NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON PROPOSED REGULATIONS REGARDING THE ACTIVE TRADE OR BUSINESS REQUIREMENT UNDER SECTION 355(b)

January 11, 2008

TABLE OF CONTENTS

Report No. 1142

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON PROPOSED REGULATIONS REGARDING THE ACTIVE TRADE OR BUSINESS REQUIREMENT UNDER SECTION 355(b)[1]

I. INTRODUCTION

This report (the "Report") of the New York State Bar Association Tax Section (the "NYSBA Tax Section") comments on Proposed Regulations issued by the Internal Revenue Service (the "IRS") and the U.S. Department of Treasury ("Treasury") under Section 355(b)[2] (the "Proposed Regulations").[3] The Proposed Regulations, *inter alia*, provide guidance regarding the active trade or business requirement of Section 355(b), including guidance necessitated by the enactment of Section 355(b)(3).[4]

Section 355 provides, generally, that a corporation may distribute stock and securities of a corporation it "controls" (as defined in Section 368(c), "Section 368(c) control") to its shareholders and security holders without causing either the distributing corporation ("Distributing") or its shareholders and security holders to recognize income, gain or loss.

---

[1] The principal drafter of this Report was Jodi Schwartz, with able assistance from Vinay Shandal. Helpful comments were received from Neil J. Barr, Kathleen L. Ferrell, Patrick Gallagher, Vincent G. Kalafat, David J. Passey, Deborah L. Paul, Michael Schler, T. Eiko Stange, Linda Swartz and Willard Taylor.

[2] Except as otherwise noted, "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and references to Regulations are to the Treasury Regulations promulgated thereunder.

[3] Prop. Treas. Reg. Section 1.355-3, 72 Fed. Reg. 26,012 (May 8, 2007).

[4] Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. 109-222, 120 Stat. 345 (2006) ("TIPRA").

Sections 355(a)(1)(C) and 355(b)(1) generally require that Distributing and the controlled corporation ("Controlled") each be engaged, immediately after the distribution, in the active conduct of a trade or business.

As a result of the addition of Section 355(b)(3) by TIPRA, as amended by the Tax Technical Corrections Act of 2007 (the "Technical Corrections Act"),[5] in the case of any distribution made after May 17, 2006, a corporation will be treated as meeting the requirement of Section 355(b)(2)(A) (that is, being engaged in the active conduct of a trade or business) if all members of such corporation's separate affiliated group ("SAG"), viewed together as a single corporation, are engaged in the active conduct of a trade or business. Section 355(b)(3)(B) defines a corporation's SAG as the affiliated group determined under Section 1504(a) as if such corporation were the common parent and Section 1504(b) did not apply ("Section 1504(a) affiliation"). Thus, the separate affiliated group of Distributing ("DSAG") is the affiliated group that consists of Distributing as the common parent and all corporations affiliated with Distributing through stock ownership described in Section 1504(a)(1)(B) (whether or not the corporations are includible corporations under Section 1504(b)). The separate affiliated group of Controlled ("CSAG") is determined in a similar manner (treating Controlled as the common parent).

We commend the IRS and Treasury for their comprehensive review of the active trade or business regulations. The existing Treasury Regulations are outdated as they do not reflect statutory changes since 1987[6] and important portions that have expired continue to be

---

[5] Pub. L. No. 110-72.

[6] Tax Relief and Health Care Act of 2006, Pub. L. 109-432, 120 Stat. 2922; TIPRA; Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685; Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788; Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388; Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342.

relied upon by taxpayers.[7] Of course, a substantial revision of the Treasury Regulations had to be undertaken to properly implement new Section 355(b)(3) and to reflect the impact of the TIPRA changes insofar as they rendered obsolete the holding company test of Section 355(b)(1)(B) (and removed references to the holding company test in Section 355(b)(2)(A)) and affected the interpretation of Sections 355(b)(1) and (2) generally.[8] Moreover, in light of both TIPRA and certain administrative developments, the Treasury Regulations needed to be revised to reflect current IRS thinking on the so-called "expansion doctrine."[9] Furthermore, significant updates to the Treasury Regulations were needed by virtue of the increased use and importance in corporate groups of partnerships and limited liability companies and the significant administrative developments of the applicable law through Revenue Rulings[10] and changes in other areas of the Treasury Regulations.[11]

II. SUMMARY OF RECOMMENDATIONS

The IRS and Treasury have undertaken the formidable task of reflecting in the Proposed Regulations both the policy objectives underlying TIPRA's introduction of Section 355(b)(3) — namely reducing the myriad internal restructurings corporate groups typically undertook to bring elements of the relevant active trade or business into the right corporate entities, and resolving many open issues in the definition of "active trade or business."

There are, however, certain areas where further clarification would be helpful.

---

7 *See* Treas. Reg. Section 1.355-3(b)(4).

8 *See* Technical Corrections Act.

9 Rev. Rul. 2003-38, 2003-1 C.B. 811 (retail shoe business created an online shoe business and this was considered an expansion); Rev. Rul. 2003-18, 2003-1 C.B. 467 (car dealer's acquisition of a different vehicle brand was considered an expansion).

10 Rev. Rul. 2007-42, 2007-28 I.R.B. 44; Rev. Rul. 2002-49, 2002-2 C.B. 288; Rev. Rul. 92-17, 1992-1 C.B. 142.

11 *See, e.g.*, Treas. Reg. Section 1.368-1(d).

1. Interaction Between "Control" Requirement and Affiliation Requirement

The Proposed Regulations correctly, we believe, interpret Section 355(b)(3)(A) as effectively repealing the holding company test of Section 355(b). However, "control" is still a concept used in Section 355, and Sections 355(b)(1)(A) and 355(b)(2)(D) still refer to the holding company test. Accordingly, a few additional examples illustrating the interaction between the "control" requirement for a tax-free spin-off and the Section 1504(a) affiliation requirement for a corporation to be included in the SAG would be helpful.

Where Distributing has Section 1504(a) affiliation with a potential Controlled and subsequently, within the five-year period ending on the date of the distribution (the "pre-distribution period"), purchases the remaining Controlled stock (thereby acquiring Section 368(c) control of Controlled), it is not apparent, from the wording of the statute, that Section 355(b)(2)(D) is not violated. Although Section 355(b)(3)(D) authorizes Treasury to prescribe regulations that "provide for the proper application" of Section 355(b)(2)(B), (C) and (D), the Proposed Regulations narrow substantially the application of Section 355(b)(2)(D), and we would recommend reconsidering this approach.

For a taxpayer that obtained Section 368(c) control but not Section 1504(a) affiliation of a potential Controlled in completely tax-free transactions, Notice 2007-60 provides that such taxpayer could make a taxable purchase of the remaining Controlled shares without violating Section 355(b)(2)(C), provided, *inter alia*, the distribution is effected on or before the date the Proposed Regulations are published as final regulations in the Federal Register.[12] In light of the Technical Corrections Act's addition of Section 355(b)(3)(C) after the publication of

[12] Notice 2007-60, 2007-35 I.R.B. 466.

the Notice, the IRS should clarify that Notice 2007-60 remains valid.[13] We recommend further that the final or temporary Treasury Regulations include a rule excepting a taxpayer's purchase of shares of a potential Controlled where such purchase (rather than the distribution) occurs after the date Section 368(c) control is reached and before the date the Proposed Regulations were issued.

