1996

IRS Overhauleds Spin-off Ruling Guidelines

Stuart M. Finkelstein

Stuart G. Lazar

Follow this and additional works at: https://digitalcommons.law.buffalo.edu/articles

Part of the Taxation-Federal Commons, and the Tax Law Commons

Recommended Citation
Available at: https://digitalcommons.law.buffalo.edu/articles/252

© 1996 CCH Incorporated and its affiliates. All rights reserved. Reprinted with permission from CCH/Wolters Kluwer.

This Article is brought to you for free and open access by the Faculty Scholarship at Digital Commons @ University at Buffalo School of Law. It has been accepted for inclusion in Journal Articles by an authorized administrator of Digital Commons @ University at Buffalo School of Law. For more information, please contact lawscholar@buffalo.edu.
IRS Overhauls Spin-Off Ruling Guidelines

Stuart M. Finkelstein and Stuart Lazar explain the new guidelines set forth in Revenue Procedure 96-30.

I. INTRODUCTION

On April 22, 1996, the Internal Revenue Service (the "Service") issued Revenue Procedure 96-30,1 reflecting a continuing refinement of its view with respect to corporate separations under Section 355.2 Rev. Proc. 96-30 describes new guidelines for obtaining private letter rulings with respect to corporate spin-off transactions3 and places increased scrutiny on, and requires significant substantiation of, the corporate business purpose for the transaction.

At first glance, it appears that the Service has attempted to restrict taxpayers' ability to satisfy the requirements of Section 355, the last bastion of tax-free corporate distributions since the repeal of the General Utilities doctrine;4 on closer

2 Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the terms "Distributing" and "Controlled" refer to the distributing corporation and the distributed corporation, respectively.
3 For purposes of this article, the term "spin-off" includes "split-offs" and "split-ups" under Section 355.
4 See General Utilities & Operating Co. v. Helvering, 36-1 USTC 9012, 296 US 200 (1935) (in which the Supreme Court held that a corporation did not recognize gain on the distribution of appreciated property to its shareholders). The General Utilities doctrine was codified in Section 311 of the Internal Revenue Code of 1954 and has since been repealed by the Tax Reform Act of 1986, P.L. 99-514, 99th Cong., 2d Sess. See Section 311(b).
inspection, however, Rev. Proc. 96-30 actually provides taxpayers applying for a ruling with valuable insights as to the Service's view of Section 355. While revenue procedures do not have the force of substantive law, as a practical matter, such pronouncements often have the same effect on a taxpayer's ability to consummate a transaction, since private letter rulings are issued at the Service's discretion and many spin-offs are conditioned on the receipt of a ruling.

Rev. Proc. 96-30 attempts to streamline the ruling request process, narrow any perceived gap between substantive law and IRS ruling practices and level the playing field for less experienced practitioners by providing more detail as to the Service's analysis of the substantive law. In order to simplify the process, Rev. Proc. 96-30 supersedes the Service's prior Section 355 ruling guidelines and consolidates such guidelines in one document. Moreover, Rev. Proc. 96-30 revokes section 3.01(23) of Rev. Proc. 96-3, which sets forth the Service's "no-rule" position regarding certain Section 355 business purposes.

Under Rev. Proc. 96-30, the Service generally requires a greater amount of supporting documentation at the outset, which may avoid the numerous supplemental filings that are often required and that typically delay the receipt of a ruling. In addition, the Service has attempted to simplify its role in determining whether a transaction satisfies the Section 355 requirements by having taxpayers highlight certain substantive legal issues and prove affirmatively (or, in some cases, represent) that the proposed transaction meets the Section 355 requirements.

With the increased use of corporate spin-offs as a business strategy in recent years, Rev. Proc. 96-30 should prove interesting to most tax practitioners. The Service should be commended for clarifying the requirements for issuing private letter rulings in this area. This article focuses on the major differences between Rev. Proc. 96-30 and its predecessor, Rev. Proc. 86-41, which relate primarily to the business purpose, active trade or business and control requirements of Section 355.

Rev. Proc. 96-30 generally applies to ruling requests postmarked or, if not mailed, received by the Service on or after June 5, 1996, although the Service may ask taxpayers to submit information specified in the revenue procedure with respect to ruling requests submitted prior to that date. Moreover, the revocation of the no-rule policy of section 3.01(23) of Rev. Proc. 96-3 is effective as of May 6, 1996. The Service will also entertain ruling requests on the business purposes listed in Rev. Proc. 96-30, whether the ruling request is submitted before or after April 22, 1996.

II. THE BUSINESS PURPOSE REQUIREMENT

The most significant difference between Rev. Proc. 96-30 and its predecessor will become apparent when taxpayers attempt to demonstrate satisfaction of the business purpose requirement of Reg. § 1.355-2(b). Rev. Proc. 96-30 is a substantial improvement over Rev. Proc. 86-41 and goes a long way toward defining the Service's view with respect to this Section 355 test. The increased focus on business purpose was expected, however, as officials at the Service had previously expressed concern regarding satisfaction of the business purpose requirement and given that the Service had been criticized in its failure to release ruling guidelines addressing this requirement.

The Service's increased focus on the business purpose test appears in three separate ways through:

(i) requiring taxpayers to prove that the transaction was effectuated for a valid corporate business purpose;

(ii) requiring taxpayers to prove certain substantive legal issues and prove affirmatively (or, in some cases, represent) that the proposed transaction meets the Section 355 requirements.

With the increased use of corporate spin-offs as a business strategy in recent years, Rev. Proc. 96-30 should prove interesting to most tax practitioners. The Service should be commended for clarifying the requirements for issuing private letter rulings in this area. This article focuses on the major differences between Rev. Proc. 96-30 and its predecessor, Rev. Proc. 86-41, which relate primarily to the business purpose, active trade or business and control requirements of Section 355.

Rev. Proc. 96-30 generally applies to ruling requests postmarked or, if not mailed, received by the Service on or after June 5, 1996, although the Service may ask taxpayers to submit information specified in the revenue procedure with respect to ruling requests submitted prior to that date. Moreover, the revocation of the no-rule policy of section 3.01(23) of Rev. Proc. 96-3 is effective as of May 6, 1996. The Service will also entertain ruling requests on the business purposes listed in Rev. Proc. 96-30, whether the ruling request is submitted before or after April 22, 1996.

II. THE BUSINESS PURPOSE REQUIREMENT

The most significant difference between Rev. Proc. 96-30 and its predecessor will become apparent when taxpayers attempt to demonstrate satisfaction of the business purpose requirement of Reg. § 1.355-2(b). Rev. Proc. 96-30 is a substantial improvement over Rev. Proc. 86-41 and goes a long way toward defining the Service's view with respect to this Section 355 test. The increased focus on business purpose was expected, however, as officials at the Service had previously expressed concern regarding satisfaction of the business purpose requirement and given that the Service had been criticized in its failure to release ruling guidelines addressing this requirement.

The Service's increased focus on the business purpose test appears in three separate ways through:

(i) requiring taxpayers to prove that the transaction was effectuated for a valid corporate business purpose;

(ii) requiring taxpayers to prove certain substantive legal issues and prove affirmatively (or, in some cases, represent) that the proposed transaction meets the Section 355 requirements.

With the increased use of corporate spin-offs as a business strategy in recent years, Rev. Proc. 96-30 should prove interesting to most tax practitioners. The Service should be commended for clarifying the requirements for issuing private letter rulings in this area. This article focuses on the major differences between Rev. Proc. 96-30 and its predecessor, Rev. Proc. 86-41, which relate primarily to the business purpose, active trade or business and control requirements of Section 355.

