

The Aftermath of a Section 355 Transaction

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Abstract

Section 355 of the Internal Revenue Code is one of the few bright spots remaining for corporate tax planners since the repeal of the *General Utilities* doctrine in the mid-1980s. However, the tax-free treatment afforded to spin-offs and other corporate separations under Section 355 can be jeopardized by transactions or other events that occur after the separation has been completed.

This article explores, through numerous hypothetical fact patterns, a wide variety of situations in which the tax-free treatment of spin-offs and other corporate separations under Section 355 can be jeopardized by transactions or other events that occur after the separation has been completed. As part of its discussion of the principal issues that arise in connection with post-spin developments, the article examines the following topics:

- Deviations from the purported corporate business purpose for the spin;
- Post-spin transactions involving dispositions of assets by the distributing corporation or the spun-off corporation;
- Post-spin transactions involving dispositions or new issuances of the stock of the distributing corporation or the spun-off corporation;
- Important recent changes in IRS ruling policy with respect to Section 355 transactions; and
- Common analytic themes for assessing, and suggestions for minimizing, the potentially adverse tax implications of post-spin developments.

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SECTION 355

THE AFTERMATH OF A SECTION 355 TRANSACTION

This article explores a wide variety of situations in which the tax-free treatment of spin-offs and other corporate separations under Section 355 can be jeopardized by transactions or other events that occur after the separation has been completed.

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Section 355 is one of the few bright spots remaining for corporate tax planners since repeal of the *General Utilities* doctrine in the mid-1980s.¹ Under that provision, a parent corporation (“Distributing” or “D”) can distribute the stock of a subsidiary (“Controlled” or “C”) to some or all of its shareholders without tax at either the shareholder or corporate levels. However, satisfaction of one or more of the requirements for Section 355 treatment can often be affected by transactions or other events that occur after the separation has been completed. This article examines, through numerous hypothetical fact patterns, the principal issues that can arise in connection with post-spin developments.²

I. Mechanics of Section 355

Section 355 transactions can take three basic forms:

- A “spin-off” (where none of the Distributing shareholders surrender any of their shares).
- A “split-off” (where one or more of the D shareholders redeem D shares for C shares).
- A “split-up” (where D completely liquidates and all D shareholders surrender all of their shares in exchange for shares of one or more Controlled).

Consistent with common parlance, the term “spin-off” or “spin” will sometimes be used in this article with reference to Section 355 transactions generally, regardless of their particular form.

Absent Section 355, spin-off distributions would be subject to tax at the *shareholder* level as dividends under the Section 301 rules; split-off distributions would be taxed as dividends or as an “exchange” of the surrendered D stock under the Section 302 rules governing redemption transactions; and split-up distributions would be taxed as an exchange of the D shares under the complete liquidation rules of Sections 331 or 332 (the latter where D has a corporate shareholder that owns at least 80% of the D stock in terms of vote and value). At the *corporate* level, spin-off and split-off distributions of the C stock would trigger taxable Section 311(b) gain (but not loss); and split-up distributions would trigger gain and, subject to certain limitations, loss under Section 336.

Where Section 355 applies, (i) the transaction generally is tax-free to Distributing;³ (ii) the D shareholders are not taxed on their receipt of the Controlled stock, but are subject to tax on any “boot” received;⁴ and (iii) the D shareholders take an allocated or substituted basis in the Controlled stock received.⁵ In some

circumstances, however, a Section 355 distribution can qualify for tax-free treatment at the shareholder level, but not at the corporate level (by reason of the application of Section 355(d) or Section 355(e)).

A. Statutory requirements.

For a distribution to qualify under Section 355, all of the following statutory requirements must be satisfied:

- Stock of Controlled must be distributed to shareholders of Distributing with respect to their D stock; or stock or securities of Controlled must be distributed to security holders of Distributing in exchange for D securities.⁶
- The distribution must not be used principally as a “device” for the distribution of the earnings and profits of Distributing or Controlled or both (the “Non-Device Requirement”).⁷
- Both Distributing and Controlled must be engaged in the active conduct of a trade or business immediately after the distribution (the “ATB Requirement”).⁸
- Distributing generally must distribute all of the Controlled stock that it holds immediately before the distribution, or at least an amount of shares constituting “control” of Controlled, as defined by Section 368(c) (the “Distribution of Control Requirement”).⁹
- Immediately after the transaction, neither Distributing nor Controlled can be a “disqualified investment corporation” in which any person who holds a 50% or greater interest in such corporation held a less than 50% interest in such corporation immediately before the transaction.¹⁰

B. Non-statutory requirements.

Additional Section 355 qualification requirements, provided in the underlying Treasury regulations, include the following:

- All Section 355 distributions must be motivated “in whole or substantial part” by one or more non-federal tax corporate business purposes that could not otherwise be feasibly accomplished on a non-taxable basis without separating Controlled as a stand-alone company (the “Business Purpose Requirement”).¹¹
- After a spin-off, “one or more persons who, directly or indirectly, were the owners of” Distributing before the spin-off must “own in the aggregate, an amount of stock establishing a continuity of interest in each of” Distributing and Controlled (the “355 COI Requirement”).¹²
- In addition to requiring continuing stock ownership, “[s]ection 355 contemplates the continued operation of the business or businesses existing prior to the separation” (the “355 COBE Requirement”).¹³

C. Divisive ‘D’ reorganizations.

Section 355 transactions are often structured as part of a “divisive” reorganization under Section 368(a)(1)(D), where, prior to the spin, Distributing transfers assets to an existing or a newly formed Controlled (a “D/355 transaction”).¹⁴ If the subsequent distribution of the Controlled stock qualifies under Section 355, and a separate “control” requirement is met (the “D Reorg Control Requirement”), Section 361(a) provides that no gain or loss will be recognized by Distributing in respect of its transfer of assets in exchange for Controlled stock. The D Reorg Control Requirement is met where one or more of the Distributing shareholders (including persons who were shareholders immediately before the asset

transfer) hold at least 80% control of Controlled (within the meaning of Section 368(c)) “immediately after” the distribution. As relevant to D/355 transactions, the fact that the shareholders of Distributing dispose of part or all of the stock of Controlled following the distribution, or the fact that Controlled issues additional stock following the distribution, will not cause the D Reorg Control Requirement to be violated.¹⁵

D/355 transactions are also subject to a separate set of nonstatutory requirements found in the Treasury regulations under Section 368. These include the following:

- *Business purpose.* The “business purpose” requirement of Reg. 1.368-1(b) applies to Distributing’s contribution of assets to Controlled.¹⁶
- *Continuity of interest.* Reg. 1.368-1(e) prescribes a separate COI requirement for acquisitive reorganizations (the “368 COI Requirement”). Although the 368 COI Requirement does not presently apply to either “acquisitive” or “divisive” type-D reorganizations,¹⁷ the interface, if any, between the 355 COI Requirement and the 368 COI Requirement is unsettled.¹⁸
- *Continuity of business.* Reg. 1.368-1(d) describes in considerable detail a separate COBE requirement (the “368 COBE Requirement”); but it is unclear whether or how the 368 COBE Requirement informs application of the 355 COBE Requirement or interfaces with other Section 355 requirements (most notably, the ATB Requirement).¹⁹

D. Corporate-level taxation.

Notwithstanding the qualification of a transaction under Section 355, Distributing may still be required under Section 355(e) to recognize gain on the distribution of the Controlled stock (i.e., on the excess of fair market value over basis). Section 355(e) is triggered where stock representing a 50% or greater interest in Distributing or Controlled (or any of their respective successors) is acquired (directly or indirectly) by one or more persons pursuant to a plan (or series of related transactions) that includes the Section 355 distribution (the “Proscribed Plan”).²⁰ Stock dispositions during the four-year period beginning two years before and ending two years after the distribution carry a rebuttable presumption of being part of a Proscribed Plan.²¹ Because Section 355(e) comes into play only if the transaction meets all of the Section 355 qualification requirements, any post-spin stock disposition must first pass muster under the Non-Device and the 355 COI Requirements (as well as all other Section 355 qualification requirements).

II. Framework for analysis

There are many ways in which compliance with the requirements of Section 355 may be affected by post-spin changes in the stock ownership and/or asset composition of Distributing or Controlled. Importantly, the fact that a favorable Section 355 private letter ruling was obtained from the IRS will not necessarily preclude a subsequent audit challenge based on post-spin developments. In that regard, since 2003 all private letter rulings issued under Section 355 have been caveated (i.e., no ruling is given) with respect to the Business Purpose and the Non-Device Requirements and the determination of whether the spin is part of a Proscribed Plan under Section 355(e).²² Moreover, under its current ruling policy, the Service generally will not rule at all on Section 355 transactions, except in very limited circumstances.²³

As a general matter, the continuing viability of an otherwise qualifying Section 355 transaction can be jeopardized in the following basic scenarios:

- Transactions or steps necessary to effectuate the asserted corporate business purpose for the spin do not occur at all or occur in a different manner than originally contemplated.
- Distributing or Controlled transfers active business assets to another person or entity (whether related or unrelated).

- Shareholders of Distributing or Controlled sell or otherwise dispose of substantial amounts of Distributing or Controlled stock.²⁴

Analyzing the impact of these post-spin developments tends to focus on three critical factual inquiries:

- How soon after the spin did such developments occur?
- Were such developments planned, otherwise contemplated, or legally “wired” to occur at the time of the spin?
- What portion of Distributing or Controlled’s assets or stock was disposed of after the spin in taxable and/or non-taxable transactions?

Acquisitions of all the assets or stock of Distributing or Controlled by unrelated parties will generally carry the greatest risk, especially if the acquisition occurs soon or relatively soon after the spin. More limited changes in the asset composition (or use) or stock ownership of Distributing or Controlled also can be problematic, as can changes in business plans or operations that might be viewed as contradicting the asserted corporate business purpose for the spin. In many instances, the risk of jeopardizing tax-free treatment under Section 355 may be serious enough to dictate modifying or not proceeding with a proposed post-spin transaction, or at least postponing it until a later date reasonably distant from the date of the spin.

III. Deviation from asserted corporate business purpose

Certain post-spin transactions or events may jeopardize Section 355 qualification because the Service views them as inconsistent with the asserted business purpose for the spin. The regulations, however, require merely that the transaction be “motivated in whole or substantial part” by one or more corporate business purposes, not that the asserted corporate business purpose actually come to fruition.²⁵ Thus, unless post-spin developments cast doubt upon the factual premises of the asserted motivating purpose for the transaction, unforeseen deviations from that purpose generally ought not invalidate otherwise available Section 355 treatment.

A. Unanticipated change in market/economic conditions.

Perhaps the most common scenario in which the Service tends to tolerate unachieved, modified, or postponed business purposes is where the deviation is caused by unanticipated changes in market or economic conditions.

Case 1

Distributing is a publicly traded corporation that conducts Business A directly and Business C through Controlled, a wholly owned subsidiary of Distributing. Business C needs to raise a substantial amount of capital in the near future to invest in plant and equipment and to make acquisitions, and Distributing has been advised by its investment banker that the best way to raise this capital is through an initial public offering (IPO) of the stock of Controlled after Controlled has been separated from Distributing. In reliance on this advice, Distributing distributes the stock of Controlled to its shareholders in a transaction to which Section 355 otherwise applies, and Controlled prepares to offer its stock to the public as soon as practicable, but with a target date approximately six months after the spin. Following the spin and before the IPO can be undertaken, market conditions unexpectedly deteriorate to such an extent that, in the judgment of Controlled and its advisors, the IPO should be postponed. One year after the spin, conditions have not improved sufficiently to permit the IPO to go forward, and Controlled instead funds its capital needs through the sale of debentures.

These were the facts of Rev. Rul. 2003-55,²⁶ where the Service concluded that the Business Purpose Requirement was met notwithstanding that Controlled did not complete the contemplated stock offering because the deterioration of market conditions following the distribution was not reasonably foreseeable at the time of the spin. The core teaching of this important ruling is that the sufficiency of an asserted Section 355 business purpose is to be determined “at the time of the distribution,” even though that purpose ultimately cannot be achieved as the result of an unexpected change in circumstances following the distribution.

Consistent with this rationale, the Service has issued favorable supplemental Section 355 rulings in a number of situations involving delays, reductions in size or cancellations of planned public offerings due to changes in market conditions, or other business circumstances.²⁷ It also has ruled that a spin completed to facilitate increased debt financing for use in future acquisitions was not jeopardized by a change in plans to instead use part of the borrowed funds for working capital needs,²⁸ or, where the principal purpose for a spin was to permit a public offering by Controlled, by subsequent open market repurchases of Controlled stock.²⁹

In short, an unanticipated change in market or economic conditions following a spin ought not preclude satisfaction of the Business Purpose Requirement. If the asserted business purpose is plausible and not contradicted by facts or circumstances known or reasonably apparent at the time of the distribution, post-spin developments that are inconsistent with the asserted purpose should not jeopardize the spin’s qualification under Section 355 on business purpose grounds.

