Tax Report #943

New York State Bar Association

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January 12, 1999

The Honorable John B. Breaux
United States Senate
516 Hart Office Building
Washington, D.C. 20510

Dear Senator Breaux:

I am writing on behalf of the Tax Section of the New York State Bar Association[1] to express support for Senate Bill No. 2358 (the "Bill"), which you introduced in the 105th Congress on October 1, 1998.[2] The Bill would amend Section 355(b)(2)(A) of the Internal Revenue Code of 1986, as amended (the "Code") to provide that, for purposes of applying the "active trade or business requirement", all corporations that are members of the same affiliated group (within the meaning of Section 1504(a)[3]) shall be treated as a single corporation.

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[1] It is my understanding that a tax partner in a New York law firm, acting on behalf of a client, participated in drafting a proposal that was ultimately embodied in the Bill. A number of members of the Tax Section Executive Committee are partners in that same law firm. Those members did not participate in drafting or lobbying efforts in connection with the Bill.

[2] Because the 105th Congress adjourned without taking action on the Bill, the Bill would have to be reintroduced during the current Congressional session. See "Senator Breaux to Revive Bill to Treat Affiliated Companies as Single Corporation," Daily Tax Report, No. 220 at G-3 (November 16, 1998).

[3] All Section references are to Sections of the Code.

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Under current law, a corporation is treated as engaged in an active trade or business for purposes of Section 355 if either (i) it is directly so engaged[4] or (ii) "substantially all"[5] its assets consist of stock or securities of controlled corporations[6] that are so engaged. To satisfy this test, corporate groups may have to restructure their operations, which can increase the (non-tax) cost of tax-free spin-off, split-off, or split-up (generically, "spinoff") transactions; in some cases, the group's ability to restructure may be hampered by one or more commercial impediments, with the result that the group may be precluded from effecting a spinoff.

For example, assume P owns 100 percent of the stock of S1 and S2. S1 and S2 each owns $90 of gross active trade or business assets and has no liabilities. In addition to the stock of S1 and S2 (each worth $90), P owns $12 of non-active trade or business assets. P has owned the S1 and S2 stock for at least 5 years and wishes to distribute the S2 stock to its shareholders in a transaction qualifying as tax-free under Section 355. Assume the distribution would satisfy all requirements of Section 355 other than Section 355(b)(2)(A).

In order to obtain an IRS private letter ruling with respect to the proposed transaction, P would have to liquidate or merge S1 into P (or transfer its non-active assets to S1) since, otherwise, immediately after the spinoff of the S2 stock, (i) P itself would not be directly engaged in an active trade or business and (ii) less than 90 percent of P's gross assets would consist of the stock or securities of a controlled subsidiary so engaged in an active trade or business.[7] Requiring P to restructure in this case does not further any policy goal inherent in the active trade or business requirement, is not necessary to prevent the type of tax abuse against which that requirement is directed (i.e., the bailout of corporate earnings at preferentially taxed capital gains rates), and, in many cases, imposes costs and burdens on taxpayers.

The Tax Section supports the basic approach of the Bill because we believe it would remove unnecessary impediments to transactions that are motivated by legitimate business

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[4] For purposes of obtaining a private letter ruling, the Internal Revenue Service (the "IRS") will ordinarily treat a corporation as directly engaged in an active trade or business if at least 5 percent of its gross assets consists of assets used in an active trade or business (the "5 percent safe harbor") or such assets are otherwise not de minimis. See Rev. Proc. 96-43, 1996-2 C.B. 330.

[5] For purposes of obtaining a private letter ruling, the IRS will treat the "substantially all" requirement as satisfied if at least 90 percent of the gross assets of the relevant corporation consists of stock or securities of controlled corporations that are engaged in an active trade or business. See Rev. Proc. 77-37, 1977-2 C.B. 568.

[6] One corporation controls a second corporation if the first corporation owns at least 80 percent of the voting stock, and 80 percent of each class of non-voting stock, of the second corporation. See Section 368(c).