Rev. Proc. 96-30 generally applies to ruling requests postmarked or, if not mailed, received by the Service on or after June 5, 1996, although the Service may ask taxpayers to submit information specified in the revenue procedure with respect to ruling requests submitted prior to that date. Moreover, the revocation of the no-rule policy of section 3.01(23) of Rev. Proc. 96-3 is effective as of May 6, 1996. The Service will also entertain ruling requests on the business purposes listed in Rev. Proc. 96-30, whether the ruling request is submitted before or after April 22, 1996.

II. THE BUSINESS PURPOSE REQUIREMENT

The most significant difference between Rev. Proc. 96-30 and its predecessor will become apparent when taxpayers attempt to demonstrate satisfaction of the business purpose requirement of Reg. § 1.355-2(b). Rev. Proc. 96-30 is a substantial improvement over Rev. Proc. 86-41 and goes a long way toward defining the Service's view with respect to this Section 355 test. The increased focus on business purpose was expected, however, as officials at the Service had previously expressed concern regarding satisfaction of the business purpose requirement and given that the Service had been criticized in its failure to release ruling guidelines addressing this requirement.

The Service's increased focus on the business purpose test appears in three separate ways through:

(i) requiring taxpayers to prove that the transaction was effectuated for a valid corporate business purpose;

(ii) requiring taxpayers to prove certain substantive legal issues and prove affirmatively (or, in some cases, represent) that the proposed transaction meets the Section 355 requirements.

With the increased use of corporate spin-offs as a business strategy in recent years, Rev. Proc. 96-30 should prove interesting to most tax practitioners. The Service should be commended for clarifying the requirements for issuing private letter rulings in this area. This article focuses on the major differences between Rev. Proc. 96-30 and its predecessor, Rev. Proc. 86-41, which relate primarily to the business purpose, active trade or business and control requirements of Section 355.

Rev. Proc. 96-30 generally applies to ruling requests postmarked or, if not mailed, received by the Service on or after June 5, 1996, although the Service may ask taxpayers to submit information specified in the revenue procedure with respect to ruling requests submitted prior to that date. Moreover, the revocation of the no-rule policy of section 3.01(23) of Rev. Proc. 96-3 is effective as of May 6, 1996. The Service will also entertain ruling requests on the business purposes listed in Rev. Proc. 96-30, whether the ruling request is submitted before or after April 22, 1996.

II. THE BUSINESS PURPOSE REQUIREMENT

The most significant difference between Rev. Proc. 96-30 and its predecessor will become apparent when taxpayers attempt to demonstrate satisfaction of the business purpose requirement of Reg. § 1.355-2(b). Rev. Proc. 96-30 is a substantial improvement over Rev. Proc. 86-41 and goes a long way toward defining the Service's view with respect to this Section 355 test. The increased focus on business purpose was expected, however, as officials at the Service had previously expressed concern regarding satisfaction of the business purpose requirement and given that the Service had been criticized in its failure to release ruling guidelines addressing this requirement.

The Service's increased focus on the business purpose test appears in three separate ways through:

(i) requiring taxpayers to prove that the transaction was effectuated for a valid corporate business purpose;
(ii) providing a nonexclusive list of corporate business purposes which generally will be accepted by the Service; and

(iii) requiring an increased level of substantiation to prove the validity of a corporate business purpose.

A. Taxpayer's Burden

While Rev. Proc. 86-41 required a taxpayer to describe only the corporate business purposes for the distribution, Rev. Proc. 96-30 requires a taxpayer to describe "in detail each purpose (whether or not a corporate business purpose) for the distribution of the stock of Controlled."10 Moreover, a taxpayer is required to:

(i) explain which of such purposes satisfy the business purpose test of Reg. § 1.355-2(b)(2);

(ii) describe how each business purpose is a "real and substantial nonfederal tax purpose germane to the business of Distributing, Controlled or the affiliated group to which Distributing belongs;" and

(iii) explain the business exigencies which require a current distribution of Controlled stock.11

The Service's new ruling guidelines with respect to the business purpose requirement are more closely aligned with the Section 355 regulations than those contained in Rev. Proc. 86-41. According to Reg. § 1.355-2(b)(1), the principal reason for the business purpose requirement is "to provide nonrecognition treatment only to distributions that are incidental to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms." Moreover, the regulations state that:

"[i]f a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive, then... the separation is not carried out for that corporate business purpose."12

Accordingly, the new ruling guidelines now expressly require taxpayers to explain the need for a current distribution of Controlled's stock and why such corporate business purpose could not be accomplished through a nontaxable transaction that does not involve a stock distribution and which is neither impractical nor unduly expensive.13

The regulations also state that a shareholder purpose is not to be treated as a corporate business purpose.14 Therefore, for example, where a spin-off is undertaken to facilitate the personal planning (such as estate planning) of a shareholder, the taxpayer requesting a ruling is required to highlight such purpose for the Service's examination.15

Where, however, a shareholder business purpose is so nearly coextensive with a corporate business purpose as to preclude any distinction between them, a transaction should be considered as conducted for a corporate business purpose.16

Furthermore, the Service recognizes that the potential for avoiding federal taxes is relevant in determining whether a corporate business purpose motivated the distribution.17 In order to ensure that a distribution is not effected in order to reduce federal taxes, the new guidelines require a taxpayer to describe any reduction in federal tax and to convince the Service by clear and convincing evidence that the distribution is motivated in whole or substantial part by one or more corporate business purposes.18 Prior to Rev. Proc. 96-30 which, as stated above, revokes section 3.01(23) of Rev. Proc. 96-1, the Service would not rule where there was any potential for a reduction of federal taxes caused by a corporate spin-off.19

The revocation of this no-rule policy is another example of the Service's attempt to conform its ruling guidelines with the Section 355 regulations and indicates that the Service no longer believes that a distribution which will cause a reduction in federal taxes is an automatic bar to

---

10 Rev. Proc. 96-30, supra, note 1, section 4.04(1).
11 Rev. Proc. 96-30, supra, note 1, section 4.04(2).
12 Reg. § 1.355-2(b)(3). See also Reg. § 1.355-2(b)(5), Ex. 3 and 4.
13 Rev. Proc. 96-30, sections 4.03(2) and (3), supra, note 1. Under Rev. Proc. 86-41, a taxpayer was required only to "explain why other feasible means of meeting the corporation's business needs were rejected in favor of the present transaction." See Rev. Proc. 86-41, supra, note 5, section 4.04(3).
14 Reg. § 1.355-2(b)(2).
16 Reg. § 1.355-2(b)(2). See also Reg. § 1.355-2(b)(5), Ex. 2 (shareholders' desires to devote their undivided attention to separate businesses conducted by the corporation, which would enhance the operations of each business was both a shareholder and corporate business purpose. The division of these businesses satisfied the business purpose requirement of Section 355). It should be noted that the above separation would fall under the fit and focus business purpose enumerated in Appendix A to the revenue procedure, as discussed below.
17 Reg. § 1.355-2(b)(1).
18 Rev. Proc. 96-30, supra, note 1, section 4.04(b)(3)(A). Nonrecognition of corporate or shareholder level gain by reason of the application of Sections 355 or 361 is ignored for this purpose.
19 See supra, text accompanying note 6.
having a valid corporate business purpose. Rev. Proc. 96-30, however, still requires taxpayers to demonstrate that the transaction was not motivated by the avoidance of federal taxes. The level of proof required to satisfy the “clear and convincing evidence” standard is unclear, and the Service should issue further guidance in this area. Such guidance could take the form of bright-line tests, extracted from the regulations, setting forth situations which would and would not meet the Service’s ruling standard. With respect to transactions that reduce both federal and non-federal taxes because of similarities in the tax laws or transactions in which the reduction of federal taxes is greater than or substantially coextensive with the reduction of non-federal taxes, the reduction of non-federal taxes should not be considered a valid business purpose. Where, however, the reduction of federal taxes is so nearly coextensive with any other corporate business purpose so as to preclude any distinction between them, the transaction should satisfy the business purpose test.