B. Continuing post-spin relationships.

Another twist on the “business purpose deviation” theme can arise in connection with continuing post-spin relationships between Distributing and Controlled (or their respective subsidiaries). Such relationships are not uncommon (especially in public company spins) and may include (i) common directors or officers; (ii) shared administrative personnel, office space, or manufacturing or supply facilities; (iii) extension of credit; or (iv) other joint business or financial arrangements. Particularly where the asserted business purpose for the spin is “fit and focus,”³⁰ the mere existence of continuing relationships might be viewed as contradicting such purpose; for the essence of “fit and focus” is that Distributing and Controlled can no longer comfortably co-exist under the same corporate umbrella and need to be completely divorced from one another. Nonetheless, where continuing relationships are intended to be effective after the spin for only a specified transitional period (as is often represented in Section 355 ruling requests), they normally will not prevent qualification under Section 355. That was the case, for example, in Rev. Rul. 2003-75,³¹ which accorded Section 355 treatment to a “fit and focus” spin involving the following described continuing relationships:

To facilitate the separation, Distributing and Controlled will enter into transitional agreements that relate to information technology, benefits administration, and accounting and tax matters. Other than the tax matters agreement, each agreement will terminate after two years absent extraordinary circumstances, in which case the affected agreement may be extended on arm’s-length terms for a limited period. Following the separation, there will be no cross-guarantee or cross-collateralization of debt between Distributing and Controlled, and an arm’s-length loan from Distributing to Controlled for working capital will have a term of two years.

Such transitional relationships were found to be acceptable because they were “designed to facilitate, rather than impede, the separation of” the Distributing and Controlled businesses. While longer than two-year continuing relationships may also be acceptable in appropriate circumstances, they normally will be accorded closer scrutiny by the Service.

Where there is a significant lengthening of an asserted transitional period, or some other change in the nature of a particular type of continuing relationship, it may be necessary to persuade the Service that the revised relationship is compatible with the asserted business purpose, or that identifiable unanticipated

circumstances have rendered that business purpose less compelling.³² That likely will be easier to do in cases not involving a “fit and focus” purpose, especially where the continuing relationship becomes permanent or of indefinite duration.³³

IV. Post-spin events involving Distributing or Controlled assets

Following a Section 355 distribution, Distributing or Controlled may sell or otherwise dispose or discontinue use of assets held at the time of the spin. Post-spin asset transfers may be made to unrelated or related parties via taxable or non-taxable transactions. In some instances, assets may be retained but become inactive (either on a temporary or permanent basis) or used in a different business.³⁴ If the affected assets were relied upon for purposes of satisfying the ATB and/or 355 COBE Requirements, the post-spin developments could jeopardize Section 355 qualification. In some instances, moreover, asset transfers in connection with certain types of tax-free reorganizations can be treated as stock acquisitions and trigger corporate-level taxation under Section 355(e).

A. ATB and 355 COBE Requirements.

The ATB Requirement encompasses several elements set forth in Section 355(b). Both Distributing and Controlled must be engaged in a qualifying ATB “immediately after” the distribution of the Controlled stock³⁵ — more specifically, in a business that (i) was actively conducted throughout the five-year pre-distribution period; (ii) was not acquired during such period in a transaction in which gain or loss was recognized in whole or in part; or (iii) was conducted by another corporation “control” of which (per Section 368(c)) was not acquired during such period other than via transactions in which no gain or loss was recognized in whole or in part (e.g., a Section 368 reorganization with no boot).³⁶

Under Section 355(b)(3), added to the Code in 2005, a qualifying ATB can be conducted directly by Distributing or Controlled or indirectly through a subsidiary that is a member of the Distributing or Controlled “separate affiliated group” (SAG). Under this regime, all SAG members (including the “top” corporation, i.e., Distributing or Controlled) are treated as a single corporation for purposes of the ATB Requirement.³⁷

Notwithstanding a taxable acquisition of an active business during the five-year pre-distribution period, the ATB Requirement can nonetheless be met under the so-called “business expansion” doctrine, where the purchased business is in the same line of business as an existing qualified ATB of Distributing or Controlled — as opposed to being a new or different business.³⁸ The business expansion exception also may apply in contexts where Distributing or Controlled purchases the stock of a corporation engaged in the same line of business during the five-year pre-distribution period.³⁹ In such cases, the transaction may qualify as a mere expansion of an existing business and thereby satisfy the ATB Requirement notwithstanding the taxable stock acquisition transaction.⁴⁰

With respect to the 355 COBE Requirement, Reg. 1.355-2(b) requires the “continued operation” of the pre-spin businesses, seemingly suggesting an unspecified temporal requirement beyond whatever period needs to elapse to satisfy the statutory “immediately after” element of the ATB Requirement. Furthermore, in a D/355 transaction, the separate 368 COBE Requirement — along with the “historic business”/“historic business assets” criteria articulated in Reg. 1.368-1(d) — may come into play. Although practitioners often assume that satisfaction of the ATB Requirement will necessarily assure satisfaction of the 355 COBE Requirement, it is by no means clear that these requirements always operate in tandem.

B. Sale of ATB assets.

A sale of all or substantially all of the assets of a business relied upon by Distributing or Controlled to satisfy the ATB Requirement will almost certainly attract the Service’s attention, particularly if done relatively soon after the spin and the corporation does not continue a different business that also could have been relied upon to satisfy the ATB Requirement.

Case 2

Distributing, a public company, conducted three unrelated active businesses. Bus. 1 and Bus. 2 were directly operated through divisions and represented, respectively, 35% and 60% of Distributing's total value; both had been operated by Distributing for more than five years. Bus. 3 was operated through a wholly owned subsidiary ("S1"), the stock of which was purchased by Distributing for cash on 6/30/09. Although Bus. 3 was worth only 5% of Distributing's total value, it was viewed by Distributing's management as having significant growth potential. On 9/30/12, Distributing transferred the Bus. 2 net assets to another wholly owned subsidiary ("S2") and distributed the S2 stock pro rata to the Distributing shareholders in a qualifying Section 355 transaction. In November 2012, the CEO of Pubco, also a public company, approached Distributing's CEO about a potential acquisition of Bus. 1. Pubco and Distributing had previously discussed a possible acquisition of Bus. 1 in 2007, and again in 2009, but Distributing had called off the discussions on both occasions. On 12/15/12, Distributing agreed to sell the Bus. 1 assets to Pubco for cash, which it plans to earmark primarily for Bus. 3 capital expansion projects. The transaction closed on 1/31/13.

This fact pattern raises potential issues under both the ATB and 355 COBE Requirements. Distributing has to be engaged in a qualifying ATB "immediately after" the spin. Is it enough that a sale of Bus. 1 was not contemplated at the time of the spin? Or, even if not contemplated, is the agreement to dispose of Bus. 1 just 75 days after the spin nonetheless problematic — especially since Pubco was a prior suitor and Distributing management may have at least suspected that it would again express interest? If Distributing cannot continue to rely on Bus. 1 as its qualifying ATB, the original Section 355 qualification of the spin will be reversed unless it can instead rely on Bus. 3. In this case, Bus. 3 may not have been a qualifying ATB at the time of the spin, because the stock of S1 was stock acquired in a taxable transaction during the five-year pre-distribution period.⁴¹

In analyzing Case 2-type situations for possible ATB violations, the most important factual inquiries are (i) how soon after the spin did the sale occur and (ii) were the circumstances or events motivating the sale known or reasonably foreseeable at the time of the spin? In general, absent a plainly "wired" transaction, the longer the "gap" period, the harder it will be for the Service to successfully assert a breach of the "immediately after" ATB Requirement via the application of conventional step-transaction principles.⁴² Several private letter rulings provide some indication of the Service's tolerance in this regard. Consistent with the rationale of Rev. Rul. 2003-55 in "deviation from business purpose" scenarios, these rulings appear to focus primarily on whether the post-spin disposition was caused by circumstances or events that were unforeseen at the time of the spin.⁴³ While the Case 2 circumstances would likely raise an agent's eyebrow upon audit (especially the short timeframe separating the spin and the sale), they ought not be fatal if the taxpayer can convincingly demonstrate that, at the time of the spin, a sale of Bus. 1 was not under consideration or recognized as a possible transaction that Distributing or Controlled would be willing to entertain.

With respect to the 355 COBE Requirement, the threshold question is whether it is automatically satisfied so long as the ATB Requirement is satisfied. While that probably will be the case in most instances,⁴⁴ the Section 355 regulations do appear to identify "the continued operation of" the pre-spin businesses by Distributing and Controlled as a separate requirement that may contemplate a longer period of post-spin operation than whatever period may be contemplated by the "immediately after" element of the ATB Requirement. For example, on the Case 2 facts, Distributing's continued operation of Bus. 1 for 4 months before the sale to Pubco may well be enough to foreclose an "immediately after" challenge, but seems less clearly indicative of the post-spin business continuity required by the Section 355 regulations.⁴⁵

Whatever parameters may exist with respect to any temporal aspect of the Section 355 "business continuity" requirement, additional uncertainty may exist with respect to the extent to which pre-spin business activities must continue to be conducted, qualitatively or quantitatively, after the spin. The Section 355 regulations are silent in that regard. The COBE regulations under Section 368, however, require continuation of a "significant historic business" or the continued use of a "significant portion of the

historic business assets” of the acquired corporation; and an example in those regulations indicates that the continuation of only one of three equally valued pre-acquisition businesses will suffice.⁴⁶

The 368 COBE Requirement clearly applies to acquisitive type-“D” reorganizations.⁴⁷ If the principles of the 368 COBE Requirement were to be imported into the 355 COBE Requirement, and assuming that Bus. 3 satisfied the ATB Requirement, Distributing’s continuation of only Bus. 3 (representing less than 10% of Distributing’s aggregate pre-spin value) could be problematic from a COBE perspective.⁴⁸ While it is reasonable to conclude that the principles of the 368 COBE Requirement should not be imported into the 355 COBE Requirement,⁴⁹ this area remains quite murky and ripe for clarifying administrative guidance.

C. Cessation/scale-down of ATB operations.

Post-spin ATB or COBE issues may also arise if an ATB relied upon by Distributing or Controlled temporarily or permanently ceases or scales down operations.

Case 3

Unrelated individuals A and B each own 50% of the outstanding stock of Realco, Inc., which they formed in 1990. Realco owns and operates a large rental apartment building (the “Apartment Building”) and a mid-rise office building with ground floor retail tenants (the “Office Building”), both through single-member limited liability companies that are treated as disregarded entities for federal income tax purposes. The Apartment Building was developed by Realco in 1990. The Office Building was purchased from a prior owner in 1995. A and B are the principal officers of Realco and actively manage the leasing and other activities of the Apartment Building and the Office Building. Realco employees perform all day-to-day maintenance and repair services for both properties. On 9/15/12, A and B part ways via a split-off transaction pursuant to which (i) the Office Building is contributed to a new, wholly owned subsidiary of Realco (“Newco”); and (ii) all of the Newco stock is distributed to B in redemption of all of B’s Realco shares. Realco also contributes borrowed cash to Newco to equalize the post-split values of Realco and Newco. Because the Office Building had never been renovated, B plans to let the existing leases run out (within six months after the spin) and temporarily close down the Office Building for extensive refurbishing (to be financed with the borrowed cash). Shortly after beginning the refurbishment process (which is expected to take six months), a serious mold problem is discovered, causing B to decide to demolish the Office Building and consider other possibilities for developing the vacant property. In the meantime, Newco blacktops the property, begins to operate it as a public parking lot, and invests the remaining cash received from Realco in bank CDs and Treasury bonds. Three months later, before any alternative development plans have been formulated, B receives and accepts an unsolicited offer from an unrelated third party to buy the parking lot property. Newco uses the sale proceeds to purchase two strip shopping centers at different locations.

Even though contemplated at the time of the split-off, the temporary closure of the Office Building should not have caused Newco to violate the ATB Requirement. The ownership and operation of rental real estate constitutes a qualifying ATB provided “the owner performs significant services with respect to the operation and management of the property.”⁵⁰ Because Newco, through its officers and employees, did in fact actively operate the Office Building for several months prior to beginning the refurbishment process, the ATB “immediately after” requirement would seem safely met under a literal reading of the statute. Had the refurbishment gone forward and the Office Building re-opened as originally planned, the anticipated one-year hiatus presumably would not have been problematic. Particularly since the need to demolish the building was unforeseen at the time of the spin, it seems inappropriate to reach a harsher result with respect to the facts as they ultimately developed.⁵¹

Moreover, even if the limited post-split continuation of the Office Building rental operations properly could be considered insufficient for purposes of the ATB or 355 COBE Requirements, the intended use of the vacant Office Building property as a pay parking lot might be viewed as a form of real estate leasing activity and, as such, a “continuation” of Realco’s pre-split real estate leasing business.⁵² While the analysis is further complicated by the absence of alternative development plans and Newco’s sale of the property only three months later, that too was unforeseen at the time of the split-off; and the fact that Newco quickly resumed leasing activities through its acquisition of the shopping centers would seem to weigh favorably against any challenge by the Service on either ATB or COBE grounds.