[7] Absent a restructuring, P's assets would consist of $12 of non-active trade or business assets and the stock of S1 and the latter would constitute only 88.24 percent ($90/$102) of P's gross assets. If S1 was liquidated or merged into P, P would be directly engaged in the active business formerly conducted by S1 and that business would represent more than 5 percent of P's gross assets (i.e., 88.24 percent).

goals and that are nonabusive.[8] The Bill's adoption of an affiliated group approach accords with the manner in which the vast bulk of U.S. corporations structure their affairs and should therefore eliminate the need for restructurings in the overwhelming majority of cases. Moreover, Section 355(b)(2) already treats an affiliated group as a single corporation for certain purposes.[9] We also understand that the Treasury Department supports the Bill.[10]

However, we recommend certain modifications to the Bill.

First, we recommend that an affiliated group for this purpose be defined without regard to the exceptions contained in Section 1504(b). Importing those exceptions into Section 355(b)(2)(A) is overly restrictive[11] and unnecessary to prevent tax abuse. Moreover, such a limited definition of the affiliated group would be inconsistent with the approach taken by Congress when it amended Section 355(b)(2)(D) in 1987 to embody an affiliated group concept.

Second, the application of the Bill to "intragroup spinoffs" within affiliated groups is unclear. For example, assume in the fact pattern described above that S1 owns all the stock of S3, a corporation that is not engaged in an active trade or business. Under current law, a distribution of the S3 stock by S1 to P would not qualify under Section 355. Under the Bill, however, S3 might be treated as engaged in an active trade or business if the P affiliated group, taken as a whole, were so engaged. We recommend that the Bill be redrafted so that affiliated group members treated as part of the single corporation consist only of those lower-tier members owned, directly or indirectly, by the distributing or controlled corporation to which the active

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[8] We recognize that enactment of the Bill would prevent certain taxpayers that are currently able to effect a tax-free spinoff from doing so. For example, assume in a variant of the fact pattern described above that (i) P's assets consist of $5 of active trade or business assets, the stock of S1 (worth $95) and the stock of S2 (worth $95), (ii) S1 owns $195 of non-active trade or business assets, subject to $100 of liabilities, and (iii) S2 owns $95 of active trade or business assets and has no liabilities. Under current law, since at least 5 percent of P's assets would consist of active trade or business assets after the distribution of the S2 stock, P would satisfy the 5 percent safe harbor. Under the provisions of the Bill, however, only 2.5 percent ($5/$200) of P's assets would be deemed to consist of active trade or business assets after the distribution of the S2 stock.

[9] See flush language to Section 355(b)(2)(treating affiliated distributee corporations as a single corporation for purposes of Section 355(b)(2)(D)).

[10] See "Treasury Announces Support for Bill to Treat Affiliated Companies as Single Corporation," Daily Tax Report, No 219 at G-5 (November 13, 1998).

[11] For example, Section 1504(b) excludes foreign corporations. Section 355(b)(2)(A) does not currently distinguish between types of corporations (e.g., domestic versus foreign) in applying the active trade or business test.

business test is being applied.[12] While we recognize that there are other issues that relate to intragroup spinoffs, they appear to be outside the scope of the Bill.[13]

Third, adoption of the affiliated group approach suggests that the existing controlled group prong of Section 355(b)(2)(A), which allows a corporation to be treated as engaged in an active trade or business if substantially all its assets consist of stock or securities of controlled corporations that are so engaged, be deleted from the statute. Because the Section 368(c) control definition differs from the Section 1504(a) affiliated group definition, retention of the controlled group approach after enactment of the Bill may result in an increased potential for taxpayer electivity.[14] Given that the purpose of the Bill is to reduce the need for corporate restructurings in spinoff transactions and that most U.S. corporate groups are organized along affiliated group (rather than controlled group) lines, the Tax Section believes that retention of the controlled group approach in Section 355(b)(2)(A) would be both unnecessary and inconsistent with approach of the Bill.[15]

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[12] For example, the Bill could provide that: "For purposes of subparagraph (A) [of Section 355(b)(2)], all corporations that are members of the relevant affiliated group shall be treated as a single corporation. A relevant affiliated group is an affiliated group, as defined in Section 1504(a) without regard to Section 1504(b), of which the distributing corporation or controlled corporation, as the case may be, is the common parent corporation (determined without regard to any other affiliated group of which such corporation may be a member)."