The Service is similarly concerned that a spin-off may have a federal tax avoidance motive where the spin-off allows Distributing, Controlled or any member of Distributing’s affiliated group to become an entity with special federal tax status (e.g., an S corporation, a REIT, an insurance company, a bank, a savings and loan or a CFC). In these cases, a taxpayer may be required to represent that it will engage in a specific course of action (such as making or not making an election) that reduces the potential for federal tax avoidance, in order to reduce the Service’s concern that the transaction is being consummated for the non-corporate business purpose of reducing federal taxes. Where the distribution will allow Distributing or Controlled to elect S corporation status, the Service requires a taxpayer to represent its intentions with regard to the S corporation election.

Finally, Rev. Proc. 96-30 requires a new representation that the distribution is motivated, in whole or substantial part, by one or more corporate business purposes. Such representation appears to add little to the ruling process in light of the Service’s increased level of scrutiny with respect to the business purpose requirement.

B. Business Purpose Guidance

Appendix A to Rev. Proc. 96-30 (Appendix A) enumerates nine generally acceptable business purposes and provides long-awaited and much needed guidance into the Service’s view on the business purpose requirement. The revenue procedure states that the business purposes listed in Appendix A are not the only corporate business purposes for which the Service will issue a favorable ruling. Moreover, if a taxpayer undertakes a spin-off for a business purpose that is enumerated in Appendix A, failure to meet the guidelines established therein will not, in and of itself, mean that the distribution lacks a valid corporate business purpose. Furthermore, regardless of whether or not the business purpose for a distribution is listed in Appendix A or, if listed in Appendix A, satisfies the ruling guidelines, Rev. Proc. 96-30 states that the Service will not issue a favorable ruling unless it is satisfied that a transaction is motivated, in whole or substantial part, by a real and substantial non-federal tax purpose and that such purpose cannot be achieved through a nontaxable transaction that does not involve the distribution of the stock of Controlled and which is neither impractical nor unduly expensive.

The corporate business purposes listed in Appendix A, and the guidelines which the taxpayer must ordinarily meet in order to satisfy the ruling standards, are as follows:

1. Key Employee. Where the corporate business purpose for the distribution is to provide an equity interest in a business of Distributing or Controlled to a current or prospective employee(s), the taxpayer must demonstrate that the employee(s) will receive a significant amount, in terms of percentage and value, of voting stock of such corporation within one year of the distribution. The revenue procedure also states that:

   (i) transactions in which stock issued to the employee(s) is subject to an option or restriction will be closely scrutinized; and

   20 Reg. § 1.355-2(b)(2). See also Reg. § 1.355-2(b)(5), Ex. 7.
   21 See, by analogy, Reg. § 1.355-2(b)(2). See also Reg. § 1.355-2(b)(5), Ex. 8.
   22 Appendix C to Rev. Proc. 96-30 requires the taxpayer to represent whether Distributing is an S corporation prior to the spin-off and whether Distributing or Controlled will elect S corporation status after the distribution.
   23 The ruling guidelines state that acquisition of a significant percentage of stock may not be required, however, if such acquisition would be prohibitively expensive to the employee(s). See section 2.01(1)(b) of Appendix A.
   24 Section 2.01(2) of Appendix A. Such scrutiny will presumably focus on whether the key employees have actually received a significant interest in Distributing or Controlled. Where the terms of an option or the restrictions on the stock indicate that the employee(s) will never benefit from the ownership of the stock or option.
(ii) the transfer of stock to an ESOP (described in Section 4975(e)(7)) will be treated, for purposes of this corporate business purpose, as if the stock were transferred to a group of employees.25

Conspicuously absent from Appendix A is the Service’s view as to what percentage of stock is “significant”; additional guidance should be provided, perhaps in the form of a safe-harbor definition of “significant.”26 Failure to satisfy such a safe harbor guideline should not bar the receipt of a favorable ruling; instead, each case should be determined based upon its particular facts and circumstances. The overriding principle for determining whether an equity interest is significant should be that an employee receive an equity interest in Distributing or Controlled which, either by vote or value, represents an equity interest in similarly situated companies held by similarly positioned employees. Thus, for example, a closely-held Distributing or Controlled may be required to transfer a large portion of both the vote and equity value to key employees. In the case of a large, publicly-held Distributing or Controlled, the vote and value of stock transferred to key employees may be small in relation to the size of the company, but such stock, nevertheless, should be considered significant if it represents a substantial amount in both absolute terms and in relation to the key employees’ total compensation package.

2. Equity Offering. Where the corporate business purpose for the distribution is to facilitate a primary stock offering of Distributing or Controlled, the taxpayer must show that the issuing corporation will:

(i) need to raise a substantial amount of capital in the near future to fund operations, capital expenditures, acquisitions, the retirement of indebtedness or other business needs;

(ii) be able to raise more funds per share or that the stock offering is otherwise more advantageous due to the separation of Distributing and Controlled (generally by submitting an analysis based upon the professional judgment of persons qualified to speak to such matters, including investment bankers);

(iii) use the funds raised for the business needs of Distributing, Controlled or a member of either corporation’s affiliated group; and

(iv) complete such offering within one year of the distribution.27

3. Borrowing. Where the corporate business purpose for the distribution is to facilitate a debt offering or other borrowing-type transaction, the taxpayer must show that:

(i) Distributing or Controlled needs to raise a substantial amount of capital in the near future to fund operations, capital expenditures, acquisitions, the retirement of indebtedness or other business needs;

(ii) the separation will enable the borrower to raise more money or to borrow on significantly better terms (generally by submitting an analysis based upon the professional judgment of persons qualified to speak to such matters, including investment bankers);

(iii) the funds raised will be used to satisfy the business needs of Distributing, Controlled or a member of either corporation’s affiliated group; and

(iv) such borrowing will be completed within one year of the distribution.28

4. Cost Savings. Where the corporate business purpose for the spin-off is cost savings, the taxpayer must demonstrate that “significant” cost savings will be realized from the spin-off, ordinarily in the form of a detailed analysis based on the professional judgment of persons qualified to speak on the matter.29

The Service’s guidelines generally define cost savings as the total combined anticipated future

(Footnote Continued)

25 Section 2.01(3) of Appendix A.

26 We understand that the Service’s current ruling policy generally requires 5% of the vote or value of Distributing or Controlled’s equity to be transferred to key employees in order to satisfy the corporate business purpose requirement. A safe harbor test for “significant” could be the lesser of 5% of the vote or value of the corporation’s stock or stock with a fair market value on the date of receipt representing a large enough absolute dollar amount (e.g., $5 million).

27 Where the distribution is effected in order to complete an equity offering of a corporation with one or more “Significant Shareholders” (defined, in section 4.05 of Appendix A, as any person who is directly or indirectly, or together with any related persons, the owner of any class of stock of Distributing or Controlled and who actively participates in the management or operation of either corporation) and such equity will be purchased by a limited number of investors which require the distribution as a condition to their participation, the Service may require appropriate substantiation from these investors.

28 Where the distribution is effected in order to enable Distributing or Controlled to borrow at a lower cost, the taxpayer must substantiate such cost savings (as discussed in Section II.B.4 hereof).

29 For example, where the distribution will result in lower insurance costs, an analysis of the cost savings would be re-
cost savings to Distributing. Controlled and members of their affiliated groups for the three-year period following the distribution, reduced by the transaction costs of the distribution and any anticipated additional direct or indirect costs to such parties ("projection period cost savings"). These savings are "significant" if they equal at least one percent of the total net consolidated financial income of Distributing's affiliated group for the three-year period prior to the distribution ("base period net income").