The final or temporary Treasury Regulations should contain an example confirming that taxpayers with both Section 368(c) control and Section 1504(a) affiliation of a potential Controlled do not run afoul of Sections 355(b)(2)(C) and (D) by virtue of a subsequent disaffiliation of Controlled through, for example, a stock issuance by Controlled to the public.

2. Transaction in Which No Gain or Loss Is Recognized

The Proposed Regulations set forth a framework that substantially revises the commonly understood meaning of the requirement that any acquisition of active trade or business assets or stock of a corporation engaged in an active trade or business be in a transaction in which "no gain or loss is recognized." These revisions are proposed in light of the TIPRA revisions and the policies of Section 355(b). We do not believe that Congress, despite permitting Treasury to prescribe regulations to "carry out the purposes" of Section 355(b), authorized the IRS and Treasury to depart so substantially from the language of the statute in this context. We do believe, however, that the IRS and Treasury have authority to interpret reasonably the words "no gain or loss is recognized." With this background, our comments focus on the specific policy rationales underlying each of the various exceptions found in the Proposed Regulations.

---

[13] Section 355(b)(3)(C) provides that if a corporation became a SAG member in a transaction or transactions in which gain or loss was recognized in whole or in part, then any trade or business conducted by such corporation (at the time that such corporation became such a member) is treated for purposes of Section 355(b)(2) as acquired in a transaction in which gain or loss was recognized.

We believe it is reasonable to treat certain transactions in which gain or loss is recognized as being consistent with Section 355(b) and, as discussed below, certain transactions in which gain or loss is not recognized as being inconsistent with Section 355(b). Specifically, we believe it is a reasonable interpretation of the statutory language to treat the following transactions in which gain or loss is recognized as being consistent with Section 355(b): (i) an acquisition by the CSAG from the DSAG of a trade or business; (ii) an acquisition solely as a result of the payment of cash to shareholders for fractional shares where the cash paid represents a mere rounding off of the fractional shares in the exchange and is not separately bargained for consideration; and (iii) an acquisition between SAG members.[14]

By contrast, we do not believe that a direct or indirect acquisition by a subsidiary, owned directly or indirectly by a SAG (including the DSAG's ownership of Controlled and any other subsidiary SAG member), of a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business, in each case from a person not included in the SAG in exchange for such subsidiary's stock should be treated as transactions in which gain or loss is recognized for purposes of Section 355(b) simply because assets of the SAG are used to make the acquisition.[15]

We do agree, however, that the acquisition by the DSAG or the CSAG of an interest in an otherwise qualifying business through a tax-free Section 351 or 721 transaction (whether through the DSAG's or CSAG's contribution of non-five-year business assets, or as a result of their contribution of a good five-year business which is subsequently disposed of by the

---

[14] *See infra* Section V for a discussion of the expansion doctrine, another exception.

[15] Prop. Treas. Reg. Section 1.355-3(b)(4)(iv)(E).

transferee) should be treated, with respect to any business not previously conducted by that SAG, as a transaction in which gain or loss is recognized for purposes of Section 355(b).[16]

In addition, we recommend that the final or temporary Treasury Regulations:

- Include an exception permitting Controlled to use its stock to acquire an affiliate that is not a member of the DSAG or the CSAG (if, contrary to our recommendation, the rule prohibiting acquisitions using subsidiary stock is preserved in the final or temporary Treasury Regulations).

- Confirm that the assumption of liabilities in excess of basis in a consolidated group, where, for example, an active trade or business is contributed to Distributing, is not a transaction in which "gain or loss is recognized" by virtue of the consolidated return regulations which make Section 357(c) inapplicable.[17]

- Continue to treat Section 304(a)(1) transactions as fundamentally taxable sales, notwithstanding the Code's re-characterization of the transferor as receiving a dividend.

- Provide that a transaction in which Section 367(a) denies corporate status to a foreign corporation (*e.g.*, an acquisition taxable to all of the selling shareholders under the Helen of Troy regulations[18]) is not one in which "no gain or loss" is recognized.

- Provide that an otherwise tax-free transaction (i) in which certain shareholders (perhaps below a specified ownership threshold) in a widely held public company recognize gain under Section 367(a) by virtue of their failure to enter into gain recognition agreements (or by reason of a subsequent triggering of such gain recognition agreements) or (ii) in which selling shareholders are required to include an amount in income under the Section

---

16 Preamble to REG-123365-03 (the "Preamble"), Section C.3.b.i.

17 Treas. Reg. Section 1.1502-80(d).

18 Treas. Reg. Section 1.367(a)-3(c).

367(b) regulations (*e.g.*, "all E&P" amount or gain) should be treated as a transaction in which gain or loss is not recognized.

- Not except from Sections 355(b)(2)(C) or (D) a fully taxable transaction merely because the consideration is acquiror stock.

- In the case of redemptions, treat payments to dissenters which do not impact "solely for voting stock" or otherwise constitute consideration from the acquirer as not causing a tax-free reorganization to be a transaction in which gain or loss is recognized.[19]

3. Additional Recommendations

In the expansion doctrine context, the final or temporary Treasury Regulations should provide an example that clarifies how soon after an expansion, by virtue of a taxable purchase of stock or assets, the acquired business could qualify as the sole active business of Controlled.

In the "hot stock" context, a general exception for stock acquired pursuant to taxable transactions that do not violate the requirements of Section 355(b) is not recommended, except for internal restructurings (transfers within the SAG or between the DSAG and the CSAG) or rules of convenience (allowing cash in lieu of fractional shares to be ignored).

The final or temporary Treasury Regulations should expand Notice 2007-60[20] and provide a transitional rule permitting taxpayers that have announced (and not merely completed) a spin-off before the promulgation of the final or temporary Treasury Regulations to rely on Treasury Regulation Section 1.355-3(b)(4)(iii), thus permitting reliance on stock or asset purchases from members of the same affiliated group.

---

[19] *See, e.g.*, Rev. Rul. 73-102, 1973-1 C.B. 186; Rev. Rul. 68-285, 1968-1 C.B. 147.

[20] Notice 2007-60, 2007-35 I.R.B. 466.

Finally, we recommend that section 4.03 (Information Concerning the Businesses of Distributing and Controlled) of Rev. Proc. 96-30, as modified by Rev. Proc. 2003-48, be updated as promptly as practicable to reflect TIPRA, the Technical Corrections Act and the final or temporary Treasury Regulations.[21]

III. IMPACT OF TIPRA

The enactment of TIPRA reflected Congressional concern about the Byzantine restructurings that corporate groups often needed to undergo to satisfy the active trade or business requirements of Section 355(b)(1).[22] As a result of TIPRA and the Technical Corrections Act, Section 355(b)(1) now requires that Distributing and Controlled each be engaged, immediately after the distribution, in the active conduct of a trade or business. Section 355(b)(2)(A) provides that a corporation shall be treated as so engaged if such corporation and its SAG, when viewed as a single corporation (*i.e.*, the DSAG or the CSAG, as appropriate), is engaged in the active conduct of a trade or business. The old rule provided that to be treated as engaged in the active conduct of a trade or business, either (i) Distributing or Controlled, as appropriate, and not merely any member of its affiliated group, had to be engaged in the active conduct of a trade or business or (ii) substantially all of Distributing's or Controlled's, as appropriate, assets had to consist of stock and securities of a corporation of which it had Section 368(c) control (immediately after the distribution) and which was so engaged. To fit in one of these two categories, corporations had to place active businesses in the right corporate entities, which often required innumerable internal transfers, drop-downs, liquidations, mergers, and spin-offs. This was the case even where the corporate groups had two — or more — obviously good

---

[21] Rev. Proc. 2003-48, 2003-6 C.B. 86.