In short, Section 355 qualification of the Newco split-off ought not be jeopardized by any of these unexpected post-spin events. At the time of the split-off, Newco fully intended to continue its Office Building rental operations and did in fact do so for several months pending a planned temporary shut-down for refurbishment that, for unforeseen reasons, failed to materialize.

D. Shifting of ATB assets into investment assets.

The holding of stock, securities, land, or other property for investment purposes generally does not constitute the active conduct of a trade or business.⁵³ Accordingly, Section 355 qualification may be jeopardized where assets that had been relied upon to satisfy the ATB Requirement are sold following the spin and the sale proceeds are invested in passive assets.

Case 4

The facts are the same as in Case 3, except that (i) the property that had been occupied by the demolished Office Building is left vacant and listed for sale by Newco (i.e., Newco does not construct a parking lot on the property); (ii) Newco sells the vacant lot to an unrelated third party; and (iii) Newco invests the sale proceeds in a portfolio of stocks and bonds (i.e., it does not use the cash to purchase other rental real estate properties).

The Service might view this fact pattern more harshly than Case 3, because Newco took the initiative in seeking to sell the Office Building property (as opposed to acting in response to an unsolicited purchase offer) and deliberately chose to stop conducting *any* active business after the mold problem surfaced seems troublesome in that the “business continuity” reference in the Section 355 regulations appears to contemplate that both Distributing and Controlled continue their pre-distribution active businesses for some period of time. However, as noted above, the supplemental letter rulings in this area appear to turn mainly or exclusively on whether the post-spin dispositions of an active business were spurred by unanticipated developments that rendered retention of such business impractical or unreasonable.⁵⁴ Assuming that discovery of the mold problem in Cases 3 and 4 was in fact such a circumstance, how Newco decided to dispose of or replace the Office Building would seem irrelevant for purposes of the ATB and 355 COBE Requirements.

There may, however, be another potential Section 355 qualification issue raised by the Case 4 facts — namely, whether Newco’s investment of the sale proceeds from the Office Building property in a securities portfolio would cause it to be considered a “disqualified investment corporation” (DIC) under Section 355(g). Added to the Code in 2006 to curb so-called “cash-rich split-off” transactions, that provision precludes Section 355 qualification if (i) “immediately after the transaction,” at least two-thirds of the total value of the Distributing or Controlled assets are tainted “investment assets”; and (ii) no person who held a less than 50% stock interest in such DIC “immediately before the transaction” holds a 50% or greater stock interest “immediately after the transaction.”⁵⁵ For purposes of applying these percentage tests, Section 355(g)(4) instructs that the term “transaction” includes “a series of transactions.” Thus, while B held a 50% interest in Newco immediately before the split-off distribution, that distribution was part of a D/355 transaction that included the formation of Newco; so immediately before the formation, B held no stock (directly or indirectly) in Newco and thus went from less than 50% (i.e., zero) to 100% ownership of Newco. If that is how the Service would construe the “50% before/after” requirement of

Section 355(g), that provision conceivably could be triggered if the sale of the Office Building property and the acquisition of the securities portfolio were considered part of the same “transaction” (or “series of transactions”) that included the split-off distribution. The unforeseen nature of these post-spin events probably should prevent that unhappy result (as it should with respect to the ATB and 355 COBE Requirements). Treasury has broad “anti-avoidance” regulatory authority under Section 355(g)(5) (as yet unexercised), and at least some guidance on Case 4-type situations would be helpful.

E. Post-spin reliance on business expansion doctrine.

If Distributing or Controlled has an existing active business and acquires another business, the acquisition may be treated as an expansion of the original business (whether or not gain or loss is recognized in the transaction), if the change is not sufficient to constitute the acquisition of a new or different business.⁵⁶ Thus, if the original business has been actively conducted for at least five years, the acquired business may be treated as having been actively and continuously conducted for the same period of years for purposes of applying the ATB Requirement.

1. Similar products/mode of operations.

A business that acquires another business that produces similar products or operates in a similar manner should constitute a mere expansion.

Case 5

Carco, Inc. (“Carco”), a domestic corporation, owned and operated two automobile dealerships — Dealership 1, which featured Brand 1 automobiles, and Dealership 2, which featured Brand 2 automobiles. Dealership 1 was started by Carco in 2000. The assets of Dealership 2 were purchased by Carco from an unrelated third party for cash on 6/30/09. On 3/31/11, Carco transferred Dealership 1 to Newco, a newly formed subsidiary of Carco. On 6/30/12, Carco distributes the Newco stock pro rata to the Carco shareholders in a transaction intended to qualify for tax-free treatment under Section 355. On 9/15/12, Carco sold Dealership 2 to an unrelated third party and acquired a car rental agency franchise with the sale proceeds.

The business activities associated with the operation of Dealership 1 (i.e., sales and service) are the same as the business activities associated with the operation of Dealership 2, Brand 1 and Brand 2 are similar products (i.e., automobiles), and the operation of Dealership 2 involves the use of the experience and know-how that Carco developed in the operation of Dealership 1. Accordingly, as confirmed by a 2003 published ruling,⁵⁷ Carco’s acquisition of Dealership 2 constituted merely an expansion of Carco’s existing business (i.e., the ownership and operation of a car dealership); and Carco and Newco should each therefore be treated as satisfying the ATB Requirement immediately after the spin.

The fairly quick post-spin sale of Dealership 2 and its replacement with a car rental agency muddies the water. Is the ATB “immediately after” requirement met? Can Carco still rely on the “business expansion” exception with respect to the 2009 purchase of Dealership 2 (which otherwise would have caused an ATB problem under Section 355(b)(2)(C))? Has there been a sufficient “continuation” of the Dealership 2 business for purposes of the 355 COBE Requirement? Is it fatal that car rental was not an historic business of Carco or Newco, or is it enough that both businesses involved making cars available to the public? The answers to these questions are not that clear-cut. But assuming that the sale of Dealership 2 was motivated by circumstances not foreseen at the time of the spin, and based on the analysis offered with respect to Cases 3 and 4, the post-spin developments in Case 5 ought not jeopardize compliance with the ATB Requirement or, though perhaps less clearly, the 355 COBE Requirement.

2. Interface with SAG rules.

Under the SAG rules of Section 355(b)(3), a taxable acquisition of the stock of a corporation may be tested for ATB purposes as an *asset* acquisition (under Section 355(b)(2)(C)) rather than as a *stock* acquisition (under Section 355(b)(2)(D)); and, if the facts otherwise warrant application of the business expansion doctrine, both Sections 355(b)(2)(C) and (b)(2)(D) are disabled, and the taxable acquisition within the five-year pre-distribution period will not prevent compliance with the ATB Requirement.⁵⁸

Case 6

The facts are the same as in Case 5, except that on 6/30/09, Carco purchased the stock of a corporation that had operated Dealership 2 (“Dealerco”) from an unrelated party. On 6/30/12, Carco organized Newco and contributed Dealership 1 to Newco. Thereafter, Carco distributed the stock of Newco pro rata to the Carco shareholders in a transaction intended to qualify for tax-free treatment under Section 355. On 9/15/12, Dealerco sold Dealership 2 and acquired a car rental agency franchise with the proceeds of that sale.

Under the SAG rules, the stock acquisition resulted in Dealerco becoming a member of the Carco SAG group.⁵⁹ Because Dealerco and Carco were in the same business, the business expansion doctrine should apply to treat Carco and Dealerco as satisfying the ATB Requirement (and, correspondingly, the 355 COBE Requirement) immediately after the spin. Again, assuming that the post-spin events were unforeseen at the time of the spin, the same analysis advanced with respect to Cases 3, 4, and 5 should likewise protect Section 355 qualification on the Case 6 facts (including preservation of the business expansion exception for the Dealerco acquisition).

3. Discontinuance/conversion of historic business.

Rev. Rul. 2003-18 confirms that the “business expansion” doctrine can appropriately apply where the acquired and existing businesses (i) have the same subject matter or product; (ii) conduct essentially the same operational activities; and (iii) draw on the same fundamental know-how and experience. These “sameness” factors were clearly present in Cases 5 and 6. The following fact pattern presents some additional twists, relating to the nature of the expansion business and the post-spin developments.

Case 7

Stepco, Inc. has owned and operated a men’s shoe store since 1990. In 2009 Stepco began to sell shoes on-line as well. The website is named “Stepco.com” to take advantage of the name recognition, customer loyalty, and other elements of goodwill associated with the Stepco name. On 6/30/11, Stepco transferred its on-line business assets to Clickco, a newly formed subsidiary. A year later, Stepco distributed the Clickco stock pro rata to the Stepco shareholders in a transaction intended to qualify for tax-free treatment under Section 355. In December 2012 Stepco sold its existing shoe store inventory and, over the next three months, converted the store premises into an outdoor recreational apparel and equipment store. Approximately 10% of the inventory in the new store is represented by hiking boots, running shoes, and other types of outdoor footwear (some lines of which also had been carried by Stepco in the shoe store). Plans regarding the shoe store conversion were under consideration at the time of the Clickco spin.

The products sold by Stepco’s retail shoe store business and the products sold on Stepco.com are the same (i.e., shoes); and the core business activities of Stepco’s retail outlet are the same as those of Stepco.com (i.e., purchasing shoes at wholesale and reselling them to the public at retail). Although selling shoes on a website does require know-how not normally associated with operating a retail shoe store (e.g., familiarity with different marketing approaches, distribution chains, and advanced computer

technologies), the website's operation nevertheless draws on Stepco's existing experience and know-how to a significant extent, and the success of the on-line business depends in large measure on the goodwill associated with the Stepco name. Accordingly, as confirmed by another 2003 published ruling,⁶⁰ Stepco's creation of the website in June 2008 likely constituted an expansion of Stepco's retail shoe store business, so that each of Stepco and Clickco should be treated as satisfying the ATB Requirement (and, correspondingly, the 355 COBE Requirement) immediately after the spin.⁶¹

The post-spin conversion of the shoe store premises into the outdoors store could raise ATB or COBE problems for both Stepco and Clickco. Is it enough that 10% of the inventory in the new store continues to be represented by footwear (some lines of which had been carried in the shoe store)? Can it be plausibly argued that the products carried in the new store are merely an expansion of those offered at the old store in that both, broadly speaking, are types of clothing? Is Clickco's reliance on the business expansion doctrine for Stepco.com jeopardized by the effective disappearance of the shoe store business?

The answers to these questions presumably are significantly influenced by the fact that the shoe store conversion was already under consideration at the time of the spin. In particular, the application of conventional step-transaction principles for purposes of the ATB and 355 COBE Requirements could result in a violation of the ATB "immediately after" requirement, as well as any temporal requirement that may be contemplated by the 355 COBE Requirement. Further questions could arise as to which iteration of the step-transaction doctrine should apply. For example, would it matter that the shoe store conversion was merely a contemplated possibility at the time of the spin (as opposed to a "done deal")? Even though the conversion was already in the planning stage, is the ATB Requirement still met by Stepco since its shoe store operations in fact continued to operate for a full year after the spin? Again, the answers are not totally clear, so proceeding to complete the shoe store conversion in such circumstances could prove problematic.⁶²

F. Post-spin reorganization transactions.

Not uncommonly, a spin-off may be followed by a Section 368 tax-free reorganization involving Distributing or Controlled. In such situations, the sole or primary business purpose for the spin often is to shed an unwanted business and thereby facilitate the planned acquisition of the "wanted" business. That was what happened in *Morris Trust*,⁶³ a 1966 decision in which Distributing, a state bank, incorporated and distributed an unwanted insurance department to enable Distributing to merge directly into a national bank, with the Distributing shareholders receiving 54% of the acquiring bank's stock in the merger. Upholding tax-free treatment for both the spin-off (under Section 355) and the reorganization (under Section 368(a)(1)(A)), the Fourth Circuit held that facilitating the subsequent merger constituted a valid Section 355 business purpose for the spin-off, and that the ATB and other Section 355 qualification requirements also were satisfied notwithstanding that Distributing had ceased to exist as a stand-alone corporation and the Distributing shareholders had disposed of all their Distributing stock in the merger.