5. Fit and Focus. While the Service has previously stated that it would not rule on distributions which relied on the so-called "fit and focus" or "core management focus" business purpose, Rev. Proc. 96-30 reverses this policy in certain circumstances. Such business purpose arises where "the separation will enhance the success of the businesses by enabling the corporations to resolve management, systemic, or other problems that arise (or are exacerbated) by the taxpayer's operation of different businesses within a single corporation or affiliated group." 32

Rev. Proc. 96-30, however, states that the Service will not ordinarily rule that "fit and focus" satisfies the business purpose requirement where Distributing is either publicly held or has a Significant Shareholder unless the distribution:

(i) is a non-pro rata distribution effected in order to enable a Significant Shareholder (or shareholder group) to concentrate on a particular business; or

(ii) effects an internal restructuring within an affiliated group. 33

Finally, Rev. Proc. 96-30 states that the Service will closely scrutinize the following situations where the taxpayer is relying on "fit and focus" as a corporate business purpose:

(i) any continuing relationship between Distributing and Controlled;

(ii) except for cases involving an internal restructuring of an affiliated group, any continuing interest (e.g., as director or employee) in both Distributing and Controlled by a Significant Shareholder (or, in the case of a nonpublicly traded corporation, any shareholder); 34 and

(iii) internal restructurings in which the distributee is not entitled to eliminate, exclude, or receive a 100 percent dividends received deduction with respect to, a distribution from Distributing (e.g., a transaction involving a foreign corporation).

6. Competition. Where a taxpayer engages in two related businesses, customers or suppliers of one business may object to purchasing or selling products or services from such business if the customers or suppliers compete with the taxpayer's other business. If such conflict is material, a taxpayer may undertake a distribution of either business in order to resolve problems with the customers or suppliers who object to the relationship between the two businesses. In order to prove that the separation of the two businesses addresses a valid corporate business concern, Appendix A requires a showing that:

(i) one or more customers or suppliers have significantly reduced (or will significantly reduce) their purchases from, or sales to (or, for potential customers or suppliers, have not made purchases from, or sales to), Distribut-

(Footnote Continued)
ing or Controlled because of the competing business;
(ii) because of the distribution, the customers or suppliers will increase (or not implement a planned significant reduction in) their purchases from, or sales to, Distributing or Controlled;
(iii) the customers or suppliers do not object to Distributing's shareholders ownership of Controlled stock after the distribution; and
(iv) sales to the customers, or purchases from the suppliers, will represent a meaningful amount of sales or purchases by Distributing or Controlled following the distribution. 37

7. Facilitating an Acquisition of Distributing. 38
Where the corporate business purpose for a distribution is to tailor Distributing's assets to facilitate a subsequent tax-free acquisition of Distributing by another corporation (a "Morris Trust" transaction 39), the taxpayer must ordinarily establish that:
(i) the acquisition would not be completed unless Distributing and Controlled are separated;
(ii) the acquisition could not be accomplished by an alternative nontaxable transaction that is neither impractical nor unduly expensive;
(iii) the acquiring corporation is not "related" to Distributing or Controlled (or the taxpayer must explain why such relationship should be disregarded); 40 and
(iv) the acquisition will be completed, except in unusual circumstances, within one year following the distribution. 41

The delineation of the facilitation of an acquisition of Distributing, but not Controlled, in Appendix A suggests that the Service may still be examining whether a spin-off to facilitate the acquisition of Controlled satisfies the business purpose requirement. 42 While the law is unclear and somewhat confused in this area, we believe that where Controlled is acquired following a spin-off and such acquisition is not pursuant to an unconditional binding agreement entered into prior to the spin-off:
(i) such acquisition should not affect the tax-free nature of the spin-off; and
(ii) if the spin-off is consummated to facilitate the acquisition, the business purpose requirement should be satisfied.

In Rev. Rul. 70-225, 43 the Service ruled that Distributing's transfer of assets to a newly-formed subsidiary, the distribution of the subsidiary's stock to Distributing's sole shareholder and the acquisition of the subsidiary by an unrelated party in a purported tax-free exchange, were all steps in a prearranged plan. The ruling held that both Sections 351 and 368(a)(1)(D) require that control of the subsidiary must reside with either the transferor or its shareholders immediately after the transfer of assets to the subsidiary and that such control was lacking since after the acquisition Distributing's shareholder did not own enough stock in the acquirer to represent "control." 44 Moreover, the Service recast the transaction as a transfer of assets by Distributing to the acquirer in exchange for acquirer stock followed by a distribution of such stock to Distributing's shareholder. Since

37 See section 2.06(2) of Appendix A (corroboration of such business purpose from customers or suppliers of the affected business may be required).
38 On March 19, 1996, as part of its budget for the 1997 fiscal year, the Clinton Administration proposed an amendment to Section 355(d) which would require Distributing to recognize gain on the distribution of Controlled if Distributing's historic shareholders do not continue to own at least 50% of the total vote and value of Distributing's and Controlled's stock during the two-year period following the distribution (i.e., the proposal would apply unless Distributing of Controlled was the larger corporation in the acquisition).
39 Such transaction takes its name from Com. v. Morris Trust, 66-2 ustc $9718, 367 F2d 794 (CA-4), in which the court held that the transfer of an insurance department of a state bank to a newly-formed corporation followed by the distribution of such insurance corporation to the bank's shareholders and the merger of the bank into an unrelated national bank qualified as a tax-free distribution under Section 355. In Morris Trust, banking regulations required the spin-off of the insurance business prior to the merger; the court determined that the taxpayer had a valid business purpose for both the spin-off and the merger.
40 In Rev. Rul. 68-603, 1968-2 CB 148, the Service announced that it would follow the Fourth Circuit's decision in Morris Trust to the extent that it holds that the active trade or business, control and business purpose requirements were satisfied under those particular facts.
41 The meaning of the term "related" for these purposes is unclear. An appropriate definition for such term should provide that (i) entities are related only where certain stock ownership tests are satisfied (e.g., Section 267) and (ii) in order to eliminate the prohibited relatedness, a related party may purge its "tainted" stock (prior to the acquisition of Distributing) through a sale to an unrelated third party. See Rev. Rul. 72-354, 1972-2 CB 216 (acquirer's unconditional sale of target corporation's "purchased" stock to an unrelated buyer prior to an acquisition of the balance of target's stock enabled the acquisition to qualify under Section 368(a)(1)(B)).
42 As discussed more fully below, the Service recently issued Rev. Rul. 96-30, in which a tax-free acquisition of Controlled following a spin-off did not adversely impact the tax-free nature of the spin-off. The stated business purpose for the spin-off, however, was not to facilitate the acquisition of Controlled although the acquisition was "a possibility recognized by the management of [Distributing] and [Controlled]" at the time of the distribution. Accordingly, the ruling at best leaves open the question of whether the Service believes that facilitating a tax-free acquisition of Controlled is an acceptable business purpose for the spin-off and could be read as providing an inference that such a business purpose would be unacceptable to the Service.
43 1970-1 CB 80.
44 See supra, text accompanying note 62.
Distributing’s shareholder did not receive stock constituting control in the acquiror, neither the spin-off nor the acquisition of Controlled qualified as a tax-free transaction.\(^4^4\)

By contrast, in Rev. Rul. 75-406, the Service ruled that where an “old and cold” Controlled was distributed to the shareholders of a widely-held Distributing and was thereafter merged into an unrelated corporation, the subsequent merger did not affect the tax-free nature of the spin-off. The business purpose for the spin-off in Rev. Rul. 75-406 was to comply with a governmental divestiture order, and the merger, which presumably was negotiated prior to the distribution, was put to a shareholder vote following the spin-off. In Rev. Rul. 96-30, which modified but did not revoke Rev. Rul. 75-406, the Service held that the distribution of an “old and cold” Controlled to the shareholders of a widely-held Distributing qualified as a tax-free spin-off even though Controlled was subsequently merged into an unrelated corporation. The Service concluded that the form of the transaction should be respected where there had been no negotiations regarding the acquisition of Controlled prior to the spin-off and the Controlled shareholders, like the Controlled shareholders in Rev. Rul. 75-406, were free to vote their Controlled stock for or against the merger.