[22] H.R. REP. NO. 109-304, at 53-54 (2005).

active businesses. Congress, by treating an SAG as one corporation, clearly intended to reduce the need for such internal restructurings which served no substantive tax policy purpose.

1. Interaction Between "Control" Requirement and "Affiliation" Requirement

We recognize that integrating, within the framework of Section 355, Congressional intent to reduce restructuring does necessitate some thought and perhaps extrapolation, especially given the addition of a consolidation-based definition to a statute which still relies heavily on Section 368(c) control. It is not clear, however, that, in enacting Section 355(b)(3), Congress intended to change substantially the interpretation of Section 355(b)(2).

The Proposed Regulations, we believe, correctly interpret Section 355(b)(3)(A) as effectively repealing the holding company test of Section 355(b), especially in light of the Technical Corrections Act by virtue of which Section 355(b)(3) no longer provides that a corporation is engaged in the active conduct of a trade or business by reference to the holding company test. [23] However, "control" is still a concept used in Section 355, and Sections 355(b)(1)(B) and 355(b)(2)(D) still refer to the holding company test. As such, a few additional examples regarding the interaction of these two concepts might be helpful.

By way of illustration, it would be useful to add a specific example to the Regulations of a Distributing the sole assets of which are two subsidiaries, each directly engaged in a good five-year active trade or business, where Subsidiary 1 is affiliated and controlled (within the meaning of Section 368(c)) and Subsidiary 2 is controlled but not affiliated. The example would describe the results where Subsidiary 2 is spun off (good spin-off) or Subsidiary 1 is spun off (bad spin-off because Subsidiary 2 is not in the DSAG, which means Distributing is not engaged in an active trade or business). A further example could describe the results where

[23] Prop. Treas. Reg. Section 1.355-3(b)(1)(i).

Subsidiaries 1 and 2 are affiliated but not controlled (clarifying that TIPRA does not affect the basic requirement of the distribution of control).

The Proposed Regulations treat the SAG concept as applying to the pre-distribution period, allowing a five-year history to accumulate by considering the functions performed by all members of the SAG.[24] This is consistent with Section 355(b)(3)(A) and, in our experience, with both past ruling practice, which allowed taxpayers to consider the functions of multiple group members, and the Congressional recognition reflected in TIPRA that complex corporations are organized in multiple entities for valid business reasons which ought not to be inconsistent with the rules of Section 355. Similarly, the Proposed Regulations define the DSAG as including functions, activities and assets of the CSAG, assuming the entire group (DSAG and CSAG) meets the SAG affiliation requirements.[25] This correctly, we believe, allows the active conduct of the trade or business to be determined with respect to activities performed and assets held by the entire SAG whether they are performed pre-spin by the DSAG, the CSAG or both.

In interpreting Sections 355(b)(2)(C) and (D), the Proposed Regulations take the view that Section 355(b)(3) treats all SAG members as one corporation for purposes of all Section 355(b) requirements even though Section 355(b)(3)(A) by its terms only applies to Section 355(b)(2)(A).[26] According to the Preamble, "a transaction that results in a corporation — including controlled — becoming a subsidiary SAG member is treated as a direct acquisition of all the assets (and activities) owned (and performed) by the acquired corporation at the time of the acquisition. Thus, such an acquisition is tested under section 355(b)(2)(C) rather than section

---

[24] Prop. Treas. Reg. Section 1.355-3(b)(3).

[25] Prop. Treas. Reg. Section 1.355-3(b)(1)(iii).

[26] Preamble, Section B.3 and Prop. Treas. Reg. Sections 1.355-3(b)(4)(i)(A) and (B).

355(b)(2)(D)."[27] Thus, Section 355(b)(2)(D) is generally not applicable to acquisitions of stock of subsidiary SAG members. (The requirements of Section 355(b)(2)(D) become relevant, and must be satisfied, (i) where the DSAG acquires control of Controlled where Controlled is not, and does not become, a DSAG member prior to the distribution (*i.e.*, where Distributing acquires Section 368(c) control of Controlled but not Section 1504(a) affiliation) and (ii) in the case of certain acquisitions of Distributing.)

Under the Proposed Regulations, because Sections 355(b)(2)(C) and (D) are interpreted consistently and treated as applying, *inter alia*, to multi-step transactions (in contrast to the current Treasury Regulations[28]), the conclusion that Section 355(b)(2)(C) (and not (b)(2)(D)) applies to acquisitions of SAG group members typically impacts situations where stock of an SAG member is acquired in multiple transactions and Section 1504(a) affiliation is attained but Section 368(c) control is not attained in a transaction in which gain or loss is not recognized. In this circumstance, the Proposed Regulations can lead to a different conclusion than the application of Section 355(b)(2)(D) prior to TIPRA. This conclusion is not required by the statute, which merely provides that (i) the active trade or business be determined on a consolidated basis and (ii) where stock satisfying Section 1504(a)(2) is acquired in a transaction in which gain or loss is recognized, the trade or business conducted by such acquired corporation is treated as acquired in a transaction in which gain or loss is recognized.[29]

Section 355(b)(2)(D) provides that control of Distributing or Controlled or a controlled subsidiary may be acquired within the pre-distribution period provided that "in each case in which such control was so acquired, it was so acquired, only by reason of transactions in

---

[27] Preamble, Section B.3.

[28] Treas. Reg. Section 1.355-3(b)(4).

[29] Section 355(b)(3)(B), (C).

which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period." The Proposed Regulations clarify that the IRS and Treasury interpret this language to mean that at the time control is first acquired, the acquiring corporation (or its SAG) must own stock meeting the requirements of Section 368(c) that was acquired in one or more transactions in which no gain or loss was recognized or by reason of such transactions combined with acquisitions before the beginning of the pre-distribution period.[30] Thus, at the time an acquiring corporation (or its SAG) first satisfies the Section 368(c) control requirement, the acquiring corporation (or its SAG) must possess Section 368(c) control without relying on any stock acquired in a transaction in which gain or loss was recognized during the pre-distribution period.

As described above, under the Proposed Regulations, if Distributing acquires Section 1504(a) affiliation with a corporation, the acquired corporation will become a DSAG member and the corporation will be treated as a division of Distributing for purposes of the active trade or business requirement. If Distributing subsequently acquires the remaining stock of the corporation in a separate transaction, such acquisition is disregarded for purposes of satisfying the active trade or business requirement (regardless of whether gain or loss was recognized in the separate transaction) because the subsidiary is already treated as a division of Distributing for this purpose.[31] Moreover, according to the Proposed Regulations, the order of these acquisitions should not be determinative in applying Section 355(b)(2)(C), provided that at the time the corporation first becomes a subsidiary SAG member, the SAG satisfies the Section

---

[30] Prop. Treas. Reg. Section 1.355-3(b)(4).

[31] Prop. Treas. Reg. Section 1.355-3(b)(1)(ii).