The Service acquiesced in *Morris Trust* and the decision remains good law today.⁶⁴ The double "tax-free" benefit of such transactions, however, was greatly restricted by the 1997 enactment of Section 355(e). If applicable, that provision triggers a corporate-level taxable gain to Distributing in respect of the distributed Controlled stock. Section 355(e) can apply only if (i) the transaction otherwise qualifies under Section 355; and (ii) a Proscribed Plan can be found linking the spin-off to the acquisition(s) of a 50% or greater interest in the stock of Distributing or Controlled during a four-year statutory period beginning two years before and ending two years after the Section 355 distribution.⁶⁵ Tainted stock ownership changes can occur via either taxable stock acquisitions or tax-free reorganization transactions (including certain asset reorganization transfers, which are treated as stock acquisitions for Section 355(e) purposes).⁶⁶

1. Asset reorganizations involving Distributing.

To avoid the normally fatal bite of Section 355(e), *Morris Trust* transactions must now be structured so that the Distributing shareholders receive 50% or more of the acquiring corporation's stock or a

Proscribed Plan cannot be found in light of (i) the particular asserted business purposes(s) for the spin, (ii) the timing of the spin and the post-spin reorganization and/or (iii) other factors and safe harbors articulated in Reg. 1.355-7 (the so-called “plan” regulations).

Case 8

Foodco, a publicly traded corporation, directly owns and operates a chain of supermarkets in several East Coast states and, through a wholly owned subsidiary formed in 2008 (“Healthco”), a separate chain of organic and specialty food stores in Massachusetts and Vermont. Substantial outside financing is needed for the construction of new Healthco stores and the renovation of several existing Foodco stores. Foodco’s principal bank lender indicated a willingness to make substantial commitments to both companies if Healthco were spun off as a stand-alone public company. A pro rata distribution of the stock of Healthco, approved by the Foodco board and shareholders, occurred on 3/31/12 (the “Healthco Spin”). In December 2010, Foodco had commenced discussions with Natco, another publicly traded grocery company, regarding a possible tax-free merger transaction. The Natco discussions terminated in February 2011 and were never resumed. On 7/31/12, i.e., four months after the Healthco Spin, Safeco, another publicly traded grocery company, announced a proposed acquisition of Foodco pursuant to a statutory merger of Foodco with and into Safeco (the “Foodco Merger”), with the Foodco shareholders receiving solely Safeco voting stock representing 60% of the total outstanding Safeco shares. Although Foodco was not then “on the market,” Safeco’s offer was considered too good to pass up and the Foodco Merger was consummated on 11/30/12. Neither Foodco nor Healthco had yet obtained any outside financing after the Healthco Spin and prior to the Foodco Merger.

As would have been true had *Morris Trust* been decided today, the Case 8 transactions avoid the reach of Section 355(e) in the first instance because the Foodco shareholders retained a greater than 50% indirect interest in the Foodco business assets and operations through their collective 60% ownership of Safeco stock received in the merger.⁶⁷ Moreover, consistent with the *Morris Trust* rationale, the Foodco Merger should not preclude Section 355 qualification of the Healthco Spin on ATB or COBE grounds.⁶⁸ If anything, the Case 8 facts present an even stronger case in that regard; for unlike *Morris Trust*, where the spin and merger were pre-ordained to occur in tandem, an acquisition of Foodco by Safeco or any other company was not planned or intended by Foodco at the time of the Healthco Spin, and Foodco in fact continued to operate its pre-spin ATB for eight months prior to the Foodco Merger. That presumably was sufficient to satisfy the “immediately after” element of the ATB Requirement, especially given the literal interpretation accorded that term by the court in *Morris Trust*⁶⁹ and the fact that, at the time of the Healthco Spin, Foodco intended to continue its supermarket business indefinitely.

Case 9

The facts are the same as in Case 8, except that the Foodco shareholders instead receive 40% of the Safeco shares as merger consideration.

In contrast to *Morris Trust* and Case 8, the Foodco shareholders in Case 9 do not retain a greater than 50% indirect interest in Foodco’s supermarket business following the Foodco Merger. Is the quantum of acquiring corporation stock received by the Foodco shareholders relevant at all to whether the merger might jeopardize compliance with the ATB Requirement? Nothing in the *Morris Trust* opinion or any other case or pronouncement from the Service since suggests that it is. Indeed, the 1996 revenue procedure describing acceptable Section 355 business purposes would appear to suggest otherwise; for it specifically blesses the *Morris Trust* transactional format without any reference to the percentage of the acquiring corporation’s stock received in the reorganization by the Distributing shareholders.⁷⁰ Thus, a good business purpose for the spin will be found to exist even if the reorganization is a “whale swallows a minnow” transaction, i.e., where the acquiring corporation is much larger than Distributing. If that scenario

could nonetheless trigger an ATB problem, the revenue procedure presumably would have contained an explicit warning to that effect.⁷¹

Assuming no adverse impact on Section 355 qualification, Safeco's acquisition of Foodco in Case 9 would, however, bring Section 355(e) into play because 60% of the Foodco stock would be treated as acquired by the Safeco shareholders. It thus becomes necessary to determine whether a Proscribed Plan exists. This in turn requires consulting the provisions of Reg. 1.355-7 to determine whether any of several Section 355(e) "plan" safe harbors applies or, if not, whether a Proscribed Plan exists based on an overall facts and circumstances determination made with reference to various "plan" and "non-plan" factors described in the regulations.⁷²

In all cases involving a post-spin acquisition of or by Distributing or Controlled, the threshold inquiry under the Section 355(e) plan regulations is whether there was an agreement, understanding, arrangement, or substantial negotiations (an "AUASN") regarding the acquisition or a similar acquisition at some time during the two-year period ending on the date of the distribution.

Absent an AUASN during the two-year pre-distribution period, the Section 355 distribution and the acquisition *cannot* be part of a Proscribed Plan and, therefore, Section 355(e) *cannot* be triggered no matter how soon after the distribution the tainted stock acquisition(s) occurred.⁷³ This absolute dispensation, sometimes referred to as the "Super Safe Harbor," would apply to eliminate any Section 355(e) risk on the Case 9 facts; for even if Foodco's terminated discussions with Natco had risen to the level of an AUASN, the plan regulations indicate that the discussions should not be considered as having occurred with respect to a "similar acquisition."⁷⁴ Moreover, even if the Super Safe Harbor did not apply, the presence of certain important "non-plan" factors would most probably lead to the same favorable result.⁷⁵

Case 10

The facts are the same as in Case 8, except that Foodco merges into a newly formed Safeco subsidiary, with the Foodco shareholders still receiving solely Safeco stock in the merger.

This structuring of the post-spin reorganization would be designed to qualify as a forward triangular merger under Section 368(a)(2)(D) and, as such, would require that Foodco transfer "substantially all" of its assets to the Safeco subsidiary. Under the rationale of another Fourth Circuit decision, *Elkhorn Coal Co.*,⁷⁶ if the prior Healthco Spin were considered part of the Foodco-Safeco "plan of reorganization," the value of the distributed Healthco stock (i.e., a significant Foodco asset) would have to be counted as part of Foodco's total assets for purposes of the "substantially all" determination and, most probably, would cause that requirement to be flunked.⁷⁷

While *Elkhorn Coal* may not be a problem on the Case 9 facts (because the acquisition was not contemplated at the time of the spin), cautious tax planners typically shy away from using "substantially all" type reorganizations⁷⁸ in *Morris Trust* contexts whether or not the sole or a substantial purpose for undertaking the spin is to set the stage for the acquisition. As a practical matter, and absent compelling non-tax impediments, the safest course is to structure any reorganization involving Distributing that occurs within two years of a spin as either a two-party statutory merger or a type-"B" stock-for-stock exchange.

2. Asset reorganizations involving Controlled.

In what are sometimes referred to as "reverse *Morris Trust*" transactions, it is Controlled rather than Distributing that is acquired in a post-spin reorganization. These transactions usually arise in contexts where at least a substantial purpose for the spin is to facilitate the subsequent reorganization.

Case 11

The facts are the same as in Case 8, except that (i) Foodco had no discussions with Natco; (ii) Foodco spins off Healthco to facilitate Healthco's immediate acquisition by a Safeco subsidiary via a forward triangular merger; and (iii) pursuant to the merger, the Healthco shareholders receive 52% of the Safeco stock in cancellation of their Healthco shares. At the time of the Healthco Spin, the Healthco acquisition had been approved by the shareholders of both Healthco and Safeco.

This format avoids a Section 355(e) trigger even though the post-spin acquisition is legally “wired” to occur, because the former Healthco shareholders retain a greater than 50% indirect ownership in the Healthco assets and operations through their stock ownership interest in Safeco. Nor should the acquisition jeopardize tax-free treatment of the spin-off at the shareholder level. In a 2003 published revenue ruling involving a spin followed by an acquisition of Controlled via a purported “C” reorganization, the Service concluded that step-transaction principles should not apply to treat the Controlled assets transferred in the merger as only part of the combined pre-spin assets of Distributing and Controlled; consequently, Controlled was treated as transferring all of its assets and the “substantially all” requirement of Section 368(a)(1)(C) was considered satisfied.⁷⁹ Moreover, as in the *Morris Trust* case itself, the post-spin merger of Healthco into the acquiring corporation, even though pre-arranged, should not jeopardize compliance with either the ATB or 355 COBE Requirements. Rather, it should suffice that the Healthco business continues to be conducted by the Safeco subsidiary and that the Healthco shareholders will become Safeco shareholders.

3. ‘Born To Die’ transactions.

Because Rev. Rul. 2003-79 involved a newly organized Controlled that ceased to exist soon after the spin, that revenue ruling has been referred to as blessing a “born to die” transaction.⁸⁰ Notably, the Service has issued a number of favorable Section 355 letter rulings in D/355 transactions followed by (i) an upstream reorganization of a newly organized Controlled with its corporate shareholder⁸¹ and (ii) a sideways merger of a newly organized Controlled into a sister corporation owned by its corporate shareholder.⁸² Analogously, the same result has been reached in situations involving Section 332 liquidations, downstream mergers, and sideways mergers of an “old and cold” Controlled into parent, subsidiary, and sister corporations.⁸³ As in Rev. Rul. 2003-79 and *Morris Trust* contexts generally, the disappearance of Controlled in these transactions, and the shifting of its business assets and operations to another related or affiliated corporation, does not jeopardize compliance with the ATB or 355 COBE Requirements — and that presumably will be so whether or not the post-spin non-recognition transaction is part of an overall D/355 transaction.

G. Post-spin asset drop-downs.

Following an otherwise qualified Section 355 distribution, Distributing or Controlled may for valid business reasons wish to transfer all or a substantial part of the assets of the ATB relied upon for Section 355 qualification to a corporate subsidiary, partnership, or an LLC. If the drop-down is viewed as a separate transaction from the spin (e.g., if not planned or intended at the time of the spin), it normally will qualify for non-recognition treatment under Section 351 (corporate transferee) or Section 721 (partnership/multi-member LLC transferee)⁸⁴ and no jeopardy to Section 355 qualification should result.⁸⁵ Where the transfer is pre-planned, or occurs soon after the spin so as to give that appearance, closer attention needs to be given to the timing and other circumstances surrounding the dropdown; but in most instances, the dropdown ought not be problematic.

Case 12

The facts are the same as in Case 8, except that (i) there is no post-spin transaction between Foodco (Distributing) and Safeco; and (ii) on the day before the Healthco Spin, Foodco contributed cash and certain intellectual property assets to Healthco.

Soon after the spin, Healthco (Controlled) forms two wholly owned subsidiaries (S1 and S2) and transfers the net assets associated with its Massachusetts stores to S1 and its Vermont stores to S2.

Foodco's pre-spin transfer of cash and intellectual property to Healthco would most probably be considered part of a D/355 transaction (particularly if explicitly referenced in a written "plan of reorganization").⁸⁶ A determination must therefore be made as to whether the post-spin dropdown of the Healthco net assets into S1 and S2 jeopardizes not only Section 355 qualification for the spin, but also qualification as a "D" reorganization. The spin can be a good Section 355 distribution whether or not the dropdown or some other circumstance precludes "D" reorganization treatment; but if the dropdown causes the spin to flunk Section 355, qualification under Section 368(a)(1)(D) will also be foreclosed.⁸⁷

At least in the context of an "acquisitive" type-"D" reorganization, a 2002 published ruling concludes that the transferee or acquiring corporation (P) can safely drop down some or all of the assets received from the transferor or acquired corporation (T) to a wholly owned subsidiary (S), where "S will continue T's historic business after the transfer and P will retain the S stock."⁸⁸ In those circumstances, the Service found that the Section 368 COBE Requirement (as articulated in Reg. 1.368-1(d)) was satisfied because S was directly controlled by P (per the 80% stock ownership tests of Section 368(c)) and, therefore, was a member of P's "qualified group."