The different holdings in Rev. Rul. 70-225, on one hand, and Rev. Ruls. 75-406 and 96-30, on the other hand, appear to rest on at least two separate grounds. First, where the distribution of Controlled is preceded by a transfer of assets to Controlled under either Section 351 or 368(a)(1)(D) (whether or not Controlled is a newly-formed or existing corporation (hereafter, a “New Controlled”)), a subsequent prearranged acquisition of Controlled generally results in Distributing’s shareholders losing control of Controlled “immediately after” the acquisition, as required by Sections 351 and 368(a)(1)(D). Accordingly, since the transfer of assets would not qualify for tax-free treatment, Section 355 will not apply to the subsequent distribution. Where, however, Controlled is an “old and cold” subsidiary and the distribution of Controlled is not preceded by a transfer of assets by Distributing to Controlled, there is no requirement that Distributing’s shareholders be in control of Controlled immediately after the distribution.\(^4^7\)

The second distinguishing ground rests on the fact that the acquisition following the spin-off in Rev. Rul. 70-225 occurred pursuant to a prearranged plan by the sole shareholder of Distributing, while the acquisitions in Rev. Ruls. 75-406 and 96-30 were consummated only after votes approving the mergers by the shareholders of widely-held Distributings. In Rev. Rul. 75-406, the Service held that the distribution of Controlled provided Distributing’s shareholders with a “real and meaningful” ownership interest in their Controlled stock since such shareholders were free to vote their Controlled stock for or against the merger.\(^4^8\)

In Rev. Rul. 96-30, the Service held that where no negotiations regarding the acquisition of Controlled had taken place prior to the spin-off and the Controlled shareholders were free to vote their stock for or against the merger, the form of the transaction reflected its substance. The Service stated that the critical issue in determining the substance of the transaction was “which party (Distributing or the shareholders of Distributing) had, in substance, disposed of the [Controlled] stock” and that such determination was based on all of the relevant facts and circumstances.\(^4^9\)

In Rev. Rul. 70-225, however, the Service viewed the acquisition of Controlled following the spin-off as a fait accompli and recharacterized the transaction as a taxable transfer of assets by Distributing for acquiring corporation stock followed by a taxable distribution of such stock to Distributing’s sole shareholder.\(^5^0\) Similarly, where pursuant to an unconditional binding commitment, Distributing’s shareholders transfer all of the stock of an “old and cold” Controlled following a spin-off, the Service may attempt to recast such transaction as an acquisition of Controlled from Distributing in exchange for acquiring corporation stock followed by a distribution of such stock to

\(^4^4\) If the form had been respected, the transactions would have qualified as a tax-free spin-off followed by a reorganization within the meaning of Section 368(a)(1)(B).

\(^4^7\) See Section III.B hereof for a discussion of the difference between the “control immediately after” requirement of Sections 351 and 368(a)(1)(D) and the “distribution of control” requirement of Section 355.

\(^4^8\) The merger of Controlled in Rev. Rul. 75-406 presumably was pursuant to a binding agreement subject to a vote of Controlled’s shareholders.


\(^5^0\) The recharacterization should be the same regardless of whether, as in Rev. Rul. 70-225, New Controlled is newly formed or whether New Controlled is an existing corporation.
Distributing's shareholders. In that case, the distribution would not be of the stock of a corporation controlled by Distributing (within the meaning of Section 368(e)) immediately prior to the distribution and would fail the control requirement of Section 355(a)(1)(A).

The Service should not be able to reorder the steps of a transaction in certain circumstances. First, where an acquisition of Controlled following a spin-off is not pursuant to a prearranged plan which was fully negotiated prior to the spin-off, the Court Holding doctrine should not apply and the form of the transaction should be respected. Moreover, we believe that (notwithstanding the issuance of Rev. Rul. 96-30) the acquisition of Controlled following a spin-off should generally be treated as the disposition of the stock of the controlled corporation by the Distributing shareholders, and not by Distributing, where such shareholders are entitled to a vote on the subsequent acquisition (and, as illustrated by such vote, the Controlled shareholders' ownership of Controlled stock is real and meaningful) and in any other situation in which the Controlled shareholders have a legitimate opportunity to reject the acquisition.

In certain circumstances, however, the form of the transaction can differ from its substance. For example, where:

(i) Significant Shareholders which have actual or effective control of Distributing have agreed prior to the distribution to vote their Controlled stock in favor of a merger following the distribution; or

(ii) there are economic disincentives (i.e., liquidated damages) if a transaction fails to close, a legitimate argument can be made that in substance the Controlled stock was disposed of by Distributing rather than Distributing's shareholders.

Moreover, in the case of a closely-held corporation, even where Controlled's shareholders vote on a subsequent merger, the Service may claim that ownership of the Controlled stock by Distributing's shareholders following a spin-off will not be respected where the acquisition of Controlled is prearranged prior to the spin-off. On the other hand, where Distributing is widely-held, given the likely turnover of a publicly traded Controlled stock following a spin-off (as the markets "fully settle"), a 30-60 day delay in setting the record date for the vote on the merger and mailing the proxy statements related thereto generally should be sufficient to establish that it was Distributing's shareholders which disposed of the Controlled stock in the acquisition and not Distributing itself (since a substantial number of record holders which vote on the merger will likely be different than the shareholders receiving Controlled stock in the spin-off). The issuance of Rev. Rul. 96-30 has only confused, not clarified, the issue of when the form of the transaction will be respected.

51 See, e.g., Court Holding Co. v. Com., 45-1 ustc ¶ 9215, 324 US 351 (1945) (where the Supreme Court held that the liquidation of a closely-held corporation followed by the sale of the corporation's sole asset by its shareholders pursuant to an agreement negotiated by the corporation prior to its liquidation was in reality a sale by the corporation followed by a liquidating distribution to the shareholders). But see United States v. Cumberland Public Service Co., 50-1 ustc ¶ 9129, 338 US 451 (1950) (a sale of a corporation's assets by its former shareholders following a liquidation was taxable to the shareholders and not the corporation where the corporation had rejected an offer to sell the property and the negotiations relating thereto had been carried on by the shareholders following the liquidation).

52 Rev. Rul. 96-30 suggests that where negotiations for the subsequent acquisition are conducted by Distributing prior to the spin-off, in "appropriate" facts and circumstances, the Service may attempt to recharacterize the transaction as a disposition of the Controlled stock by Distributing, and not its shareholders. Where, however, Distributing is widely held and the shareholders have a real and meaningful right to reject a proposed transaction involving Controlled following the spin-off, such recharacterization misrepresents the substance of the transaction. As a substantive matter, the vote by Distributing's widely dispersed shareholders is a significant condition precedent to the consummation of the sale and enables such sale to be consummated every bit as much as the negotiations conducted by Distributing's management prior to the spin-off. Thus, in such circumstances, we believe that Distributing should not be viewed as selling the Controlled stock prior to the spin-off. In fact, many practitioners believe that the Court Holding doctrine should apply only to closely-held corporations and not to widely-held corporations.