1504(a)(2) ownership test in the corporation without relying on any stock acquired during the pre-distribution period in a transaction in which gain or loss was recognized.[32]

Assume that Corporation Y is directly engaged in a five-year business and has two classes of stock outstanding that are identical except that the 90 shares of Class A vote and the 10 shares of Class B do not. Assume further that Distributing acquires all 90 Class A shares pursuant to a tax-free Section 351 transaction. One year later, in an unrelated transaction, Distributing purchases the remaining 10 nonvoting Class B shares. Later that year, Distributing would like to distribute the Corporation Y stock to its shareholders. Since the acquisition of Corporation Y is treated as an asset/trade or business acquisition (as the Proposed Regulations apparently intend[33]), then Corporation Y's assets were acquired in a transaction in which gain or loss was not recognized under Section 355(b)(2)(C) and the subsequent purchase of the Class B shares is a nothing. If judged under Section 355(b)(2)(D), "control" was not acquired until the Class B shares were purchased. It is simply not clear, in light of the language of Section 355(b)(2)(D), whether Section 355(b) is satisfied by this transaction, despite the fact that Section 355(b)(3)(D) authorizes the Treasury to prescribe regulations that provide for the proper application of Section 355(b)(2)(B), (C) and (D).

The result is perhaps less problematic when Section 368(c) control is irrelevant to the statutory scheme — for example, if Corporation Y is the active trade or business for Distributing (and Corporation Y is not being distributed). In that case Section 368(c) control of Corporation Y has no statutory import and it is Section 1504(a) that allows Corporation Y's

---

[32] Prop. Treas. Reg. Section 1.355-3(b)(4)(i)(A).

[33] Prop. Treas. Reg. Section 1.355-3(b)(4)(iv)(F).

active business to be taken into account. The final or temporary Treasury Regulations should, pursuant to Section 355(b)(3)(D), confirm whether Section 355(b)(2)(D) applies.[34]

Helpfully for taxpayers that have reached Section 368(c) control in completely tax-free transactions but not Section 1504(a) affiliation of a potential Controlled, Notice 2007-60[35] recognizes that taxable purchases of the remaining Controlled shares could violate Section 355(b)(2)(C) under the Proposed Regulations (even though Section 355(b)(2)(D) is not violated). The Notice acknowledges that taxpayers may not have anticipated that such acquisitions of additional stock of Controlled would adversely impact Controlled's ability to satisfy the active trade or business requirement. The Notice provides that the IRS will not challenge Distributing's (or its SAG's) acquisition of additional stock of Controlled as a violation of Section 355(b)(2)(C) with respect to Controlled in the case of distributions effected on or before the date the Proposed Regulations are published as final regulations in the Federal Register, provided that the transaction satisfies the requirements of Section 355(b)(2)(D) as in effect before the enactment of Section 355(b)(3). In light of the Technical Corrections Act's addition of Section 355(b)(3)(C) after the publication of the Notice, the IRS should clarify that Notice 2007-60 remains valid. Further, given that acquisitions of shares or repurchases for up to five years before a distribution can affect the qualification of an active trade or business, we recommend that the final or temporary Treasury Regulations include a rule excepting any purchases of shares after the acquisition of Section 368(c) control before the date the Proposed Regulations are published as final regulations in the Federal Register, regardless of when the distribution occurs.

---

[34] Section 355(b)(3)(C) now provides that where stock satisfying Section 1504(a)(2) is acquired in a transaction in which gain or loss is recognized, the trade or business conducted by such acquired corporation is treated as acquired in a transaction in which gain or loss is recognized. However, the final or temporary Treasury Regulations should clarify whether Section 355(b)(2)(D) applies.

[35] Notice 2007-60, 2007-35 I.R.B. 466.

It would be helpful to include an example in the final or temporary Treasury Regulations to confirm that the taxpayer does not violate Sections 355(b)(2)(C) and (D) by virtue of a subsequent disaffiliation of Controlled before the spin-off (whereby Distributing loses Section 1504(a) affiliation but retains Section 368(c) control of Controlled) through, for example, a stock issuance by Controlled to the public.

2. Transaction in Which No Gain or Loss Is Recognized

Beyond the discussion of which of Section 355(b)(2)(C) or (D) is the appropriate framework to judge whether the active trade or business test is satisfied, both sections generally provide that a trade or business acquired, directly or indirectly, during the five-year pre-distribution period will not satisfy the active trade or business requirement unless it was acquired in a transaction in which no gain or loss was recognized. As noted above, a number of legal and transactional developments had compelled a re-examination of the Treasury Regulations in this area. In the Proposed Regulations, however, the IRS and Treasury arguably went much further. According to the Preamble:

> The IRS and Treasury Department believe that these provisions have been and should continue to be interpreted and applied in a manner consistent with the overall purposes of section 355. For example, in certain situations, transactions in which gain or loss is recognized have been found not to violate the purposes of section 355(b)(2)(C) and (D). See, for example, C.I.R. v. Gordon, 382 F.2d 499 (2d Cir.1967), rev'd on other grounds, 391 US 83 (1968) (discussed in section C.2. of this preamble). Additionally, while the enactment of section 355(b)(3) substantially revised how distributing and controlled may satisfy the active trade or business requirement, TIPRA did not contain conforming amendments to section 355(b)(2)(C) and (D). As such, the IRS and Treasury Department also believe that a purpose-based interpretation of section 355(b)(2) is essential to harmonize these provisions. Accordingly, these proposed regulations interpret and apply section 355(b)(2)(C) and (D), and section 355(b)(3), in a manner consistent with their

purpose, even if not always consistent with the literal language of the statute.[36]

It is not entirely clear to us, with a few exceptions, why the enactment of the TIPRA rules necessitates, or in fact allows, such a dramatic re-examination of the concept of whether "gain or loss is recognized" and how it authorizes the IRS and Treasury to issue Regulations that are not "consistent with the literal language of the statute." We acknowledge, as the Preamble notes, that there have always been case law and regulatory exceptions for treating as tax-free certain transactions in which gain or loss was in fact recognized, primarily for transactions between related taxpayers.[37] These circumstances have often been by-products of necessary pre-distribution reshufflings and have been seen as benign and not inconsistent with the statute. At most, they have constituted small departures from the statutory language. The existence of these exceptions, which are found throughout the Code,[38] is not by itself a rationale to make large departures from the literal language of the statute. We do not believe, moreover, that anything in Section 355(b)(3), including the authority under Section 355(b)(3)(D) to prescribe regulations to carry out the purposes of Sections 355(b)(2) and (b)(3), is fundamentally inconsistent with the commonly understood meaning of when gain or loss is recognized. Nonetheless, as contemplated by the Preamble, there are a number of tax-free transactions which the Proposed Regulations treat as not satisfying the purposes of Section 355(b)(2). While in

---

[36] Preamble, Section C [emphasis added].

[37] *See* Comm'r v. Gordon, 382 F.2d 499 (2d Cir.1967) (even though gain was recognized when Distributing transferred a trade or business to Controlled, new assets were not brought within the combined corporate shells of Distributing and Controlled, thereby not violating the common purpose of Sections 355(b)(2)(C) and (D)), rev'd on other grounds, 391 U.S. 83 (1968); Rev. Rul. 69-461, 1969-2 C.B. 52 (a first-tier subsidiary's taxable distribution of stock of a second-tier subsidiary to its parent did not violate Section 355(b)(2)(D), because Section 355(b)(2)(D) is intended to prevent the acquisition of control of a corporation from a party not within the direct or indirect control of Distributing); Rev. Rul. 78-442, 1978-2 C.B. 143 (gain under Section 357(c) on the transfer from Distributing to Controlled does not violate Section 355(b)(2)(C)).

[38] *See, e.g.*, Rev. Rul. 66-365, 1966-2 C.B. 116 (cash received in lieu of fractional shares not treated as separately bargained for consideration).

some cases there are compelling policy arguments for the positions taken, we do not believe these policy arguments justify such marked departures from the statutory language. Moreover, the words of the statute provide no basis for reaching certain of these results.