The post-spin dropdowns to S1 and S2 will shift Healthco's active business assets and operations into two other wholly owned corporations, each of which will conduct a geographic segment of the same overall business. That ought not be problematic for purposes of either the ATB or 355 COBE Requirements, particularly since S1 and S2 are members of the Healthco SAG (any member of which can, under Section 355(b)(3), house the ATB relied upon for Section 355 qualification). This result is perhaps less clear if Controlled drops assets into a subsidiary that is controlled under Section 368(c) but is not a SAG member because it is not controlled under Section 1504(a)(2). That could occur, for example, where (i) the transferee subsidiary has Class A voting common and Class B non-voting common shares; (ii) Controlled owns 80% of the Class A stock and 80% of the Class B stock; but (iii) another shareholder owns Class A and B shares representing more than 20% of the subsidiary's total value. It would seem odd to conclude that the ATB Requirement is violated in such circumstances, especially since the same dropdown would satisfy the "qualified group" rule for purposes of the 368 COBE Requirement. Nevertheless, administrative guidance on this point would be helpful.

Suppose that Controlled instead drops its ATB into a joint venture corporation (Newco) in exchange for a 60% stock interest, with an unrelated investor (X) contributing cash for the remaining 40% of the stock. In that scenario, Newco is not a member of the Controlled SAG, but Controlled and X collectively hold Section 368 control of the Newco stock (so that Controlled can qualify for Section 351 non-recognition treatment on the dropdown). Despite Healthco's lack of control over Newco, this dropdown may also be harmless from the standpoint of the ATB and 355 COBE Requirements, by analogy to (i) *Morris Trust* transactions in which the post-spin reorganization is of the "whale swallows minnow" variety⁸⁹ or (ii) dropdowns into partnerships in which, as discussed below, corporate partners with as low as a 20% interest may be able to rely upon the partnership's ATB as if it were directly conducted by such partner. In both of these scenarios a substantial group of new owners enters the picture, yet that circumstance does not jeopardize Section 355 qualification. While the rationale for attributing a partnership business to a partner may be rooted in the "aggregate v. equity" concept, policy differences between the corporate joint venture dropdown scenario and the *Morris Trust* scenario seem more difficult to identify. In any event, the safest course from a planning perspective may be to postpone the dropdown for a significant period (e.g., at least 12 months), so as to remove it from the plan of reorganization and thereby better support compliance with the ATB and 355 COBE Requirements.

Case 13

The facts are the same as in Case 12, except that all of the Healthco stores are transferred to a limited partnership (LP) in which Healthco receives a 20% general partner interest and an unrelated cash investor receives an 80% limited partner interest.

The LP business operations are managed and conducted by Healthco and LP employees.

The post-spin dropdown of Controlled or Distributing assets into a partnership or multi-member LLC can be problematic if the corporate transferor retains no other qualifying ATB, depending on the nature and extent of the corporation's ownership and active involvement in the partnership's business. Accordingly, both the ATB and 355 COBE Requirements need to be revisited in these situations.

ATB analysis. Published rulings address various situations in which a corporate partner may be viewed as directly engaged in the partnership's ATB for Section 355 purposes. In the earliest of these rulings, the ATB Requirement was deemed satisfied where Distributing owned a 20% general partnership interest in a limited partnership (LP) that conducted a real estate leasing business; and Distributing's officers performed "active and substantial management functions" with respect to LP, including "significant business decision-making" and regular participation in the "overall supervision direction and control of LP's employees."⁹⁰

In later rulings, the Service reached the same result where (i) Distributing and an unrelated corporation, each owning a 20% member interest in an LLC, jointly managed the LLC's business;⁹¹ and (ii) Distributing owned a 33 1/3% member interest in an LLC (considered a "significant interest"), but all "management and operational functions" were performed by LLC employees.⁹² The opposite result was reached, however, where Distributing owned only a 20% LLC member interest, and all management and operational functions with respect to the LLC business were performed by LLC employees.⁹³

The 20% and 33 1/3% administrative benchmarks are also incorporated in the proposed ATB regulations under Section 355.⁹⁴ The bottom line for planning purposes is that a one-third partnership interest will suffice even without any active management or operational involvement by Distributing or Controlled, as will a 20% partnership interest coupled with significant active involvement in the business. The Case 13 facts should clearly meet the 20% test given Healthco's substantial active involvement in the LP business. However, uncertainties remain as to the sufficiency of percentage interests that fall outside the 20% and 33 1/3% parameters, as well as the particular types and level of services that must be performed by the corporate partner. Moreover, in what is somewhat a trap for the unwary, where the partnership has no employees and another partner or LLC member performs all managerial functions and activities with respect to the partnership business, the proposed ATB regulations provide that even a one-third or more ownership interest by Distributing or Controlled may *not* suffice for ATB purposes.⁹⁵

In all events, the partnership business must have the requisite five-year history in order to be attributed to the corporate partner for ATB purposes. Further, although the determination regarding partnership ATB attribution is normally made immediately after the spin, a reduction soon thereafter in the corporate partner's percentage interest, or a change in the nature or level of such partner's participation in the partnership business, could adversely affect application of the 20% and one-third tests and thus jeopardize compliance with the ATB Requirement on step-transaction grounds.

COBE analysis. Because it was part of an overall D reorganization, it may be best to analyze the Healthco spin and dropdown into LP for COBE purposes under the "qualified group" concept of Reg. 1.368-1(d). Those regulations embrace the same 20% and 33 1/3% tests that apply for purposes of the ATB Requirement, thus permitting the 368 COBE Requirement to be satisfied via a partnership business where (i) members of the qualified group own, in the aggregate, a "significant interest" in the partnership business;⁹⁶ or (ii) one or more group members exercise "active and substantial management functions as a partner" with respect to such business.⁹⁷ Examples in the regulations indicate that (i) a one-third partnership interest is a "significant interest" without need for any management participation; (ii) substantial management participation by a 20% corporate partner will suffice; and (iii) substantial management participation by a 1% corporate partner will not suffice.⁹⁸

Under these regulations, Healthco's 20% partnership interest plus its substantial involvement in the LP business should suffice to permit its reliance on such business for purposes of both the 368 COBE Requirement and the 355 COBE Requirement. The result presumably would be the same if the Healthco

spin were not part of a “D” reorganization; for if the LP business is relied on as Healthco’s ATB, the 20% and one-third tests would still have to be applied under the published rulings referenced above. Thus, at least in the partnership attribution context, the ATB and 355 COBE Requirements clearly operate in tandem.

V. Post-spin dispositions of Distributing or Controlled stock

Post-spin transactions involving Distributing or Controlled *stock* may jeopardize Section 355 qualification of the spin on “device” or “continuity of interest” grounds or, notwithstanding continuing qualification, trigger corporate-level gain to Distributing under Section 355(e). Potentially troublesome stock transactions can include (i) taxable stock sales by Distributing or Controlled shareholders; (ii) redemptions by Distributing or Controlled; (iii) exchanges of Distributing or Controlled stock for stock of another corporation pursuant to an acquisitive-type Section 368 reorganization; and (iv) direct issuances of Distributing or Controlled stock via public offerings or private placements. Again, if a particular post-spin stock transaction violates either of the Non-Device or 355 COI Requirements (or any other Section 355 qualification requirement), Section 355 cannot apply and the spin will be taxable at both the corporate and shareholder levels. Moreover, even though all Section 355 qualification requirements continue to be satisfied, Section 355(e) can still rear its head if a 50% or greater change in the stock ownership of Distributing or Controlled occurs in connection with a Proscribed Plan. The following addresses various stock transaction scenarios in which device, continuity of interest and/or Section 355(e) risks can arise, and the principles that need to be considered in determining the severity of such risks.

A. Sales of some Distributing or Controlled stock.

Whether taxable sales of some of the Distributing or Controlled stock following a spin will alter the Section 355 treatment of the distribution of the Controlled stock typically depends on how large a portion of the shares are sold, when the shares are sold, and whether the sale was already negotiated or otherwise contemplated at the time of, or prior to, the spin.

Case 14

Acme, Inc. (“Acme”) owns and operates several general hardware stores and, through a wholly owned subsidiary (“Homeco”), also conducts a substantial home improvement business. The hardware and home improvement businesses have each been actively conducted by Acme and Homeco, and the Homeco stock has been owned by Acme for more than five years. Individuals Q, R, S, and T each own 25% of the Acme stock. Individual K, a key Homeco employee, has threatened to move to a competing company unless he is given the opportunity to acquire a direct equity interest in the home improvement business. On 9/15/13, not wanting to lose K, Acme distributes all of the Homeco stock pro rata to its shareholders, each of whom then sells a 5% Homeco stock interest to K for cash. On 3/15/14, Q and R sell all their Homeco stock to U for cash.

Device. The Non-Device Requirement is intended mainly to prevent shareholder “bailouts” at capital gain rates of earnings and profits that, absent Section 355, would have been taxable as Section 301 dividend distributions to the Distributing shareholders.⁹⁹ Under the regulations, the device determination generally is to be made on an overall “facts and circumstances” basis in light of various “device” and “non-device” evidentiary factors.¹⁰⁰

Shareholder sales of Distributing or Controlled stock relatively soon after a *pro rata* distribution of the Controlled stock are considered “substantial evidence” of device if pre-arranged and “evidence” of device if not pre-arranged.¹⁰¹ The strength of such evidence will depend on a variety of factors, including how much stock is sold and how soon after the spin the sale occurs. In general, the lower the percentage sold, and the longer the gap between the spin and the sale, the better. Although the regulations do not provide specific quantitative benchmarks in this regard, sales of more than 20% of the Distributing or Controlled

stock are normally considered to fall within the device danger zone.¹⁰² Importantly, however, the regulations do provide that evidence of device can be overcome by a strong corporate business purpose,¹⁰³ and the Tax Court has in one case relied on that factor to sustain Section 355 qualification where, following a spin, Distributing's sole shareholder sold 49% of the distributed Controlled shares in a pre-arranged transaction.¹⁰⁴

Applying these principles to the Case 14 facts, the pre-arranged initial sales to K totaled 20% of the Homeco stock and occurred very soon after a spin that, absent Section 355, would have been a taxable Section 301 dividend distribution. Nonetheless, the fact that such stock sales were inextricably tied to carrying out the corporate business purpose for the spin, i.e., to provide a meaningful stand-alone equity interest to a key employee to avoid losing such employee,¹⁰⁵ should preclude a finding that the principal purpose for the spin was to avoid the dividend provisions of the Code.

The later stock sales by Q and R to U seem more problematic from a device perspective, because they resulted in an additional 40% of the Homeco stock changing hands relatively soon after the spin (within six months) and, unlike the sales to K, were not linked to the "key employee" business purpose for the spin. However, if the sales by Q and R were not contemplated at the time of the spin but were instead motivated by unforeseen post-spin developments (e.g., to fund emergency personal financial needs), such sales arguably should be disregarded for device purposes notwithstanding their substantiality and timing. That result is consistent with the core principle of Rev. Rul. 2003-55 — namely, that Section 355 qualification should be determined based on the known and reasonably anticipated facts and circumstances existing at the time of the spin. Thus, even though an unanticipated post-spin sale of Distributing or Controlled stock may constitute evidence of device under the regulations, that evidence alone ought not cause a violation of the Non-Device Requirement.

COI. The non-statutory 355 COI Requirement dictates that, after the spin, the pre-spin shareholders of Distributing "own, in the aggregate, an amount of stock establishing a continuity of interest in each of" Distributing and Controlled. Examples in the regulations indicate that 50% continuing ownership is sufficient, whereas 20% is not.¹⁰⁶ Since the initial sales to K in Case 14 total only 20%, they result in clearly acceptable 80% continuity of interest by the original Acme shareholders.

The subsequent sales to U, however, could be problematic from a COI perspective because they leave the collective ownership of the pre-spin Distributing shareholders at only 40%. There are two potential issues here: First, for how long must the requisite continuity of interest be retained? And second, if the sales to U (six months after the spin) must be taken into account, is 40% continuity enough?

The Section 355 regulations appear to contemplate that the requisite level of stock ownership be maintained in both Distributing and Controlled for some period of time following the separation (as opposed to simply "immediately after" the spin, as under the ATB Requirement). Similar to the device analysis, the COI risk should steadily dissipate as the post-spin "holding period" gets longer. For example, stock sales after two years should generally be considered quite "safe," whereas dispositions within a few months of the spin are more likely to "count against" the COI threshold. In the final analysis, though, shorter holding periods may be acceptable under conventional "step-transaction" principles. For example, if post-spin stock sales clearly were not contemplated at the time of the spin and were precipitated by unforeseen circumstances, those sales should not count against the COI threshold. Again, consistent with the rationale of Rev. Rul. 2003-55, if there was no plan or intention to sell stock at the time of the spin, the 355 COI Requirement should be considered met no matter what happens after the spin.

