all, transactions, to allow it as an acceptable corporate business purpose effectively would eliminate business purpose as a separate requirement for a section 355 distribution.

5. Device for Distribution of Earnings and Profits. The section 355 distribution cannot be principally a device for the distribution of earnings and profits of either the distributing or controlled corporations. Code § 355(a)(1)(B). The determination of whether a section 355 distribution is principally a device for the distribution of earnings and profits will depend on all facts and circumstances surrounding the transaction. Treas. Reg. § 1.355-2(d)(1). The Treasury regulations set forth factors to be examined with regard to determining whether the section 355 distribution is a device.[2]

a. Pro rata distribution. A pro rata or substantially pro rata distribution is evidence of a device because it has the greatest potential and the most likely use as a means to avoid

[2] Although the discussion of the device factor in the Treasury regulations is drafted neutrally so as to apply to spin-offs, split-offs, and split-ups, it is most applicable to spin-offs. Section 1.355-2(d)(5)(iv) of the Treasury regulations provides that a distribution ordinarily will not be viewed as evidence of a device if, absent section 355, section 302(a) would have applied to each shareholder distributee. In a split-off or split-up, section 302(a) often may apply to each shareholder distributee, and thus, such distributions ordinarily will not be viewed as evidence of a device.

the dividend provisions of the Code. Treas. Reg. § 1.355-2(d)(2)(ii). Because split-offs and split-ups are non-pro rata distributions, this factor will not apply to these types of section 355 distributions.

b. Subsequent Sale or Exchange. A subsequent sale or exchange of stock of the distributing or the controlled corporation is evidence of a device, which becomes more persuasive based on either the greater the percentage of stock that is sold or exchanged or the shorter the period of time between the distribution and the sale or exchange. Treas. Reg. § 1.355-2(d)(2)(iii)(A). The Treasury regulations distinguish between a subsequent sale or exchange that was negotiated or agreed upon before the distribution and one that was not. If the sale or exchange is pursuant to an arrangement that was negotiated or agreed upon prior to the distribution, it is substantial evidence of a device. Treas. Reg. § 1.355-2(d)(2)(iii)(B). If the sale or exchange is not pursuant to an arrangement negotiated or agreed upon prior to the distribution, it is still evidence of a device. Treas. Reg. § 1.355-2(d)(2)(iii)(C). However, if a subsequent exchange is pursuant to a reorganization in which no gain or loss, or only an insubstantial amount of gain, is recognized, the exchange is not treated as a subsequent exchange. Treas. Reg. § 1.355-2(d)(2)(iii)(E).

The Treasury regulations describe the situations in which an arrangement will have been negotiated or agreed upon before a distribution. If enforceable rights to buy and sell existed before the distribution, a subsequent sale or exchange always will be pursuant to a negotiated or agreed-upon arrangement. If the parties discussed and reasonably anticipated a subsequent sale or exchange, the subsequent sale or exchange ordinarily will be considered to be pursuant to a negotiated or agreed-upon arrangement. Treas. Reg. § 1.355-2(d)(2)(iii)(D).

The regulations do not discuss what is reasonable anticipation of a subsequent sale or exchange. It would seem to address the extent of the discussions between the parties. If the parties had explored the possibility of a sale or exchange but had not discussed preliminarily specific terms of the sale or exchange, then it would seem questionable whether they reasonably had anticipated a subsequent sale or exchange. In contrast, if the parties had discussed a possible sale or exchange and also had discussed terms of the sale or exchange, then it would seem more likely that the parties had a reasonable anticipation of a subsequent sale or exchange. However, the difference under the Treasury regulations between what is and is not reasonable anticipation of a subsequent sale or exchange is an open question.

There are additional open questions as to a subsequent sale or exchange. One question is the inference to be drawn if the distributing corporation had discussions with a potential buyer prior to the distribution and the parties reasonably anticipated the sale or exchange, but it actually occurs to another, unrelated buyer. The subsequent sale or exchange would not be pursuant to a negotiated or agreed-upon arrangement and, thus, would not be substantial evidence of a device. However, under the Treasury regulations, it still would be evidence of a device.

How persuasive should this type of evidence of a device be? On the one hand, once the original parties' negotiations had terminated, it became uncertain whether a subsequent sale or exchange would occur or whether another potential buyer could be found. On the other hand, the relevant focus of the device factor should be on the intent of the distributing corporation rather than the parties' joint intent. As a result, although the original negotiations had terminated, the fact that the distributing corporation was involved in them may be viewed as strong evidence that the distributing corporation used the distribution as a device to distribute its earnings and profits.