53 Moreover, in situations in which a New Controlled is acquired subsequent to the distribution and such acquisition was not pursuant to a prearranged plan which is binding on the Controlled shareholders, such acquisition should not violate the requirements of Sections 351 and 368(a)(1)(D). See Intermountain Lumber Co. v. Com., CCH Dec. 33,670, 65 TC 1023, 1031-1032 (1976), in which the Tax Court stated that: "A determination of 'ownership' as that term is used in Section 368(c) and for purposes of control under Section 351, depends on the obligations and freedom of action of the transferor with respect to the stock when he acquired it from the corporation. Such traditional ownership attributes as legal title, voting rights and possession of stock certificates are not conclusive. If the transferee, as part of the transaction in which the shares were acquired, has irrevocably foregone or relinquished at that time the legal right to determine whether to keep the shares, ownership in such shares is lacking for purposes of Section 351. By contrast, if there are no restrictions on freedom of action at the time he acquired the shares, it is immaterial how soon thereafter the transferee elects to dispose of his stock or whether such disposition is in accord with a preconceived plan not amounting to a binding obligation."

54 Prior to the issuance of Rev. Rul. 96-30, the Service had not issued a single published or private letter ruling which expressly relied on Rev. Rul. 75-406 to permit an acquisition of an "old and cold" Controlled following a spin-off. While not entirely clear, we believe that Rev. Rul. 96-30 provides a safe harbor factual setting in which the form of a transaction will be respected and leaves open the question of whether the negotiation by Distributing...
Second, where the acquisition of Controlled would not occur unless Controlled was separated from Distributing, the Service’s ability to rely on the Court Holding doctrine to reorder the steps of the transaction is unjustified and the distribution and subsequent acquisition should not be integrated. In such case, the substance of the transaction matches its form and should be respected.

8. Facilitating an Acquisition by Distributing or Controlled. Where the corporate business purpose for a distribution is to tailor Distributing’s assets or Controlled’s corporate structure to facilitate a subsequent tax-free acquisition by Distributing or Controlled, the taxpayer must ordinarily establish that:

(i) the acquisition would not be undertaken unless the two corporations are separated;
(ii) the acquisition could not be accomplished by an alternative nontaxable transaction that is neither impractical nor unduly expensive;
(iii) the target corporation is not “related” to Distributing or Controlled (or the taxpayer must explain why such relationship should be disregarded);[57] and
(iv) the acquisition will be completed, except in unusual circumstances, within one year following the distribution.

9. Risk Reduction. If a corporate business purpose for the distribution is to significantly enhance the protection of one or more businesses (the “other businesses”) from the risks of another business (the “risky business”), the taxpayer generally must substantiate the following factors:

(i) the nature and magnitude of the risks faced by the risky business;
(ii) whether the assets and insurance associated with the risky business are sufficient to meet the reasonably expected claims arising from such business;
(iii) whether, under applicable law, the distribution will significantly enhance the protection of the other businesses from the risks of the risky business;[58] and
(iv) whether under applicable law, an alternative nontaxable transaction which does not involve the distribution of Controlled and is neither impractical nor unduly expensive, would provide similar protection.

The Service’s willingness to rule that risk reduction is a valid business purpose appears to be a reversal of prior policy,[59] although it seems unlikely that many taxpayers will be able to satisfy the strong burden of proof required by the new guidelines. For example, where a spin-off is proposed in order to separate property of a risky business contaminated by hazardous waste from a taxpayer’s other businesses, the taxpayer may be thwarted by state and federal environmental cleanup laws which continue to hold former owners of property jointly and severally liable for the costs of restoring the contaminated property to a non-hazardous condition. These laws may prevent a taxpayer from demonstrating that a spin-off would provide the taxpayer’s other businesses with

(footnote continued)
adequate protection from the risky business. Similarly, where a taxpayer operates all of its businesses as divisions of a single entity, the transfer of the risky business to a subsidiary corporation (without a spin-off) may be sufficient to protect the taxpayer's other businesses from the risks associated with the risky business.  

C. Requests for information

In order to substantiate the business purpose for the distribution, Rev. Proc. 96-30 requires taxpayers to provide the Service with substantially more information than Rev. Proc. 86-41, including:

(i) proxy statements, information statements or prospectuses filed or prepared in connection with the distribution or any related transaction and a list of any other documents that have been or will be filed with (or prepared for) any federal, state, local or foreign regulatory body in connection with the transaction;

(ii) materials prepared for directors, including those relating to the purpose for the distribution, those prepared for or presented to the board and relevant portions of board minutes; and

(iii) press releases, letters or memoranda relating to the distribution which were sent to shareholders or employees.

III. THE CONTROL REQUIREMENTS OF SECTION 355

Section 355(a)(1)(A) requires that Distributing be in control of Controlled immediately prior to the distribution in order for the distribution to qualify under Section 355. Furthermore, Section 355(a)(1)(D) requires that Distributing distribute to its shareholders either all of its stock and securities of Controlled or an amount of stock in Controlled constituting control.

A. In Control Prior to the Distribution

Under section 4.02(f) of the revenue procedure, a taxpayer must state whether Distributing has modified or will modify its ownership of Controlled within the five-year period preceding the distribution in order to obtain control prior to the distribution. This requirement highlights an issue which has recently gained public attention, namely, whether such modification (e.g., through a recapitalization) should be respected as the first step in a plan to allow Distributing to distribute Controlled stock in a tax-free spin-off. According to applicable revenue rulings and private letter rulings, such modification should be respected where it effects a permanent change in the voting power of the recapitalized corporation.

For example, in Rev. Rul. 56-117, Distributing owned all of the common stock and 12 percent of the nonvoting preferred stock of Controlled. Pursuant to a plan of reorganization which provided Distributing with control of Controlled, Controlled exchanged newly issued common stock for all of the preferred stock not held by Distributing. Distributing then distributed its entire interest in Controlled (consisting of 93 percent of Controlled's common stock and 100 percent of Controlled's preferred stock) to certain of its shareholders in a non-pro rata split-off. The Service held that Distributing satisfied the control requirements of Section 355.

Similarly, in Rev. Rul. 69-407, the Service held that a recapitalization of Controlled common stock owned by Distributing into a greater number of shares of Controlled common stock with a lower par value in order to allow Distributing to satisfy the control requirement of Section 355 constituted a tax-free reorganization within the meaning of Section 368(a)(1)(E). Since after the recapitalization, Distributing was in control of Controlled (and such control was acquired in a transaction in which no gain or loss was recognized), the distribution of Controlled qualified as a tax-free distribution under Section 355.
In Rev. Rul. 69-407, the Service distinguished Rev. Rul. 63-260, in which an individual (A) owned 30 shares of Controlled and all 100 shares of Distributing, which, in turn, owned the remaining 70 shares of Controlled. A contributed 10 shares of Controlled stock to Distributing in order to provide Distributing with control of Controlled, which would allow Distributing to distribute all of its Controlled stock to A under Section 355.

The Service held that the distribution did not qualify under Section 355 because Distributing was not in control of Controlled immediately before the distribution except in "a transitory and illusory sense." Since both immediately prior to and immediately after the transaction A owned the 10 shares of Controlled, the transfer of such stock to Distributing had no significance. The Service stated that "[s]ection 355 of the Code cannot be made to apply to a transaction in which an immediately preceding contribution by the distributor corporation's shareholder is made solely to attempt to qualify the transaction under that section." In Rev. Rul. 69-407, however, the recapitalization prior to the distribution was respected as it "resulted in a permanent realignment of voting control."

The Service has also ruled privately that a recapitalization as a preliminary step to a subsequent spin-off should be respected. In LTR 9547049, Distributing owned less than 80 percent of the voting power of Controlled and exchanged shares of Controlled common stock for a new class of Controlled preferred stock which had 10 votes per share. As a result, Distributing acquired control of Controlled, allowing the distribution of Controlled stock to Distributing's shareholders to qualify under Section 355. In LTR 8631014, the distribution of Controlled stock qualified as tax-free under Section 355 where, prior to the distribution, Controlled's common stock had been recapitalized into two classes of common stock, one with .6 votes per share and the other with 1.4 votes per share, in order to allow Distributing to acquire control of Controlled. Finally, in LTR 9409043, Controlled's common stock was recapitalized into two classes, one with three votes per share and the other with one vote per share, as a preliminary step for a spin-off of Controlled. Distributing distributed Controlled's high vote common stock tax-free under Section 355; Controlled issued the low vote stock to the public following the distribution, which enabled Controlled to raise additional capital without Distributing's shareholders losing control of Controlled.