The current regulations regarding the 368 COI Requirement (as substantially amended in 1998) eliminate any post-acquisition holding period for acquiring corporation stock received in an acquisitive reorganization, requiring only that such stock represent "a substantial part" of the total value of the acquired corporation's outstanding stock immediately before the reorganization.¹⁰⁷ An example in these regulations approves 40% as an acceptable COI threshold.¹⁰⁸ However, the preamble to these regulations states that, pending further study by the Service and Treasury as to the role of the Section 368 COI Requirement in "D" reorganizations and Section 355 transactions, the amended COI rules for acquisitive reorganizations do not apply to Section 355 transactions or type-"D"

reorganizations — including, presumably, the 40% example and the removal of any post-reorganization holding period requirement for D/355 transactions.¹⁰⁹

It is uncertain whether or when further administrative guidance will be issued in this murky area. A cogent case can be made that the 368 COI Requirement and the 355 COI Requirement should run in parallel fashion — i.e., that it should suffice for Section 355 purposes that the distributed Controlled stock represents at least 40% of the total value received by the Distributing shareholders in the spin-off (including any permitted “boot”); or perhaps alternatively, that the Distributing shareholders retain collectively Distributing and/or Controlled stock representing at least 40% of the total value of their Distributing stock immediately prior to the spin (as opposed to at least 40% in each of Distributing and Controlled).¹¹⁰

Nonetheless, absent any action by Treasury or the Service clarifying the purpose and application of the 355 COI Requirement, and at least in post-spin contexts where new shareholders enter the picture, the safest course from a planning perspective is for the persons or entities comprising the Distributing shareholder group immediately prior to the spin to collectively maintain at least 50% stock ownership in each of Distributing *and* Controlled for at least 12 months, if not longer.¹¹¹ Thus, on the Case 14 facts, there is some risk that the aggregate sales of 60% of the Homeco stock within six months of the spin could trigger a violation of the 355 COI Requirement (even if not a device violation).

Section 355(e). The two critical inquiries under Section 355(e) are (i) whether one or more “acquisitions” of the stock of Distributing or Controlled representing, in the aggregate, a 50% or greater interest, have occurred during the four-year period starting two years before the spin; and (ii) if so, whether such acquisition(s) can be linked to the spin as part of a Proscribed Plan.¹¹² Subject to certain statutory exceptions,¹¹³ both taxable and non-taxable acquisitions “count” toward the 50% calculation; and multiple acquisitions do not have to be part of a plan linking each to the other.¹¹⁴

On the Case 14 facts, the initial sales of 20% of the Homeco stock to K carried out the “key employee” business purpose for the spin and, thus, were clearly part of a plan including the spin. Such sales alone could not trigger Section 355(e). However, if the subsequent sales to U of an additional 40% of the Homeco stock (also occurring during the four-year presumption period) are linked to the spin, the 50% threshold would be surpassed, and Section 355(e) would apply to impose a corporate-level tax on Acme in respect of any gain inherent in the distributed Homeco stock. The sales to U clearly were not part of the “key employee” motivation for the spin (which involved only K); but they still could be tainted for Section 355(e) purposes if otherwise contemplated at the time of the spin. In that regard, the Section 355(e) “plan” regulations provide protection under the Super Safe Harbor, which comes into play if, at no time during the two-year period ending on the date of the spin, there was any AUASN¹¹⁵ with respect to the post-spin acquisition in question or a “similar acquisition.”

Even if an AUASN did exist during the Super Safe Harbor period, the post-spin sale might still escape Section 355(e) under application of either another “plan” safe harbor¹¹⁶ or the overall “facts and circumstances” test based on the presence or absence of specific “plan” and “non-plan” factors described in the regulations.¹¹⁷ However, if the post-spin sale was contemplated at the time of the spin (even if only by reason of discussions or other communications that may have fallen short of an AUASN), and it occurs fairly soon after the spin (i.e., within 12 months), the Service is likely in most such instances to challenge the Section 355 qualification of the transaction on device or COI grounds (thus rendering any Section 355(e) analysis unnecessary).

B. Sale of all Distributing or Controlled stock.

Where all of the Distributing or Controlled stock is disposed of after the spin, the device, COI, and Section 355(e) implications may differ depending on whether the disposition is a taxable sale or a wholly or partially non-taxable exchange pursuant to a qualifying Section 368 reorganization. Moreover, as is so with respect to partial stock dispositions, the risk of adverse implications will be significantly greater if the disposition was contemplated at the time of the spin.

Case 15

Unrelated individuals X and Y each own 50% of the outstanding stock of Realco, Inc. (“Realco”). Through two wholly owned subsidiaries (“Apco” and “Shopco”), Realco has owned and operated several hi-rise apartment buildings and shopping centers since 2000. X and Y are actively involved in the management and operations of Realco properties. They decide to part ways via a split-off transaction pursuant to which Realco transfers cash to Shopco (to equalize the values of Shopco and Apco) and then distributes the Shopco stock to X in redemption of all his Realco shares on 9/1/13. On 12/15/13, Y receives an unsolicited cash offer for the Realco stock from Trumpco, a publicly held developer and owner of luxury apartment complexes throughout the country. Y decides to accept the offer and retire to Florida. The sale to Trumpco closes on 1/31/14. Trumpco had no prior dealings or communications with Realco, X, or Y prior to 9/1/13.

Device. At first blush, Y’s decision to sell 100% of the Distributing (i.e., Realco) stock only a few months after the spin is likely to cause at least a raised eyebrow by an examining revenue agent. Although not pre-arranged, the sale is still “evidence” of a device. There was, however, a strong business purpose for the spin, i.e., to allow X and Y to go their separate ways (which they still are doing notwithstanding Y’s sale of Realco to Trumpco). More importantly, in the absence of Section 355, the redemption distribution to X would have qualified for sale or exchange treatment under Section 302(a).¹¹⁸ In such circumstances, the Section 302 “safe harbor” rule of Reg. 1.355-2(d)(5)(iv) should foreclose a finding of device notwithstanding the magnitude and relatively near-term timing of Y’s sale of Realco to Trumpco.¹¹⁹

COI. The 50% ownership threshold of the 355 COI Requirement is clearly violated by Y’s sale of all the Realco stock to Trumpco. The analysis therefore hinges on whether the 355 COI Requirement includes some minimum post-separation “holding period” for the Realco stock and, if so, how long. In that regard, the discussion in connection with Case 14 is germane — especially the discussion with respect to the application of conventional step-transaction principles and the uncertainty as to the interface (if any) between the 355 and 368 COI Requirements. Accordingly, the fact that the Trumpco sale was not under consideration or reasonably foreseen at the time of the spin may not alone suffice to satisfy the 355 COI Requirement.

Section 355(e). Assuming that the Trumpco sale does not jeopardize Section 355 qualification, such sale fell within the Section 355(e) four-year window and therefore will trigger corporate-level gain if the requisite Proscribed Plan exists. That would not be the case, however, because there were no pre-spin discussions or contacts with Trumpco. Consequently, the Super Safe Harbor would protect Realco against any application of Section 355(e).¹²⁰

Device, COI, and Section 355(e) risks must also be assessed where taxable sales of all of the stock of Distributing or Controlled follow a spin-off distribution that would otherwise be governed by Section 301. In such situations, the Section 302(a) “device” safe harbor would not be available, thus putting more pressure on the strength of the corporate business purpose for the spin, whether the sale was pre-arranged, and other device/non-device factors articulated in the regulations. With respect to COI and Section 355(e), the framework for analysis would be essentially similar to Case 15; but the Section 355(e) implications of post-spin sales may entail special considerations in public company contexts involving businesses that are attractive acquisition targets. Consider, for example, the following variation of the Case 8 fact pattern, where: (i) Foodco spun-off Healthco on 3/31/12 to increase the stand-alone outside borrowing capacity of Foodco and Healthco; (ii) Foodco was acquired on 11/30/12 by Safeco in a tax-free merger announced four months after the spin; and (iii) 16 months before the spin, Foodco had discussed a merger transaction with Natco.

Case 16

The facts are the same as in Case 8 (Foodco spun Healthco to enhance outside financing opportunities and merged tax-free into Safeco four months later), except that

(i) the Foodco Merger is not consummated; (ii) Safeco acquires all of the Healthco stock for cash on 4/30/13; (iii) negotiations between Safeco and Healthco began in November 2012 and a definitive acquisition agreement was announced 1/31/13; (iv) Foodco's terminated pre-spin discussions had been with Safeco (not Natco) with respect to a potential cash (not stock) acquisition of Healthco's assets; and (v) Foodco, but not Healthco, had obtained outside loan financing prior to the Healthco acquisition.

Device. The device implications of Case 16 are not entirely clear. The *pro rata* nature of the Healthco Spin is certainly indicative of dividend avoidance, especially where 100% of the Healthco stock is converted into capital gain.¹²¹ The sale of the Healthco stock to Safeco is clearly “evidence” of device, though probably not “substantial evidence” because Foodco’s pre-spin discussions with Safeco were terminated 16 months before the spin and were, in any event, with respect to a possible taxable acquisition of Healthco’s assets rather than a taxable acquisition of Healthco’s stock.¹²² Moreover, at least two non-device factors may be present in this situation: (i) Foodco is publicly traded and may not have a shareholder that is directly or indirectly the beneficial owner of more than 5% of any class of its stock,¹²³ and (ii) the corporate business purpose for the Healthco Spin — i.e., to enhance the separate borrowing power of both Foodco and Healthco may be sufficiently strong to outweigh any device evidence.¹²⁴

In the final analysis, because the post-spin discussions with Safeco were initiated by Safeco, did not commence until eight months after the spin and did not result in a definitive agreement until ten months after the spin, the strength of any device evidence generated by the stock sale seems relatively weak. While it is difficult to predict how the factor balancing/weighting exercise mandated by the regulations would come out in these circumstances, the absence of any plan or intention at the time of the spin to sell the Healthco stock to Safeco (or any other interested buyer) could provide the tipping point in favor of a non-device result.

COI. The distributee public shareholders of Foodco collectively owned 100% of each of Healthco and Foodco immediately following the Healthco Spin; and subject to any market trading that may have been undertaken by such shareholders, the requisite COI (i.e., at least 50% stock ownership in Foodco and Healthco) continued to be maintained for ten months after the spin. As discussed earlier, the minimum duration of any required post-spin holding of the Distributing and Controlled stock is uncertain. The fact that the Healthco stock sale occurred more than 12 months after the spin, and that negotiations for that transaction did not begin until eight months after the spin, may well be sufficient for purposes of the 355 COI Requirement—particularly since Safeco initiated that transaction and there was no apparent plan or intention at the time of the spin to sell Healthco to Safeco or any other party.¹²⁵ The rationale of Rev. Rul. 2003-55 should therefore apply to protect Section 355 qualification of the spin, notwithstanding the relatively quick post-spin disposition of the Healthco stock.¹²⁶

Section 355(e). Case 16 raises the potential application of Section 355(e) since the Healthco acquisition occurred within the four-year statutory presumption period. If the pre-spin discussions between Foodco and Safeco did not rise to the level of an AUASN, the Super Safe Harbor would apply. In that regard, the pre-spin discussions would be viewed as “substantial negotiations” only if they included discussions of “significant economic terms” — for example, the exchange ratio or purchase price in a potential acquisition.¹²⁷ Moreover, any AUASN with respect to a potential acquisition can be considered as being with respect to a “similar acquisition” even if the potential (pre-spin) and actual (post-spin) acquisitions have different timing or other terms (e.g., cash v. stock), so long as (i) the actual acquisition “effects a direct or indirect combination of all or a significant portion of the same business operations as the combination that would have been effected by . . . [the] potential acquisition;” and (ii) the “ultimate owners of the business operations” combined in the actual acquisition are not “substantially different from” the ultimate owners that would have emerged from the potential acquisition.¹²⁸

Applying these principles to Case 16, the Healthco and Safeco business operations combined in the actual stock acquisition were the same as those that would have been combined in the potential asset acquisition that had been the topic of the pre-spin discussions between Foodco and Safeco. Safeco and its shareholders were the ultimate owners of Healthco’s business operations after the actual Healthco

stock acquisition; and they would also have been the ultimate owners of those business operations after the potential Healthco asset acquisition. Thus, assuming that the pre-spin discussions produced an AUASN, the potential Healthco asset acquisition would be considered “similar” to the actual Healthco stock acquisition and, consequently, the Super Safe Harbor would not be available to foreclose application of Section 355(e).