What if the distributing corporation distributes the controlled corporation with the expectation that there are one or more potential buyers for the controlled corporation? In this situation, the distributing corporation clearly does not have a negotiated or agreed-upon arrangement to sell or exchange, or even the probability of one, at the time of the distribution. Again though, the fact that a subsequent sale or exchange would occur still would make it evidence of a device at the time of the distribution under the Treasury regulations. This situation though clearly does not seem to be as persuasive as the previously discussed situation. After the distribution, the management and the board of directors of the controlled corporation may offer the controlled corporation for sale or exchange, resist any proposed takeover, or simply continue the business of running the corporation. The distributing corporation may no longer be a factor in any subsequent takeover situation. Moreover, when a controlled corporation is distributed, there is always the possibility that it will become a more attractive acquisition target at that time even if the distributing corporation did not have this purpose for the distribution. Thus, it would be difficult to identify when a corporation had this purpose for the distribution.

A third question concerns the distributing corporation's receipt of, as part of the distribution, an indemnity from the controlled corporation from any tax on the distribution that may arise because of a subsequent sale or exchange. More frequently in recent distributions, distributing corporations have been receiving this kind of indemnification. It is unclear whether an indemnification itself should be viewed as evidence of an intent to sell or exchange the controlled corporation. However, it seems more likely that an indemnification is a defensive mechanism to avoid or to discourage a takeover by increasing the cost of acquiring the controlled corporation.

It should be noted that the section 355 Treasury regulations, in discussing the device factor, focus on the situation where the sale or exchange is subsequent to the distribution (i.e., the classic spin-off situation). They do not address in the discussion of this factor the situation where an acquiring corporation acquires stock of a target corporation and, pursuant to a negotiated or prearranged plan or prior discussions, the distributing corporation subsequently distributes the controlled corporation to the acquiring corporation in a section 355 distribution. The silence of the Treasury regulations in this regard suggests that the device factor may not be relevant to acquisitions of stock of the distributing corporation, followed by a distribution of the controlled corporation to the acquiring corporation.

c. Nature and Use of Assets. If the distributing corporation or the controlled corporation has assets that are not used in a trade or business and that are not related to the reasonable needs of the trade or business, it is evidence of a device. Treas. Reg. § 1.355-2(d)(2)(iv)(B). Again, this analysis is based on all facts and circumstances. Id. In either a split-off or a split-up, the fact that the ratio of such assets to trade or business assets varies between the distributing and the controlled corporations is not evidence of a device to the extent that it was done to equalize the values between the two corporations. Id.

Additionally, if the trade or business of either the distributing or the controlled corporation is a "secondary business" that continues as such for a significant period of time after the distribution and could have been sold without adversely affecting the business as a whole, there is evidence of a device. Treas. Reg. § 1.355-2(d)(2)(iv)(C). A "secondary business" is a business the principal purpose of which is to serve the other corporation, such as the providing of property or the performing of services. Id.

d. Corporate Business Purpose. As stated above, the corporate business purpose or purposes of the section 355 distribution are evidence that the distribution is not a device. Treas. Reg. § 1.355-2(d)(3)(ii). The strength of the corporate business purpose or purposes to counter other evidence of a device will depend on all facts and circumstances, including (i) the importance of the purpose or purposes to the success of the trade or business, (ii) the extent to which external factors encourage the transaction, and (iii) the immediacy of the conditions that encourage the transaction. Id.

e. Public Corporation. If the corporation is publicly traded with no shareholder who beneficially owns more than 5 percent of any class of stock, this fact is evidence that the distribution is not a device. Treas. Reg. § 1.355-2(d)(3)(iii).

f. Domestic Corporate Shareholders. If a domestic corporate shareholder receives the controlled corporation, the fact that it would otherwise, be entitled to a dividends received deduction is evidence that the distribution is not a device. Treas. Reg. § 1.355-2d)(3)(iv).

In addition to the above factors to be considered, there are three types of transactions that are ordinarily considered not to be a device, regardless of the presence of factors that indicate a device, These transactions are where:(i) neither the distributing nor the controlled corporation has either accumulated or current earnings and profits (including earnings and profits deemed to result from the transaction); (ii) section 303(a) otherwise would apply to each shareholder distributee; or (iii) section 302(a) otherwise would apply to each shareholder distributee. Treas. Reg. § 1.355-2(d)(5). This provision will not apply to the latter two types of distributions if the distribution “involves the distribution of the stock of more than one controlled corporation and facilitates the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation.” Treas. Reg. § 1.355-2(d)(5)(i). As noted previously, the provision regarding what otherwise would be a section 302(a) distribution often may apply to split-offs and split-ups.