The Preamble suggests that Section 355(b)(2) buttresses the statutory purpose of preventing dividend avoidance by preventing the tax-free distribution to shareholders of the proceeds of reinvested corporate assets. Basically, the IRS and Treasury conclude that recognition of gain or loss is a statutory proxy for acquisitions using corporate assets:

> Accordingly, the IRS and Treasury Department believe that the common purpose of section 355(b)(2)(C) and (D) is to prevent distributing from using assets — instead of its stock or stock of a corporation in control of distributing — to acquire a new trade or business in anticipation of distributing that trade or business (or facilitating the distribution of another trade or business) to its shareholders in a tax-free distribution. A distribution of a corporation holding assets that would have been used to effect a purchase generally would be treated as a dividend and section 355 was not intended to allow a tax-free separation of such assets. Acquiring a new trade or business using these assets and distributing it (or an existing trade or business) would effectively accomplish such a separation, and should not qualify under section 355.[39]

The Preamble also argues that the use of Distributing stock "ensure[s] that the historic owners of the acquired trade or business are participants in the divisive transaction."[40] While it is clear that Section 355(b) is fundamental to the notion that a separation of two historically conducted businesses occur, we believe that these device and continuity requirements are contained in other statutory requirements and should not be used to "reinterpret" the notion of "no gain or loss."[41]

---

[39] Preamble, Section C.1.

[40] Preamble, Section C.1.

[41] The Proposed Regulations also acknowledge that Section 355(b)(2)(D) has an independent General Utilities repeal function, insofar as a tax-free spin-off of Controlled after a taxable acquisition of Distributing could lead to high basis in Controlled; this function is not affected by this purpose-based analysis.

Thus, we do not believe that TIPRA gives authority to overlay entirely new concepts — such as this stock versus assets rule — into the question of whether "gain or loss is recognized." We do believe, consistent with current law, that the IRS and Treasury have authority reasonably to interpret the term "no gain or loss." It is therefore not objectionable *per se* that the Proposed Regulations describe a number of transactions in which gain or loss is recognized in connection with the acquisition of a trade or business and, consistent with current case law, find those transactions not to be inconsistent with Section 355(b). We believe that these exceptions are generally warranted and/or are consistent with other similar exceptions in the reorganization area. These exceptions include (i) gain or loss recognized on the acquisition by the CSAG from the DSAG of a trade or business, (ii) gain or loss recognized in an acquisition solely as a result of the payment of cash to shareholders for fractional shares where the cash paid represents a mere rounding off of the fractional shares in the exchange and is not separately bargained for consideration, and (iii) acquisition between SAG members.[42]

The Proposed Regulations also disregard the recognition of gain or loss in applying Section 355(b)(2)(D) to a limited universe of direct or indirect acquisitions of control of Distributing stock by a distributee corporation in one or more transactions in which gain or loss is recognized but where the basis of the acquired Distributing stock in the hands of the distributee corporation is determined in whole or in part by reference to the transferor's basis. Thus, for example, if Bigco acquires from Holdco, an unrelated corporation, control of Distributing in a Section 368(a)(1)(A) merger with boot (or if Bigco purchases the stock of Holdco and then merges downstream into Holdco for stock), then the basis of the new controlling corporation, Bigco, in the stock of Distributing will be the same as that of the former

---

[42] *See infra* Section IV for a discussion of the expansion doctrine, another exception.

holder, Holdco, and Section 355(b)(2)(D) would not be violated on Distributing's spin-off of Controlled to Bigco (although a further spin-off of Controlled to Bigco's shareholders would not be permitted). This approach seems to us to be consistent with the approach of the regulations under Section 355(d).[43]

The Proposed Regulations then list a number of transactions not otherwise taxable, which, because they involve the use of DSAG "assets," are questionable and are therefore treated as violations of Section 355(b)(2)(C) or (D). The first category involves the acquisition by the DSAG or the CSAG of an interest in an otherwise qualifying business through a tax-free Section 351 or 721 transaction (whether through the DSAG's or CSAG's contribution of non-five-year business assets, or as a result of their contribution of a good five-year business which is subsequently disposed of by the transferee), and the Proposed Regulations treat this tax-free formation transaction, with respect to any business not previously conducted by that SAG, as a transaction in which gain or loss is recognized for purposes of Section 355(b).[44] The Preamble cites Situation 2 of Rev. Rul. 2002-49, 2002-2 C.B. 288 (treating a corporation's use of appreciated securities to acquire a trade or business of a partnership in a transaction to which Section 721 applies as an acquisition in which gain or loss was recognized) and section 4.01(29) of Rev. Proc. 2007-3, 2007-1 I.R.B. 108 (providing that the IRS will not ordinarily rule where Distributing acquires control of Controlled by transferring inactive assets in a transaction meeting the requirements of Section 351(a) or 368(a)(1)(D) and in which no gain or loss is recognized) as illustrative of this notion.[45] It is possible to distinguish an acquisition for cash,

---

[43] Treas. Reg. Section 1.355-6(b)(2)(iii)(C). This approach is also consistent with the result reached in PLR 200736004.

[44] Preamble, Section C.3.b.i. *See* Prop. Treas. Reg. Section 1.355-3(b)(4)(ii)(A).

[45] Preamble, Section C.3.b.i.

marketable securities or other liquid assets that is akin to a purchase, on the one hand, from a tax-free contribution of less-than-five-year business assets intended to be retained by the transferee, on the other. However, the risk of such a distinction is that Distributing could evade Section 355(b)(2)(C) or (D) by, instead of making a tax-free Section 351 or 721 contribution of cash or marketable securities, using the cash to purchase assets and then contributing the assets to Controlled. Therefore, we agree with the approach of the Proposed Regulations here.

Under the Proposed Regulations, tax-free acquisitions in exchange for stock of subsidiaries also can result in "bad" acquisitions. The Proposed Regulations provide that if a SAG directly or indirectly owns stock of a subsidiary (including the DSAG's ownership of Controlled and any other subsidiary SAG member) and the subsidiary directly or indirectly acquires a trade or business, an interest in a partnership engaged in a trade or business, or stock of a corporation engaged in a trade or business, in each case from a person not included in the SAG, in exchange for such subsidiary's stock in a transaction in which no gain or loss is recognized, then, solely for purposes of applying Section 355(b)(2)(C) or (D) with respect to the trade or business requirement, the partnership interest or the subsidiary's stock directly or indirectly owned by the SAG immediately after the acquisition is treated as acquired at the time of the acquisition in a transaction in which gain or loss is recognized.[46] Thus, the newly acquired business is considered purchased in an amount equal to the percentage of shares retained by the SAG. While every business combination for stock involves a pooling of businesses and therefore a "swap" of assets to an extent, nothing in the legislative history of Section 355 indicates that this type of clearly tax-free acquisition should be considered one in which gain or loss is recognized. The statute explicitly contemplates that Controlled may have shareholders

[46] Prop. Treas. Reg. Section 1.355-3(b)(4)(iv)(E).

that do not participate in the spin-off,[47] and, given the applicability of both the continuity of shareholder interest and continuity of business enterprise requirements to spin-offs,[48] we do not find the mere fact that the shareholders of the former business are not impacted by the spin-off troubling. If this change were viewed as correct as a policy matter, we believe it should be addressed by a statutory amendment. If, contrary to our recommendation, the rule prohibiting acquisitions using Controlled stock is preserved in the final or temporary Treasury Regulations, we recommend considering the adoption of specific exceptions consistent with the intent of the Proposed Regulations. For example, we think an exception ought to be allowed where Controlled uses its stock to acquire an affiliate that is not a member of the DSAG or the CSAG.