In determining what constitutes a permanent change in Controlled's voting power, much attention has been focused on transactions in which a recapitalization of Controlled's stock into high and low vote stock (in order to satisfy the control requirement of Sections 355 and 368(c)) would later be reversed (i.e., the high vote stock would effectively convert into low vote stock). While there is no authority defining "permanent" for these purposes, Rev. Rul. 66-23 may, by analogy, suggest that five years of unrestricted voting rights is sufficient. In Rev. Rul. 66-23, the Service held that the continuity of interest requirement of Section 368 was satisfied where a shareholder receiving stock in a tax-free reorganization was required to dispose of such stock within seven years.

(Footnote Continued)

purpose of diluting the voting power of one class of stock in order to increase the voting power of another class, thereby shifting voting control to a different group of shareholders, is sufficient purpose to qualify the exchange as a reorganization under Section 368(a)(1)(E) of the 1939 Internal Revenue Code [the predecessor to Section 368(a)(1)(E)].

1963-2 CB at 147.

1969-2-CB at 51.

1 CCH IRS LETTER RULINGS REPORT No. 978, Nov. 29, 1995, LTR 9547049 (June 2, 1995).


3 CCH IRS LETTER RULINGS REPORT No. 888, Mar. 9, 1994, LTR 9409043 (Dec. 9, 1993). LTR 9409043 was issued to C. Brewer Homes & Co., Ltd. in connection with its distribution of the stock of its subsidiary, C. Brewer Homes, Inc., to its shareholders. Distributing's shareholders had to be "in control" of Controlled "immediately after" the distribution because Controlled was a New Controlled. See IRC Sec. 368(a)(1)(D). While Distributing need only "distribute control" of Controlled under Section 355, Section 368(a)(1)(D) requires the transferor (or its shareholders) to be "in control" of the transferee corporation "immediately after" the exchange. Thus, the failure of Distributing's shareholders to remain in control of Controlled after the distribution would have caused the distribution to be taxable. See Section III.B hereof.


1966-1 CB 67.
years. The Service stated that five years of unrestricted ownership would satisfy the continuity of interest requirement. Moreover, the Service has previously ruled, in transactions consummated under Sections 355 and 368, that a recapitalization of a corporation's stock should be respected even if the effects of such recapitalization are later reversed after five years.  

Furthermore, the Service has also issued private letter rulings where the voting power of Controlled's shares is altered upon a transfer of such shares prior to five years from the date of the spin-off. For example, in LTR 9409043, the Service ruled that a distribution qualified under Section 355 even though high vote stock distributed to Distributing shareholders automatically converted into low vote stock upon the transfer of such stock. We understand, however, that the Service may no longer issue private letter rulings where the disproportionate voting power converts for any reason to proportionate voting rights within five years of a spin-off. Rulings, such as LTR 9409043, however, reach the correct result where the alteration of the voting rights of the Controlled stock is an inherent characteristic of such stock.

**B. Distributing Control**

Taxpayers are now required by Rev. Proc. 96-30 to describe any planned or intended issuances, redemptions or disposals of Controlled's shares and the effect of such transactions on the "distribution of control" requirement of Section 355(a)(1)(D) or, if applicable, the "control immediately after" requirement of Section 368(a)(1)(D). As discussed below, the Service generally permits Controlled to consummate a primary offering of more than 20 percent of its voting stock (or any class of nonvoting stock) following a tax-free spin-off where Controlled is an "old and cold" subsidiary of Distributing, but such an offering would not be allowed in the case of a New Controlled.

Under Section 355(a)(1)(D), Distributing must distribute control of Controlled to Distributing's shareholders; there is no requirement that such shareholders retain the stock received following the distribution. Sections 351 and 368(a)(1)(D), however, allow taxpayers to transfer property to a corporation on a tax-free basis if such taxpayers (or their shareholders) are in control of the transferee corporation immediately after the exchange. The Service has ruled that the phrases "distribute control" and "in control immediately after" as used in the foregoing sections have different meanings.

In Rev. Rul. 73-246, the Service held that a distribution of 100 percent of the stock of an "old and cold" Controlled by Distributing to its sole shareholder qualified under Section 355 even though, after the completion of a prearranged acquisition by Controlled, the amount of Controlled stock distributed represented only 75 percent of its outstanding stock. In G.C.M. 36462, the Service concluded that a distribution of stock of an "old and cold" Controlled qualified under Section 355 notwithstanding a prearranged sale by Controlled (following the distribution) of newly issued shares constituting 51 percent of such corporation. In reaching its conclusion, the Service analyzed the statutory language of Section 355(a)(1)(D) and found that "[u]nlike Code Sections 351 and 368(a)(1)(D), Code Section 355 has no specific requirement that the [Distributing] shareholders receiving the [Controlled] stock have 'control' immediately after all the steps in the transaction have been completed." Rev. Proc. 96-30 appears to confirm the Service's view with respect to this aspect of the control requirement.

---

76 See CCH IRS LETTER RULINGS REPORT No. 978, Nov. 29, 1995, LTR 9547049 (June 2, 1995) (preferred stock with six votes per share was redeemable by the issuer after six years); CCH IRS LETTER RULINGS REPORT No. 183, Sept. 3, 1980, LTR 8034089 (May 29, 1980) (valid reorganization even though voting stock automatically converted into nonvoting stock after five years); CCH IRS LETTER RULINGS REPORT No. 179, Aug. 6, 1980, LTR 8030007 (Apr. 14, 1980) (common stock with six votes per share was to be automatically converted into common stock with one vote per share after six years).

77 See supra, text accompanying note 75.

78 Compare Rev. Rul. 73-28, 1973-1 CB 187 (stock was considered voting stock for purposes of Section 368(a)(1)(B) even though a particular shareholder was unable to vote such stock under state law; upon a transfer of such stock to any other person, the stock could be voted) and Rev. Rul. 72-72, 1972-1 CB 104 (stock was not voting stock even though such stock obtained the right to vote after five years; the non-voting nature of the stock was an inherent characteristic of the stock).

79 Rev. Proc. 96-30, supra, note 1, section 4.02(e).

80 Except, of course, to the extent that retention of such stock may be required by the continuity of interest or device requirements of Section 355.

81 1973-1 CB 181.

82 Coincidentally, Distributing's sole shareholder received the 25% of Controlled stock issued in the acquisition. Thus, both before and after the acquisition, such shareholder owned 100% of Controlled stock.


84 See CCH IRS LETTER RULINGS REPORT No. 925, Nov. 23, 1994, LTR 9446023 (Aug. 17, 1994) (valid Section 355 distribution notwithstanding a primary offering of 40% of the shares of an "old and cold" Controlled following such distribution).

85 Where a primary offering of more than 20% of a New Controlled's stock cannot be integrated with the spin-off of New Controlled under the step-transaction doctrine, such offering should not cause the distribution to fail to qualify under Section 355. For a discussion of the step-
IV. THE ACTIVE TRADE OR BUSINESS REQUIREMENT

In order for the distribution of Controlled to qualify under Section 355, the transaction must satisfy the device and active trade or business requirements. One commentator states that the device requirement was intended "primarily to prevent the separation of surplus corporate liquid assets, or properties acquired therewith, from the assets which generated the surplus."86

The active trade or business requirement of Sections 355(a)(2)(C) and 355(b) was thus enacted, in part, to prevent corporate profits from being distributed to shareholders free of the taxes applicable to dividends and from being subjected only to capital gains tax if and when such distributed stock is sold.