It is unclear what the intent of the language “facilitates the avoidance of the dividend provisions of the Code” in section 1.355-2(d)(5)(i) of the Treasury regulations is. Assuming a distribution to a shareholder distribute to which section 302(a) would apply, if one of the two controlled corporations to be distributed were sold by the distributing corporation and the sales proceeds were distributed to such shareholder distributee along with the other controlled corporation, section 302(a), rather than section 301, still would apply to the distribution. Thus, it is unclear how the timing of the distribution and sale of one of the controlled corporations “facilitates the avoidance of the dividend provisions of the Code.” It appears more likely that the timing of the distribution and sale of one of the controlled corporations affects whether the distributing corporation would incur a corporate-level tax.

B. Two-Year Holding Period — Historical Shareholder.

As discussed in the preceding section, section 355 imposes a continuity of interest requirement with respect to the distributee shareholder. This requirement ensures that an acquiring corporation cannot distribute its accumulated earnings through the acquisition of a target corporation and the distribution of the target corporation to the acquiring corporation shareholders by means of a section 355 distribution. If the acquiring corporation were able to do so, a subsequent sale of the target corporation by the acquiring corporation shareholders effectively would convert dividend income into capital gains.

However, prior to the Revenue Act of 1987, an acquiring corporation could acquire control of a distributing corporation in a taxable transaction. The distributing corporation then could distribute a controlled corporation to the acquiring corporation in a section 355 distribution. Pursuant to then section 355, the distribution was not taxable, even though five years had not passed since the taxable acquisition, because the acquiring corporation was neither the distributing corporation nor the controlled corporation. Accordingly, the five-year holding period requirement of then section 355(b)(2)(D) did not apply. See code § 355(b)(2)(D)(1986).

The Service expressly had ruled that the above-described transaction would not be subject to the five-year holding period requirement. Rev. Rul. 74-5, 1974-1 C.B. 82. As the basis of its ruling, the Service reasoned that the transaction was not abusive as the acquiring corporation could not distribute its accumulated earnings to its shareholders through the acquisition and distribution of another corporation as the distribution was to the acquiring corporation. In the ruling, the Service stated that the acquiring corporation had acquired the stock in 1969 and that the distribution occurred in 1971. These facts were the foundation for the position by taxpayers that they would be deemed to be historical shareholders of the distributing corporation and to satisfy the continuity-of-interest requirement if they had held stock of the distributing corporation for at least two years prior to a distribution.

In the Revenue Act of 1987, Congress amended section 355(b)(2)(D), and it made technical corrections to the 1987 amendments in the Technical and Miscellaneous Revenue Act of 1988. Section 355(b)(2)(D) currently provides that control of the distributing corporation or controlled corporation cannot be acquired in a taxable transaction by the acquiring corporation “directly (or through one or more corporations, whether through the distributing corporation or otherwise)” during the five-year period preceding the distribution. The same rule applies to the distributing corporation's acquisition of direct or indirect control of the controlled corporation. Code § 355(b)(2)(D).[3]

In enacting these amendments to section 355(b)(2)(D), Congress stated:

> Under the conference agreement, in addition to the requirements of present law, section 355 does not apply to any distribution by a corporation if control of the distributing corporation was acquired by a corporate distributee within five years prior to the distribution.

H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 969 (1987).

Thus, under current law, where an acquiring corporation acquires control of a distributing corporation in a taxable transaction, the distributing corporation clearly cannot distribute a controlled corporation to the acquiring corporation two years after the acquisition in a tax-free section 355 distribution. To acknowledge this change in the law, the Service recently declared obsolete the portion of Revenue Ruling 74-5 that discussed the distribution of the controlled corporation to the acquiring corporation. Rev. Rul. 89-37, 1989-11 I.R.B. 4.

However, if the acquiring corporation does not acquire control of the distributing corporation because it does not

[3] Section 355(b)(2)(D) applies only to corporate distributees and not to noncorporate distributees. As such, individuals and partnerships, among other types of noncorporate taxpayers, who acquire direct or indirect - control of the controlled corporation will not be subject to the five-year holding period before nontaxable distribution may occur.

acquire at least 80 percent of the total combined voting power of all classes of stock of the distributing corporation entitled to vote and at least 80 percent of the total number of shares of all other stock of the distributing corporation, then section 355(b)(2)(D) will not apply. Accordingly, there would be no statutory requirement that five years must pass for a section 355 distribution to be nontaxable.

Although the five-year time period would not apply, the regulatory requirement regarding continuity of interest would apply. However, section 1.355-2(c)(1) of the Treasury regulations, which sets forth the continuity-of-interest requirement, does not state any specific time period that a person must have owned the stock of the controlled corporation in order to be considered to be one of “the owners of the enterprise prior to the distribution or exchange.”

Additionally, it should be noted that, because the Treasury regulations require the historical shareholder to maintain a continuing interest in each corporation following a section 355 distribution, an acquisition of stock of a distributing corporation followed by an immediate split-off distribution, where the other distributing corporation shareholders did not retain probably at least a 40 percent interest in each corporation, would violate continuity of interest.