In the assumption of liabilities context, the Proposed Regulations provide that an assumption of liabilities of a transferor by the DSAG or the CSAG is not treated as the payment of assets, provided no other provision of the Code treats such assumption as the payment of money or other property.[49] This rule should protect most reorganizations, and we do agree with the conclusion that a non-taxable assumption of liabilities not treated under the applicable statute as the payment of money or other property should not be treated as a taxable transaction. The examples confirm that an assumption of liabilities giving rise to gain recognition under Section 357(c) is not excluded. In the relevant example, P (not a member of the DSAG) owns all the stock of Distributing and contributes an active trade or business to Distributing in a transaction that satisfies the Section 351 requirements.[50] In connection with the contribution, P recognizes gain under Section 357(c) on the contribution of the active trade or business to Distributing as a

---

47 Section 355(a)(2).

48 Treas. Reg. Section 1.355-2(c).

49 Prop. Treas. Reg. Section 1.355-3(b)(4)(ii)(A).

50 Prop. Treas. Reg. Section 1.355-3(d)(2), Ex. 33.

result of Distributing assuming liabilities of P. The example concludes that Distributing cannot rely on the contributed active trade or business to satisfy the requirements of Section 355(b). We recommend adding an additional example that would describe the result where P and Distributing are members of the same consolidated group. Under such circumstances, Treasury Regulation Section 1.1502-80(d) renders Section 357(c) inapplicable. Therefore, we suggest the example conclude that if P and Distributing are members of the same consolidated group, then Distributing's assumption of P's liabilities in connection with the transfer of the active trade or business (an assumption of liabilities that would otherwise result in gain recognition to P under Section 357(c)) should not prevent Distributing from relying on such active trade or business.

We also agree that Section 304(a)(1) transactions are fundamentally taxable sales, notwithstanding the Code's re-characterization of the transferor as receiving a dividend.

Finally, the Proposed Regulations provide that an acquisition consisting of a distribution from a partnership is generally treated as a transaction in which gain or loss is recognized because it constitutes an acquisition in exchange for assets.[51] That is, the distributee partner is generally exchanging an indirect interest in all the assets of the partnership for a direct interest in the distributed property. However, these Proposed Regulations provide that if the corporation is already attributed the partnership's trade or business assets and activities, the corporation's acquisition of such trade or business assets and activities from the partnership is not, in and of itself, the acquisition of a new trade or business.[52] Again, we believe that the disguised sale, Section 704(c) and other anti-abuse rules applicable in the partnership context

---

[51] Prop. Treas. Reg. Section 1.355-3(b)(4)(ii)(B).

[52] Further, the Proposed Regulations provide that an acquisition consisting of a pro rata distribution from a partnership of stock or an interest in a lower-tier partnership is not an acquisition in exchange for assets to the extent the distributee partner did not acquire the interest in the distributing partnership during the pre-distribution period in a transaction in which gain or loss was recognized and to the extent the distributing partnership did not acquire the distributed stock or partnership interest within such period.

should be sufficient to police these transactions. We do note, however, that in some respects this rule is more favorable than the existing Treasury Regulations, which appear to treat the acquisition of assets in a complete liquidation of a partnership as a transaction in which gain or loss is recognized since such liquidation generally would give rise to "substituted" rather than "transferred" basis (which would arise from a nonliquidating distribution from a partnership).[53]

Unlike current Treasury Regulation Section 1.355-3(b)(4)(i), which took "a predecessor in interest" into account only for purposes of applying Section 355(b)(2)(D), the Proposed Regulations correctly, we believe, provide that any reference to a corporation includes a reference to a predecessor of such corporation in applying both Sections 355(b)(2)(C) and (D). Further, because Section 355(b)(3)(B) effectively treats all SAG members as a single entity for purposes of Section 355(b), these Proposed Regulations also apply Sections 355(b)(2)(C) and (D) to acquisitions during the pre-distribution period by corporations that later become DSAG or CSAG members. This approach seems consistent with the statute, and necessary given that Section 355(b)(2)(C) is the primary lens through which acquisitions are reviewed.

3. Additional Recommendations

The IRS and Treasury have requested comments on further exceptions to Sections 355(b)(2)(C) and (D).

a. Section 367. It would seem appropriate to treat a transaction in which gain or loss is recognized by reason of Section 367(a) denying corporate status to a foreign corporation as a transaction in which gain or loss is recognized for purposes of Section 355(b). For example, an acquisition taxable to all of the selling shareholders because, inter alia, of the

[53] Treas. Reg. Section 1.355-3(b)(4)(i).

Helen of Troy regulations[54] should not, in our view, be considered one in which "no gain or loss" is recognized. In contrast, if gain recognition under Section 367(a) occurs as a result of a minority shareholder failing to enter into a gain recognition agreement or as a result of a subsequent triggering of a gain recognition agreement, it would seem appropriate not to treat such a transaction as an acquisition in which gain or loss was recognized for purposes of Section 355(b). For example, in a transaction qualifying as tax-free, a foreign corporation issues solely voting stock to shareholders of a domestic corporation, and a five percent shareholder of the domestic corporation fails to enter into a gain recognition agreement with the IRS. This would seem to be the type of transaction in which it is reasonable for the IRS and Treasury to disregard the effective elective reporting of gain by a shareholder which typically is not within the control of the acquiring corporation. However, if the same domestic corporation is controlled by a single shareholder who fails to enter into a gain recognition agreement, then it would seem appropriate to treat such a transaction as an acquisition in which gain or loss was recognized for purposes of Section 355(b). We believe it would be reasonable for the final or temporary Treasury Regulations to provide that the failure by a shareholder (perhaps below a specified ownership threshold) of a widely held public domestic corporation to file a gain recognition agreement does not cause the transaction to be treated as an acquisition in which gain or loss is recognized for purposes of Section 355(b).

Because the Section 367(b) rules address policy objectives that are not implicated in the context of Section 355(b), it would seem appropriate to disregard any income inclusions required under the Section 367(b) regulations (*e.g.*, "all E&P amount" or gain required to be recognized pursuant to Treasury Regulation Section 1.367(b)-3(c)(2)) in determining whether

---

[54] Treas. Reg. Section 1.367(a)-3(c).

gain or loss was recognized for purposes of Section 355(b). For example, if a foreign corporation or a controlled foreign corporation is merged into a domestic corporation and the selling shareholders are required to include in income the all E&P amount, or gain, we are of the view that this type of transaction is fundamentally tax-free in nature.

b. Taxable stock acquisitions. We do not believe that a fully taxable transaction should be excepted from Sections 355(b)(2)(C) or (D) merely because the consideration is Distributing stock. The basis of the acquired assets (including corporate stock) would be fair market value, and this seems to us to be squarely the type of transaction Congress intended to exclude.

c. Redemptions. We do not believe that prior law treating redemptions as taxable transactions is necessarily impacted by TIPRA. However, we believe it would be reasonable for the IRS and Treasury to create an exception for payments to dissenters which do not impact "solely for voting stock" or otherwise constitute consideration from the acquirer.[55] One issue on which our Executive Committee was divided is the following. Some were of the view that consideration could be given to whether the principles of partnership business attribution should be replicated in the corporate area, and thus where a shareholder actively involved in managing a corporation acquires control by virtue of a redemption of the non-participating preferred stock, such shareholder would be entitled to rely on such corporation for satisfying the active trade or business requirement. Others were of the view that such an exception was not justified as it would constitute a marked departure from the literal language of the statute.