Nonetheless, Case 16 would still likely avoid a Section 355(e) trigger under Safe Harbor I of the “plan” regulations. Pursuant to that safe harbor, a spin and a post-spin acquisition of Distributing or Controlled (whether taxable or tax-free) will not be considered part of a Proscribed Plan if:

- The spin was motivated in whole or substantial part by a corporate business purpose other than a purpose to facilitate an acquisition of the acquired corporation.
- The acquisition occurred more than six months after the spin.
- There was no AUASN concerning the acquisition or a similar acquisition during the period that begins one year before the spin and ends six months thereafter.¹²⁹

In this instance, the Healthco Spin was completed at the request of Foodco’s principal lender, which had indicated a willingness to make substantial loan commitments to both Foodco and Healthco if Healthco was spun off as a stand-alone public company. The spin was thus motivated entirely by a corporate business purpose other than a business purpose to facilitate an acquisition of Healthco. Such acquisition, moreover, occurred more than 12 months after the spin; there was no apparent AUASN during at least the eight-month period following the spin; and the pre-spin discussions between Safeco and Foodco occurred and were terminated more than one year before the spin. In these circumstances, Safe Harbor I should apply.¹³⁰

Case 17

The facts are the same as in Case 16, except (i) Safeco acquires all of the Healthco stock pursuant to an unsolicited tender offer on 7/31/12 (four months after the spin); and (ii) Foodco does not engage in any pre-spin discussions regarding potential acquisitions of Healthco’s stock or assets. During the 12-month period preceding the Healthco Spin, two public company acquisitions involving major food companies occurred and, at the time of the Healthco Spin, there was continuing speculation in the financial press regarding other possible food industry combinations. Healthco was often mentioned as a likely target company.

On these facts, the so-called “hot market” example of the plan regulations indicates that the Super Safe Harbor should apply even though a Healthco acquisition or an AUASN with respect to a Healthco acquisition was “reasonably certain” to occur “soon after” the spin (and neither Safe Harbor I or II could apply).¹³¹

While it may be tempting to assume that the Non-Device or 355 COI Requirements would necessarily be met in Case 17 in light of the hot market example, the regulations expressly warn that “no inference” is to be drawn from any of the Section 355(e) “plan” examples regarding how any other Section 355 requirement might be interpreted to apply under the same facts.¹³² In light of this warning, it is conceivable that a very quick “hot market” sale (e.g., within 60 days of the spin) could be viewed as breaching the indefinite post-spin holding requirement of the COI regulations under Section 355, notwithstanding the fact that the Super Safe Harbor otherwise might have applied with respect to the analysis under Section 355(e). The broader lesson here is that the device and COI restrictions represent independent Section 355 qualification requirements, both of which (along with all other Section 355 requirements) must be satisfied before Section 355(e) can come into play; and that particular facts and circumstances that may be viewed favorably for Section 355(e) purposes will not necessarily dictate a favorable outcome with respect to one or more of the qualification requirements of Section 355.

C. Reorganization transactions.

The device and COI implications of post-spin reorganizations that qualify for non-recognition treatment require different analyses than do taxable acquisitions of the Distributing or Controlled stock. Conversely, the Section 355(e) analysis with respect to post-spin reorganizations that qualify for non-recognition treatment is generally the same as for taxable acquisitions. Consider the following variations in the Case 15 fact pattern, which involved Realco's split-off of Apco to shareholder X and, four months later, Y's sale of the Realco stock to Trumpco for cash.

Case 18

The facts are the same as in Case 15, except that (i) Y does not sell the Realco stock to Trumpco; (ii) Realco instead merges directly into Trumpco via a statutory merger, with Trumpco surviving; and (iii) pursuant to the merger, Y exchanges his Realco stock (worth \$12 million) for 100,000 Trumpco shares having a current market value of \$10 million (\$100 per share) plus \$2 million cash. Immediately before the reorganization, Trumpco had 3 million total outstanding shares.

Device. Had Y received solely Trumpco stock in the merger, the exchange of Realco shares for Trumpco shares would be non-taxable (per Sections 368(a)(1)(A) and 354(a)(1)) and would not trigger a device problem because: (i) no conversion of the Realco shares into capital gain would have occurred on account of the merger transaction; and (ii) the split-off distribution, if taxable, presumably would have been taxed as an exchange under Section 302(a), i.e., the Section 302(a) device safe harbor would apply.

Where, however, a post-spin reorganization involves non-stock consideration, i.e., taxable "boot," the acquired corporation's shares have been converted into cash (or other non-stock property) to the extent of such boot. Under the reorganization "boot" rules of Section 356, the amount of the boot is recognized, i.e., taxed, to the extent of the overall gain realized by the exchanging shareholder; and the recognized gain will generally be taxed as capital gain unless the receipt of the boot "has the effect of the distribution of a dividend" under Section 356(a)(2), determined by applying the dividend equivalency tests of Section 302(b) under the "hypothetical redemption" methodology mandated by the U.S. Supreme Court in *Clark*.¹³³

The Section 355 regulations provide that reorganization boot will generally constitute device evidence if "more than an insubstantial amount" of boot is received, but not if the boot is taxable as a dividend under the Section 356 rules.¹³⁴ On the Case 18 facts, the *Clark* analysis would yield exchange treatment under Section 302(a),¹³⁵ and the boot amount received by Y — representing 16 2/3% of the total merger consideration — might be considered "more than insubstantial" by an examining agent.¹³⁶ Nonetheless, since the transaction was structured as a split-off redemption of X's Realco shares, the Section 302 device safe harbor should apply to render the amount of the boot received by Y in the merger transaction irrelevant for device purposes.¹³⁷

The device exception for reorganization exchanges has sensibly been extended to post-spin Section 351 transfers of Distributing or Controlled stock into an existing or newly organized controlled corporation. Thus, if the Realco-Trumpco reorganization had instead been structured as a stock-for-stock "B" reorganization and Trumpco had then dropped the Realco stock into a lower-tier controlled subsidiary, no device implications should arise.¹³⁸ However, if Trumpco were to receive a substantial amount of boot in connection with a Section 351 transfer of the Realco stock, reliance on the principles of the reorganization device exception might be less certain.

COI. The post-spin exchange of all the stock of Distributing or Controlled pursuant to a tax-free reorganization is unlikely to violate the Section 355 COI Requirement, no matter how soon after the spin the reorganization occurs. This result follows because the 355 COI Requirement contemplates both "direct" and "indirect" COI,¹³⁹ and the exchanging shareholders will maintain an *indirect* equity interest of

equivalent value in the acquired corporation through the acquiring corporation stock received in the reorganization. The “indirect continuity” principle for Section 355 transactions was first addressed in a 1962 published ruling involving successive spin-off transactions;¹⁴⁰ and it has since been applied in post-spin reorganization contexts by other published and private rulings,¹⁴¹ as well as the *Morris Trust* decision itself.¹⁴² It applies, moreover, even though the exchanging shareholders end up with less than 50% of the acquiring corporation stock, including in a “whale swallows a minnow” situation such as Case 18 (where Y received only 3% of the Trumpco stock in exchange for his Realco stock).¹⁴³ For similar reasons, COI should be considered preserved in the case of a post-reorganization contribution of the stock of Distributing or Controlled to a controlled subsidiary.¹⁴⁴

Section 355(e). For purposes of Section 355(e), it is irrelevant whether the stock “acquisition” occurs incident to a taxable or tax-free transaction. In contrast to the 355 COI Requirement, the amount of acquiring corporation stock received in a subsequent tax-free reorganization involving Distributing or Controlled within two years of the spin is critical, as Section 355(e) will be triggered if the exchanging shareholders receive, in the aggregate, less than a 50% interest in the acquiring corporation, unless it can be shown that the requisite Proscribed Plan is lacking. The Proscribed Plan determination requires the same factual and “safe harbor” analysis in the context of a tax-free stock acquisition as it does with respect to taxable stock acquisitions. Thus, in Case 18 (as in Case 15), the absence of any pre-spin discussions between Y or Realco and Trumpco should prevent a Section 355(e) trigger by reason of the Super Safe Harbor, even though the acquisition occurs only four months after the spin.

If for any reason the Super Safe Harbor were not available, however, Y’s disposition of the Realco stock less than six months after the spin would prevent application of Safe Harbor I, II, or III.¹⁴⁵ In that event, the overall facts and circumstances analysis might still lead to a “no plan” conclusion, based on at least two non-plan factors specified in the regulations — namely: (i) the spin was not motivated by a purpose to facilitate the Trumpco acquisition or a similar acquisition;¹⁴⁶ and (ii) regardless of any such acquisition, the spin “would have occurred at approximately the same time and in similar form.”¹⁴⁷ Less clear is the application of another non-plan factor — namely, the existence of “an identifiable, unexpected change in market or business conditions . . . that resulted in the acquisition that was otherwise unexpected at the time of the distribution.”¹⁴⁸ While the mere unsolicited nature of Trumpco’s offer was arguably enough to constitute a “change in market or business conditions,” the Service might contend otherwise based on the purely voluntary decision by Y to abandon his direct involvement in the Realco business. On balance, the risk of a Section 355(e) trigger in such circumstances seems quite serious.¹⁴⁹

The post-spin acquisition scenarios discussed thus far have all involved situations where the spin was not motivated by a business purpose to facilitate an acquisition involving Distributing or Controlled and no such acquisition was in fact planned or intended at the time of the spin. However, as in the *Morris Trust* case, spins are often done specifically to pave the way for a reorganization transaction involving Distributing or Controlled and another corporation; and the Service has acknowledged that such spins are motivated by an acceptable corporate business purpose.¹⁵⁰ Consider in this regard the following variation on Case 8, involving Foodco’s spin-off of Healthco on 3/31/12, to enhance each company’s stand-alone borrowing power and Foodco’s subsequent unanticipated acquisition by Safeco on 11/30/12.

Case 19

The facts are the same as in Case 8, except that access to outside borrowing was not a concern and that Safeco had approached Foodco about an acquisition in November 2011, provided that Foodco first spin off Healthco (which Safeco did not want to acquire). Following the Healthco spin, a newly formed transitory subsidiary of Safeco merges with and into Foodco on 4/1/12, with Foodco surviving. Pursuant to this statutory merger, (i) the Foodco shareholders exchange their Foodco shares solely for Safeco voting shares representing 55% of the total outstanding Safeco shares; and (ii) Foodco becomes a wholly owned subsidiary of Safeco.

This fact pattern describes a classic *Morris Trust* transaction, designed to achieve double tax-free treatment for a Section 355 distribution followed by a qualifying Section 368 acquisitive reorganization.

The reverse triangular merger of the Safeco subsidiary into Foodco entails a stock-for-stock exchange and, as such, qualifies as a type-“B” reorganization.¹⁵¹ Given the absence of any boot in the Safeco-Foodco reorganization, the regulatory device exception for stock dispositions in tax-free reorganizations should clearly apply; and the 355 COI Requirement should likewise be satisfied because the former Foodco shareholders will maintain an indirect equity interest of equivalent value in Foodco through the Safeco stock received in exchange for their Foodco stock. Moreover, Section 355(e) is avoided because the Foodco shareholders are treated as retaining a 55% indirect interest in Distributing (Foodco) through their Safeco stock. Thus, even though there is a clear “plan” linking the spin and the subsequent reorganization, the 50% threshold of Section 355(e) has not been broken.

Case 20

*The facts are the same as in Case 19, except that Foodco acquires Safeco via a merger transaction in which the Safeco shareholders exchanged their Safeco stock for newly issued Foodco shares representing 45% of Foodco’s total outstanding stock.*¹⁵²

The same results should obtain under the facts of Case 20. Again, none of the Foodco shares have been reduced to cash, so there should be no device “bail out” concern; and the 45% change in the stock ownership of Foodco is not enough to violate the threshold of the 355 COI Requirement because more than 50% collective ownership is maintained by the Foodco shareholder group after the spin.¹⁵³

With respect to both COI and Section 355(e), however, the fact that the Safeco-Foodco combination is essentially a “merger of equals” leaves only a small margin of error in the event that there are additional post-reorganization changes in stock ownership that might be linked to the spin—especially where such changes occur within the two-year post-spin period and cause the aggregate stock ownership changes during such period to reach or surpass the 50% thresholds of the 355 COI Requirement and Section 355(e).

Case 21

The facts are the same as in Case 20, except that, four months after the Healthco Spin, Foodco acquires Doughco, a successful, closely held wholesale bakery company via a statutory merger in which the Doughco shareholders receive newly issued Foodco shares representing 10% of the then total outstanding Foodco shares.

Together with the 45% change in Foodco’s stock ownership resulting from the Safeco-Foodco merger, Foodco has undergone an aggregate stock ownership shift in excess of 50% under the facts of Case 21 within only four months of the Healthco Spin — clearly a red flag for both COI and Section 355(e) purposes. However, the analysis in both contexts should focus on whether and to what extent the Doughco acquisition may have been contemplated or was otherwise on Foodco’s radar at the time of the spin. If Foodco and Doughco had no pre-spin discussions regarding a potential acquisition, and there was no other evidence of any plan or intention at the time of the spin to pursue such an acquisition, any COI risk may be neutralized despite the short timeframe during which more than 50% continuity was maintained in Foodco — although that result is not entirely clear given the lingering uncertainty as to how long after the spin the requisite level of continuity must be maintained.