A distribution which separates real property, intellectual property or other intangible property from the party using such property is the quintessential example of the joining of the active trade or business and the device requirements, because such assets could be viewed as passive assets similar to investment securities.87 Regulations under Section 355 state that the active conduct of a trade or business does not include:

(i) holding for investment purposes stock, securities, land or other property; or
(ii) owning or operating (including leasing) real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property.89

Where real, intellectual or other intangible property is separated from its use as part of a spin-off, it may be difficult to convince the Service that the owner's activities relating to the operation and management of the property will satisfy the active trade or business requirement.90

Rev. Proc. 96-30 requires a taxpayer to disclose:

(i) whether all or a portion of any real property, intellectual property, or other intangible property historically occupied or used by one business will be separated in the transaction from that business;
(ii) whether the business formerly using the property will continue to use the property after the transaction;
(iii) the terms on which the historic user will be allowed to use the property;
(iv) any other planned use of the property after the transaction;

(footnote continued)


86 Under Section 355(a)(1)(B), a spin-off cannot be used principally as a device for the distribution of the earnings and profits of Distributing, Controlled or both.

87 See Massee, "Section 355: Disposal of Unwanted Assets in Connection with a Reorganization," 22 Tax L. Rev. 439, 449 (1967). As support, Massee cites to Senator Humphrey's belief that the device inherent in a spin-off was the ability to use such transaction "for the establishment of new corporate enterprises out of the undistributed reserves and earnings of large corporate business." See Cong. Rec. 12213 (1954).

88 See Rafferty v. Com., 72-1 ustc §9101, 452 F2d 767, 772 (CA-1 1971) (where the court, in holding that the separation of owner-occupied real estate from the taxpayer's other business did not satisfy the active trade or business requirement, stated that "a corporation must engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitively distinguish its operations from mere investments").

89 Reg. §1.355-3(b)(2)(iv).

90 Such conclusion is supported by both regulations and case law. See Reg. §1.355-3(c), Ex. 13 (Controlled did not satisfy the active trade or business requirement where its business activity consisted of leasing 75% of a building to Distributing and the balance to an unrelated third party). But see Reg. §1.355-3(c), Ex. 12 (active trade or business requirement was satisfied where Controlled leased 10 of 11 floors of a building to tenants unrelated to Distributing or Controlled).

See also Appley v. Com., CCH Dec. 24,665, 35 TC 755 (1961) (controlled's rental activities did not satisfy the active trade or business requirement where 50% of the rental space and 70% of the rental income came from Distributing. Controlled conducted little activity and kept no records to show the profits and losses from the operation of a rental business); Elliott v. Com., CCH Dec. 25,573, 32 TC 283 (1961) (same); Bonsall v. Com., 63-1 ustc §9462, 317 F2d 61 (CA-2) (Controlled was not engaged in the active conduct of a rental business where it occupied most of the space in its properties, third-party rental income was derived from a supplier of its other business at less than fair market value, and no separate records of rental income and expenses were kept); Gada v. Com., 78-2 ustc §9739, 460 FSupp 283 (D. Conn. 1978) (Controlled, which derived most of its revenues from rentals to two sister corporations, had minimal third-party rentals and lacked employees, was not engaged in an active trade or business); Rev. Rul. 56-266, 1956-1 CB 184 (ownership of land and other buildings used in the operation of another business did not represent a separate trade or business); Rev. Rul. 57-464, 1957-2 CB 244 (ownership of rental properties acquired either for investment or as a convenience to employees of the taxpayer's other business and which provided little income did not constitute the active conduct of a trade or business).

But see King v. Com., 72-1 ustc §9341, 458 F2d 245 (CA-6), where the court held that three subsidiaries were engaged in the active conduct of a real estate leasing business even though they leased their properties to their parent on a net lease basis. The court relied on the fact that the subsidiaries were created for a valid business purpose and that the parent and subsidiaries acted as unrelated entities. Each subsidiary purchased land, negotiated with contractors for the construction of terminals, obtained loans and insurance on the facilities, leased the terminals to the parent, collected rent, made payments of principal and negotiated for additions and alterations to terminals. The use of long-term net leases did not cause the income to be treated as passive income since the court found that net lease income represented the most advantageous method of doing business, the leases were bona-fide and were of a type customarily used in the industry.

June 1996 | TAXES

379
(v) the reason for separating the ownership of the property from its historic user.

More guidance is needed, however, which explains in greater detail (possibly with “safe harbor” examples) the circumstance in which the separation of real, intellectual or other intangible property from its user will satisfy the active trade or business test, including:

(i) whether the Service believes that any (or, if any, how much) of the property must be leased to parties unrelated to Distributing or Controlled;

(ii) the terms on which such property may be leased; and

(iii) the level of activity the owner of such property must perform in order to be considered engaged in an active trade or business.

V. THE CONTINUITY OF INTEREST REQUIREMENT

Rev. Proc. 96-30 requires taxpayers to explain how the continuity of interest requirement will be satisfied and states that continuity will generally be satisfied if “one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution own, in the aggregate, 50 percent or more of the stock in each of the modified corporate forms in which the enterprise is conducted after the separation. In appropriate cases, the Service may require a continuity of interest representation from the taxpayer.”

The revenue procedure’s formulation of the continuity of interest test appears to be a significant departure from the requirement imposed by regulations under Section 355 or Rev. Proc. 86-41. According to Reg. §1.355-2(c)(1), the continuity of interest requirement is satisfied if Distributing’s shareholders own an amount of stock establishing a continuity of interest in both Distributing and Controlled after the distribution. Examples in the regulations appear to require that shareholders retain an equity interest in both Distributing and Controlled equal to 50 percent of the value of their equity interest in Distributing prior to the distribution. In order to satisfy such requirement, however, it is not necessary for each shareholder to own a continuing interest in each corporation following the distribution (thus allowing for a non-pro rata spin-off).

Taxpayers requesting rulings under the Service’s old guidelines (Rev. Proc. 86-41) were required to represent that the continuity of interest test was satisfied only where a shareholder had a plan to dispose of any stock in Distributing or Controlled subsequent to the distribution. Such representation, identical to the representation required for rulings under Section 368, generally required that Distributing’s shareholders have no plan or intention to dispose of stock in either Distributing or Controlled following the distribution which would reduce their ownership in such corporations to a number of shares having a value, as of the date of the distribution, equal to 50 percent of the value of the outstanding stock as of such date.

The continuity of interest requirement of Section 368, the Section 355 regulations and Rev. Proc. 86-41 and 86-42 focus on the continuing interest in Distributing and Controlled by Distributing’s historic shareholders. Such requirement attempts to ensure that the distribution is not being used as a means to allow Distributing’s shareholders to “cash out” by selling their equity interest in Distributing or Controlled after a tax-free distribution. Rev. Proc. 96-30’s formulation of the continuity of interest requirement appears to inquire whether Distributing’s shareholders prior to the spin-off maintain an interest in both Distributing and Controlled which represents the majority of the benefits and burdens associated with the businesses of Distributing and Controlled.

On its face, the language of Rev. Proc. 96-30 appears to contradict the statements regarding continuity of interest in both the regulations and the prior ruling guidelines. It is unclear why the Service has changed such language in the new revenue procedure; we assume that it is simply a restatement and confirmation of the long-standing view of continuity that had existed prior to the issuance of Rev. Proc. 96-30.

91 Rev. Proc. 96-30, supra, note 1, section 4.06.
93 As such, the continuity of interest requirement, like the business purpose requirement, is closely related to the device requirement. See Reg. §1.355-2(d)(2)(iii) (stating that a sale or exchange of stock of Distributing or Controlled after the distribution is evidence of a device). Continuity of interest, however, is a separate requirement which must be satisfied even if there is no evidence of device. See Reg. §1.355-2(c).