---

[55] *See, e.g.*, Rev. Rul. 68-285, 1968-1 C.B. 147 and Rev. Rul. 73-102, 1973-1 C.B. 186.

d. Acquisitions of Distributing stock for money or property acquired for cash during the pre-distribution period. Finally, the IRS and Treasury requested comments regarding whether a transaction in which a distributee corporation acquires, in a transaction in which no gain or loss is recognized, newly issued stock of Distributing in exchange for money or property previously acquired for cash during the pre-distribution period should be treated as a transaction in which gain or loss is recognized. The Preamble offers the following example:

> [A]ssume D and C have each engaged in the active conduct of a trade or business for more than five years. During the pre-distribution period, P, an unrelated corporation, purchases trucks and transfers them to D in exchange for D stock meeting the requirements of section 368(c) in a transaction to which section 351 applies. No gain or loss is recognized. D subsequently distributes all the C stock to P in a separate transaction within five-years of P's acquisition of the D stock.[56]

This transaction would permit the distributee corporation, P, to receive a fair market value basis (or close to a fair market value basis) in the stock of Distributing, enabling the potential sale of Controlled (subject to the device rules) without gain recognition. For the reasons discussed earlier, we do not believe a distinction should be made between contributing cash or marketable securities, on the one hand, and contributing business assets, on the other. Therefore, we believe this rule is appropriate.

IV. EXPANSION DOCTRINE

Existing Treasury Regulation Section 1.355-3(b)(3)(ii) provides that "if a corporation engaged in the active conduct of one trade or business during that five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during that five-year period,

---

[56] Preamble, Section C.4.

unless that purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business." Therefore, an acquired trade or business that is an expansion of the original trade or business inherits the business history of the expanded business. Until TIPRA, the IRS had interpreted this rule as requiring a purchase of business assets by an entity already engaged in an active trade or business. There was no definitive pronouncement on whether a purchase of shares could satisfy the expansion doctrine.[57]

Under the Proposed Regulations, since the SAG rule treats a stock acquisition in which the acquired corporation becomes a subsidiary SAG member as an asset acquisition, a corporation engaged in a trade or business would be able to expand its existing trade or business by acquiring Section 1504(a) affiliation of a corporation (including Controlled) engaged in a trade or business in the same line of business. However, since Section 355(b)(3) does not allow a corporation to rely on the trade or business of a non-SAG subsidiary — even if the corporation controls the subsidiary — to satisfy the active trade or business requirement, the Proposed Regulations preclude treating stock acquisitions as expansions where the acquired corporation does not become a subsidiary SAG member. According to the Preamble, since "[S]ection 355(b)(3) is the exclusive means by which a corporation is attributed the assets (or activities) owned (or conducted) by another corporation, ... a stock acquisition that does not result in the acquired corporation becoming a subsidiary SAG member should not be an expansion of the SAG's original business."[58] The practical implication of this conclusion, which seems reasonable, is that the acquisition of control but not affiliation of Controlled in a taxable transaction cannot be an expansion.

---

[57] But, *see* Athanasios v. Comm'r, 69 T.C.M. (CCH) 1902 (1955).

[58] Preamble, Section E.

The Proposed Regulations add to the definition of expansion the factors described in the recent published rulings on expansion.[59] In general, in determining whether "an acquired business is in the same line of business as the original business, all facts and circumstances shall be considered, including the following:

(A) Whether the product of the acquired business is similar to that of the original business;

(B) Whether the business activities associated with the operation of the acquired business are the same as the business activities associated with the operation of the original business; and

(C) Whether the operation of the acquired business involves the use of the experience and know-how that the owner of the original business developed in the operation of the original business or, alternatively, whether the operation of the acquired business draws to a significant extent on the existing experience and know-how of the owner of the original business and the success of the acquired business will depend in large measure on the goodwill associated with the original business and the name of the original business."

In light of this third prong (which appears to assume the same management for the original and expanded business), it would be helpful if the Proposed Regulations contained an example illustrating how soon, after an expansion of a business through the creation of a web presence, the new business could be relied on for a spin-off. Currently, Proposed Treasury Regulation Section 1.355-3(d)(2), Example 19 envisions a spin-off of the web presence (treated as an expansion of the original business) eight months after its creation. However, as noted above, since the expanded portion of the original business inherits the business history of the

[59] Rev. Rul. 2003-18, 2003-1 C.B. 467 and Rev. Rul. 2003-38, 2003-1 C.B. 811; Prop. Treas. Reg. Section 1.355-3(b)(3)(ii).

expanded business, it would be helpful for the final or temporary Treasury Regulations to confirm through an example whether the newly created web presence could be immediately spun-off. Similarly, it would also be helpful to extend this example to illustrate how quickly a purchased business could become the basis for a spin-off. Currently, Proposed Treasury Regulation Section 1.355-3(d)(2), Examples 18 and 20 envision a spin-off of a purchased business (treated as an expansion of the original business) two years after the purchase. It would be helpful for the final or temporary Treasury Regulations to specify through an example how soon after being purchased a business could be spun-off.

V. HOT STOCK

Section 355(a)(3)(B) provides that stock of Controlled acquired by Distributing during the pre-distribution period in a transaction in which gain or loss is recognized is treated as boot. In the Preamble, the IRS and Treasury request comments regarding whether Treasury Regulation Section 1.355-2(g) should be amended to make it consistent with the rules provided in these Proposed Regulations for determining whether an acquisition is one in which gain or loss is recognized for purposes of Sections 355(b)(2)(C) or (D).[60] In other words, how should Section 355(a)(3)(B) apply where there are taxable acquisitions of stock of Controlled in gain or loss transactions that, under these Proposed Regulations, are not treated as violating the requirements of Section 355(b)? Given that Section 355(b)(3) has no relationship with Section 355(a)(3)(B), we do not believe a broad exception is appropriate. For example, where Distributing acquires stock of Controlled in a transaction in which gain or loss is recognized and that is treated as an expansion of Distributing's existing trade or business (because Controlled is in Distributing's line of business and becomes a DSAG member), we believe the acquired stock

[60] Preamble, Section F.

should be subject to Section 355(a)(3)(B).[61] It may be appropriate, however, in the case of transactions that are in the nature of internal reshufflings (transfers within the SAG or between the DSAG and the CSAG) or rules of convenience (allowing cash in lieu of fractional shares to be ignored) to exclude such acquired shares from the hot stock rules.[62]

VI. LIMITED AFFILIATE EXCEPTION

Other than with respect to transfers of assets (or activities) that are owned (or performed) by the SAG immediately before and immediately after the transfer, the Proposed Regulations do not retain the special treatment accorded to affiliated group members in Treasury Regulations Section 1.355-3(b)(4)(iii). Thus, the Proposed Regulations treat non-SAG member affiliates of Distributing or Controlled in the same manner as unrelated persons for purposes of applying Sections 355(b)(2)(C) and (D). (While Distributing is the common parent of its SAG, in some cases, Distributing may be a subsidiary member of a larger affiliated group. Therefore, not all members of Distributing's affiliated group are always DSAG members.) We agree that limiting this special treatment to transfers in which the assets (or activities) remain in the SAG (as opposed to the larger affiliated group) is a reasonable interpretation of Section 355(b)(3).