[13] Among these issues is whether appreciated stock of a group member held by another group member should be treated as a distinct asset subject to the "usual" tax rules. The consolidated return rules generally treat group member stock as a distinct asset. See generally Treas. Reg. Section 1.1502-13(f). Also, under certain circumstances, intragroup spinoffs may arguably result in unwarranted tax benefits. See 358(g).

[14] For example, assume that, immediately after a purported tax-free spinoff, the sole assets of the distributing corporation ("D") consist of $1 of non-active trade or business assets and all the common stock (worth $79) of a second corporation ("D1"). D1, in turn, has $5 of active trade or business assets and $95 of non-active trade or business assets; D1 also has outstanding non-voting "straight" preferred stock (worth $21), none of which is owned by D.

Under the Bill, since D and D1 are members of the same affiliated group, D would be treated as owning the $5 of active trade or business assets and the $95 of non-active trade or business assets owned by D1, and thus would not satisfy the 5 percent safe harbor (i.e., $5 of active trade or business assets/$101 of total assets, or 4.95 percent). However, D might recapitalize the D1 preferred stock into new voting preferred stock possessing 20 percent or less of the aggregate voting power of the D1 stock but otherwise having the same economic terms as the existing D1 preferred stock. In such case, D1 would no longer be a member of the D affiliated group, but D would now control D1 (within the meaning of Section 368(c)). Since D1 satisfies the 5 percent safe harbor, D would now satisfy the IRS's 90 percent substantially all test (i.e., D1 stock worth $79/total assets of $80, or 98.75 percent) and therefore the active trade or business requirement.

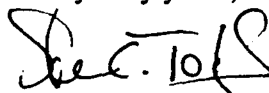
[15] An affiliated group requirement might be applied more generally in Section 355. For example the requirement in Section 355(a)(1) that the distributing corporation control (within the meaning of Section 368(c)) the distributed corporation could be replaced with a requirement that the distributing corporation own stock in the distributed corporation satisfying

Finally, the Tax Section believes that, consistent with the single corporation approach of the Bill, if a corporation (an "acquired member") joins the affiliated group during the five-year period ending on the date of the spinoff (the "relevant five-year period") as a result of a transaction that is, in whole or part, taxable, such transaction should be treated for purposes of Section 355(b)(2)(A) as a taxable acquisition of the assets of the acquired member. Accordingly, if such assets are in the same line of business as the affiliated group's existing active trade or business, they could potentially qualify as active trade or business assets under the expansion doctrine of Treasury Regulation Section 1.355-3(b)(3)(ii).[16] Otherwise, such assets would be treated as non-active trade or business assets. This would avoid the sometimes disparate treatment of asset and stock acquisitions under current Section 355(b)(2) and would be consistent with the Bill's overall purpose of reducing the necessity for engaging in corporate restructurings solely to satisfy Section 355(b)(2)(A).[17]

In conclusion, the Tax Section supports the approach of the Bill. We believe its enactment (with the modifications we have suggested) would eliminate the need for many corporate restructurings in connection with spinoffs without increasing the potential for tax avoidance.

Please let me know if we can be of any further help in addressing the issues raised by the Bill.

Very truly yours,



Steven C. Todrys
Chair

cc: The Honorable William V. Roth, Jr.
The Honorable Daniel P. Moynihan
The Honorable Bill Archer

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the 80-percent vote and value test of Section 1504(a)(2). We express no view on this issue at this time.

[16] Under the expansion doctrine, the purchase, creation, or other acquisition during the relevant five-year period of assets that are in the same line of business as the corporation's existing active trade or business may be treated as an expansion of that active trade or business (all of which is treated as having been actively conducted during the relevant five-year period), unless the purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business.

In recommending that the treatment of taxable stock and asset purchases be thus conformed, the Tax Section takes no position on the appropriate scope of the expansion doctrine.

[17] The Tax Section recognizes that this approach is arguably inconsistent with Section 355(b)(2)(D). Nevertheless, in addition to our questions about the continuing need for the control group prong of the active trade or business definition (which Section 355(b)(2)(D) is intended, in part, to police), we also note that the current control group approach, unlike that of the Bill, is <u>not</u> premised on treating multiple corporations as a single corporation.

ccs: *(continued)*

The Honorable Charles B. Rangel
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