We further commend the Treasury for its prompt issuance of Notice 2007-60, allowing taxpayers to rely on the existing, long-standing affiliated group rule for all distributions effected on or before the date of publication in the Federal Register of final Regulations

---

[61] Note that it is not clear whether this suggested rule would pose a significant obstacle in light of case law. *See* Trust of E.L. Dunn, 86 T.C. 745 (1986) (all stock of target, including hot stock, is contributed to Newco followed by a spin-off of Newco; Section 355(a)(3)(B) inapplicable), acq. in result, 1997-1 C.B. 1.

[62] The Preamble notes that such an approach may be consistent with certain current authorities. *See* Preamble, Section C.3.b.i. *See also* Treasury Regulation Section 1.355-2(g)(1) (not applying section 355(a)(3)(B) to a taxable acquisition from an affiliate); Rev. Rul. 78-442 (stating "[l]ikewise, for the same reasons [that section 355(b)(2)(C) does not apply], section 355(a)(3)[(B)] of the Code is not applicable").

modifying the rule stated in Treasury Regulation Section 1.355-3(b)(4)(iii).[63] Given the lead time for effecting a spin-off, we would recommend that consideration be given to including a transitional rule in such final or temporary Treasury Regulations which would allow taxpayers that have announced a spin-off prior to the effective date of the final or temporary Treasury Regulations to rely on the existing rule contained in Treasury Regulation Section 1.355-3(b)(4)(iii).

VII. ACTIVITIES PERFORMED BY RELATED PERSONS

In order to satisfy the active trade or business requirement, the corporation generally is required to perform active and substantial management and operational functions (exclusive of activities performed by independent contractors). Consistent with current authorities,[64] the Proposed Regulations reflect that a corporation may rely on the activities performed by certain related parties in conducting these functions.[65]

While Section 355(b)(3) treats all SAG members as one corporation, the Preamble notes that affiliated groups of corporations that include non-SAG member affiliates might use employees of one member of the group to perform management or operational functions for another member of the group, and that the IRS and the Treasury believe a corporation can satisfy the active trade or business requirement even if all the management and operational functions are performed by employees of affiliates that are not members of either the DSAG or CSAG.[66] Such individuals bear a close enough relationship to the DSAG or CSAG to be distinguished from mere independent contractors for purposes of the active trade or business requirement. The

---

63 Notice 2007-60, 2007-35 I.R.B. 466.

64 Rev. Rul. 79-394, 1979-2 C.B. 141, amplified by Rev. Rul. 80-181, 1980-2 C.B. 121.

65 Prop. Treas. Reg. Section 1.355-3(b)(2)(iii).

66 Preamble, Section H.

Proposed Regulations appropriately, we believe, extend this principle to the performance of management (in addition to operational) functions by employees of an affiliate. Thus, the Proposed Regulations provide that, in determining whether a corporation is engaged in the active conduct of a trade or business, activities (including management and operational functions) performed by employees of the corporation's affiliates (including non-SAG members) are taken into account.

The Proposed Regulations also extend this principle to shareholders of closely held corporations, providing that in determining whether a corporation is engaged in the active conduct of a trade or business, activities (including management and operational functions) performed by shareholders of a closely held corporation are taken into account in certain cases.[67]

VIII. ACTIVITIES CONDUCTED BY A PARTNERSHIP

In light of the increased use in corporate groups of partnerships and limited liability companies, updated guidance in this area was critically needed. The Proposed Regulations significantly expand and clarify the circumstances in which a corporation that is a partner in a partnership can satisfy the active trade or business requirement by reason of its ownership of the partnership interest where the partnership conducts a trade or business.

Previously issued published rulings[68] clarified that a corporation owning a 20-percent interest in a state law partnership or limited liability company that is classified as a partnership for Federal income tax purposes can be treated as engaged in the active conduct of the trade or business of the partnership if the corporation performs active and substantial management functions for the partnership's business. In addition, Revenue Ruling 2002-49

---

[67] Prop. Treas. Reg. Section 1.355-3(b)(2)(iii).

[68] Rev. Rul. 92-17, 1992-1 C.B. 142. *See also* Rev. Rul. 2002-49, 2002-2 C.B. 288.

concludes that such a corporation can be treated as engaged in the active conduct of a partnership's trade or business, even if another partner also performs active and substantial management functions for the partnership's trade or business. Recently, Rev. Rul. 2007-42 set forth the government's position in the common circumstance where the partnership or limited liability company has its own employees and management and no significant activities are performed by the corporate partner.[69]

The Proposed Regulations adopt the conclusion reached in Rev. Rul. 2007-42 that in certain cases, a partner that owns a "significant interest" in an entity that is treated as a partnership for Federal income tax purposes should be attributed the trade or business assets and activities of a partnership, even if the partner does not directly conduct any activities relating to the business of the partnership.[70] This is consistent with the regulations interpreting the continuity of business enterprise requirement applicable to reorganizations[71] and is an extremely helpful clarification of these rules. The IRS previously ruled that a corporation can rely on its working interests in an oil and gas partnership resulting from operating agreements in satisfying the active conduct of a trade or business test even where the corporation owns less than 20-percent of the partnership.[72] We recommend that the IRS and Treasury provide examples and issue rulings that describe the meaning of a "significant interest" in a partnership, as that term is

---

69 Rev. Rul. 2007-42, 2007-28 I.R.B. 44.

70 Prop. Treas. Reg. Section 1.355-3(b)(2)(v)(B).

71 Treas. Reg. Section 1.368-1(d)(5), Ex. 9.

72 *See* Rev. Rul. 89-27, 1989-1 C.B. 106 (owner of working interest in oil lease met the test for attribution of active business despite some outside work by independent contractors).

used in Proposed Regulation Section 1.355-3(b)(2)(v)(B). Presumably that may depend upon the nature of the business, as multiple forms of businesses are operated by partnership.[73]

IX. ADDITIONAL REQUESTS FOR COMMENTS

The Preamble contains a few additional requests for comments.

Comments are requested whether the Treasury Regulations should include a rule that would treat an acquisition in which gain or loss is *not* recognized as an acquisition in which gain or loss *is* recognized if that would be the treatment had the transaction been executed in the opposite direction. We would not recommend the addition of such a blanket rule to the Treasury Regulations. The form and direction of a transaction matters greatly in reorganizations and the fact that reordering the steps could lead to a different conclusion is true throughout Subchapter C of the Code.[74]

Comments are also requested regarding how the indirect acquisition should be measured where the acquired corporation has multiple classes of stock outstanding, or where the acquired entity is a partnership. The issue of how to treat multiple classes of stock is one that arises throughout the Code. We recommend that consideration be given to an approach whereby one looks to relative value for determining the value of the indirect acquisition, and to relative vote for determining the voting power.

Finally, comments are requested regarding whether the "good faith" and inadvertence exceptions in Notice 2004-37[75] (regarding the value requirement in Section 1504(a)(2)(B)) should apply in determining whether corporations are SAG members even if they

---

[73] *See generally* Lewis R. Steinberg, Selected Issues in the Taxation of Section 355 Transactions, 51 Tax Law. 7, 37-40.

[74] A taxpayer is usually bound by the form of the transaction.

[75] Notice 2004-37, 2004-1 C.B. 947.

are not members of a consolidated group. We are of the view that these exceptions should apply as we believe that this is what the reference to Section 1504(a) in Section 355(b)(3)(B) suggests, and that these exceptions should be interpreted in the same way for SAG membership as for affiliation in the context of filing consolidated returns.