The avoidance of Section 355(e) in such circumstances is more assured, because the Super Safe Harbor should apply to disassociate the Doughco acquisition from any Proscribed Plan involving the Healthco Spin.¹⁵⁴ Moreover, even if there had been pre-spin contact between Foodco and Doughco, a Section 355(e) trigger ought not occur absent an AUASN at the time of the spin (with respect to the Doughco acquisition) or other facts and circumstances indicating a clear linkage between the Doughco acquisition and the purpose and timing of the Healthco Spin.¹⁵⁵

D. Redemption transactions.

Where Distributing or Controlled redeems stock relatively soon after a spin, the spin may be rendered taxable at both the shareholder and corporate levels on account of the transaction's impact on the Non-Device or 255 COI Requirements. Post-spin stock redemptions also have the potential to cause the spin to be taxable to Distributing under Section 355(e).

Device. Post-spin stock redemptions involve a shareholder's sale of stock back to the corporation and, as such, may constitute "evidence" (or, if pre-arranged, "substantial evidence") of device in the same way as a third-party stock sale.

In general, a post-spin redemption that passes muster under Section 302(a)¹⁵⁶ will be taxable as an "exchange" and may be viewed as a capital gain "bailout" if, absent Section 355, the spin would have been taxed as a Section 301 dividend-type distribution. In such circumstances, the strength of the device evidence will depend on an overall facts and circumstances evaluation, including, the amount of stock redeemed, the reason for the redemption, the timing of the redemption relative to the spin, and the strength of the asserted corporate business purpose for the spin.¹⁵⁷

When the post-spin redemption is treated as a Section 301 distribution (because none of the Section 302(b) exceptions apply), the device "bailout" concern will not be present. Moreover, if the Section 355 distribution is structured as a split-off that otherwise would be taxable as an "exchange" under Section 302(a), the Section 302 device safe harbor should eliminate any device concern that may be associated with the post-spin redemption.¹⁵⁸ Finally, if the post-spin redemption was not planned or intended at the time of the spin and occurred because of unforeseen circumstances or developments, the redemption ought not occasion device concerns irrespective of its size or timing relative to the spin.¹⁵⁹

The device implications of post-spin redemptions must also be considered in public company contexts, mostly in connection with stock repurchase programs established by Distributing or Controlled. Common in many public companies, such programs often are in existence at the time of a spin or may be adopted not long after a spin.

Under an advance ruling safe harbor announced in 1996, certain redemptions by public companies were not considered a device if (i) the redemption was motivated by a sufficient business purpose; (ii) the stock to be redeemed was "widely held;" (iii) the redemption was effectuated through an "open market" transaction; and (iv) there was no plan or intention that the aggregate amount of redemptions would equal or exceed 20% of the corporation's total outstanding stock.¹⁶⁰ New or amended stock repurchase programs commonly incorporated the safe harbor conditions, and companies seeking Section 355 letter rulings typically represented that all of the safe harbor conditions would be met. Letter rulings on situations that fell outside the safe harbor could be obtained on a case-by-case basis.

In 2003, the Service announced a no-rule policy with respect to the device restriction¹⁶¹ that eliminated the former administrative safe harbor and made the potential device implications of post-spin open market stock repurchases by Distributing or Controlled uncertain. Nonetheless, taxpayers have continued to draw comfort from the conditions of the former administrative safe harbor, and some post-2003 letter rulings have signaled an accommodative approach by the IRS with respect to this issue.¹⁶² It remains to be seen whether the Service's tolerance level in this area will be affected by its recent announcement of a no-rule policy with respect to Section 355 qualification generally (limiting rulings only to "significant issues").¹⁶³

COI. As a practical matter, post-spin redemptions above the 20% device "warning light" level are relatively rare; and, with the exception of "going private" tender offer situations,¹⁶⁴ redemptions at or near the 50% threshold of the 355 COI Requirement are even rarer. In any event, the impact of post-spin redemptions on the 355 COI Requirement is not entirely clear from a conceptual standpoint. Specifically, when a Distributing or Controlled shareholder is redeemed, the percentage stock interest of each of the remaining shareholders increases, but the *collective* percentage ownership of the remaining persons who were Distributing shareholders at the time of the spin remains the same. The 355 COI Requirement does not

contemplate continuing stock ownership by each Distributing shareholder. Rather, it is sufficient that at least one of the historic Distributing shareholders maintains the requisite COI in both Distributing and Controlled.

For example, assume Distributing has four shareholders — E (30%), F (30%), G (20%), and H (20%) — at the time of a spin-off of Controlled. After the spin, Distributing redeems all of its shares held by E and F. Following the redemption, G and H each own 50% of Distributing's stock and, therefore, can be viewed as collectively maintaining 100% COI. This analysis does not hold, however, if the 50% threshold of the 355 COI Requirement is calculated with reference to the *value* of the stock interests owned by E, F, G, and H in each of Distributing and Controlled, as only 40% of the aggregate value of Distributing's stock remains outstanding following the post-spin redemption. Thus, because the post-redemption value of G and H's collective interest in Distributing is less than 50% of the collective value of all the Distributing stock immediately after the spin, the post-spin redemption of the stock held by E and F could cause the spin to fail the 355 COI Requirement. Although collective "value" is the correct touchstone for purposes of applying the 368 COI Requirement,¹⁶⁵ it remains unclear whether the same approach applies for Section 355 purposes. If sorely needed administrative guidance is ever issued with respect to the 355 COI Requirement, it should certainly address this fundamental point.

Whatever the appropriate methodology for measuring COI, post-spin redemptions ought not "count against" the 50% threshold of the 355 COI Requirement if the redemption was not planned or intended at the time of the spin, is prompted by circumstances that were unforeseen at the time of the spin, and cannot otherwise be linked to the spin under a conventional "step-transaction" analysis. These criteria mirror closely the rationale of Rev. Rul. 2003-55, which should apply in like fashion with respect to the 355 COI Requirement. Accordingly, if the redemption does not cause a device problem under an overall facts and circumstances analysis, it is difficult to see why it should cause a COI problem.¹⁶⁶

Section 355(e). Section 355(e) cannot apply absent a 50% or greater shift in the ownership of Distributing or Controlled via direct or indirect "acquisitions" of stock. Moreover, as noted in connection with the preceding COI discussion, a redemption *reduces* the percentage stock ownership interest of the redeemed shareholder and, correspondingly, *increases* the percentage interest of the remaining, i.e., unredeemed, shareholders. Is that increase an "acquisition" for Section 355(e) purposes and, if so, how is such acquisition taken into account in determining whether the 50% threshold has been breached? The Service has announced that, pending the issuance of regulations, it will entertain letter ruling requests regarding the effect of a redemption under Section 355(e), *if* an adverse ruling would result in there being tainted stock acquisitions representing, in the aggregate, a 50% or greater interest in Distributing or Controlled.¹⁶⁷

The risk of a redemption triggering Section 355(e) is more likely to arise in closely held contexts — for example, if, following a *pro rata* spin, a 50% or more Distributing shareholder were to completely terminate his or her interest via a Section 302(b)(3) redemption transaction. The issue also can surface in public company contexts — for example, where post-spin redemptions pursuant to open market stock repurchase programs,¹⁶⁸ together with other stock acquisitions during the statutory presumption window, collectively account for a 50% or more stock ownership shift.¹⁶⁹

In recent private letter rulings, however, the IRS has adopted a taxpayer-friendly stance that likely will prevent a Section 355(e) trigger in situations involving public company stock redemptions. In these rulings, open market stock repurchases are treated as having been made *pro rata* from *all* public shareholders.¹⁷⁰ The effect of such treatment is that the percentage ownership interests of the public shareholders remain the same after the stock repurchases, i.e., the stock repurchases do not result in an indirect "acquisition" by the unredeemed shareholders.

In light of the existing guidance on this topic, where a public company post-spin redemption occurs pursuant to negotiated transactions with significant shareholders (i.e., 5% or more), or as a result of "going private" tender offers made to all shareholders, the redemption likely will give rise to "acquisitions" by the unredeemed shareholders for Section 355(e) purposes. In each instance, the initial question is whether the Super Safe Harbor is applicable.¹⁷¹ If not, the Proscribed Plan analysis will require

consideration and weighing of the relevant “plan” and “non-plan” factors under the regulations, if the post-spin redemption does not otherwise fall under Safe Harbors I, II, or III.¹⁷² In any event, the cleanest case for avoiding an adverse “plan” determination in these situations is where (i) no plan or intention to complete the redemption existed at the time of the spin; (ii) the redemption was motivated by circumstances that were unforeseen at the time of the spin; and (iii) the spin would have occurred at the same time and in the same manner regardless of whether any post-spin redemption might occur. All of these criteria are fact-intensive; and the taxpayer’s burden of proof will likely be more difficult to meet where the redemption occurs very soon after the spin (i.e., within 60-90 days) and there is at least some indication that the redemption may have been contemplated prior to, or at the time of, the spin.

VI. Post-spin issuance of new stock for cash

In contrast to shareholder dispositions of Distributing or Controlled stock, new shareholders may also enter the picture by investing cash in exchange for new shares issued directly by Distributing or Controlled. These transactions may involve post-spin private placements or public offerings by Distributing or Controlled.¹⁷³ The Non-Device and 355 COI Requirements generally are not a serious concern in such situations. Section 355(e), however, can be problematic and, in that regard, the “plan” regulations include special rules applicable to acquisitions of Distributing or Controlled stock via public offerings.

Consider the following variation on the facts of Case 14, where Acme spun off Homeco to Acme’s four equal shareholders (Q, R, S, and T), each of whom then sold a 5% Homeco stock interest to key employee K; and six months later Q and R sold their respective 20% Homeco stock interests to U.

Case 22

The facts are the same as in Case 14, except that (i) Q and R do not sell their Homeco shares to U and (ii) three months after the spin and the shareholders’ sale of a 20% interest in Homeco to K, Homeco received a cash investment from U in exchange for newly issued Homeco shares representing approximately 44% of Homeco’s then total outstanding stock.

Device. There should be no device evidence on these facts, because there has been no shareholder-level “sale or exchange” and thus no conversion of Distributing or Controlled stock into other property in a capital transaction. Consequently, for device purposes, neither the magnitude of Homeco’s stock issuance to U, nor whether that stock issuance may have been pre-arranged, should matter.

COI. If Homeco’s stock issuance to U were to “count against” the applicable threshold of the 355 COI Requirement, that stock issuance would have to be aggregated with the shareholder-level stock sales to K, thus leaving the “historic” Homeco shareholders (Q, R, S, and T) with approximately 45% collective stock interest in Homeco. While that percentage may be sufficient under the parameters of the examples in the regulations,¹⁷⁴ the better approach would be to disregard Homeco’s stock issuance to U for purposes of the 355 COI Requirement, because the new stock issued by Homeco does not reduce the aggregate *value* of the Homeco stock interests that continue to be owned by its historic shareholders, i.e., Q, R, S, and T. Significantly, this approach seemingly is consistent with the approach used for purposes of the 368 COI Requirement.¹⁷⁵

Section 355(e). Since the post-spin sales to K are stock acquisitions clearly linked to the Homeco spin, the 50% Section 355(e) threshold will be breached if the Homeco stock issuance to U (clearly an “acquisition” of Homeco stock) is also considered part of a Proscribed Plan. Again, the “plan” and “non-plan” factors in the regulations must be considered, along with any potentially applicable safe harbors. In particular, if Homeco and U had no discussions or other contact until after the spin, the Super Safe Harbor should prevent a Section 355(e) trigger.¹⁷⁶

Suppose, however, that the Super Safe Harbor were not available because U and the Acme shareholders had engaged in aborted substantial negotiations during the two-year period preceding the spin.¹⁷⁷ The regulations state that the existence of such negotiations “tends to show that the distribution and the acquisition are part of a plan,” but that other facts and circumstances may establish that a Proscribed Plan does not exist — including where (i) the spin was at least substantially motivated by a business purpose other than to facilitate “the acquisition;” and (ii) the spin “would have occurred at approximately the same time and in similar form” regardless of whether the post-spin acquisition occurred.¹⁷⁸

Both of these circumstances are present on the revised Case 22 facts; the purpose of the spin was to facilitate an acquisition of Homeco stock by K (not U), and it presumably was that acquisition that dictated the timing and form of the spin. While these factors may alone suffice to neutralize any suspicion caused by the timing of Homeco’s stock issuance to U (i.e., only three months after the spin), the strongest defense against any Section 355(e) challenge would be to demonstrate that the transaction with U was not on the drawing board at the time of the spin but, rather, was attributable to an “unexpected change in market or business conditions” arising after the spin.¹⁷⁹

Like private placements, a public stock offering by Distributing or Controlled also constitutes an “acquisition” of stock for purposes of Section 355(e). The main hallmarks of a public offering are the involvement of investment bankers and the fact that “potential acquirers have no opportunity to negotiate the terms of the acquisition.”¹⁸⁰ Facilitating a post-spin public offering of Distributing or Controlled stock is generally an acceptable corporate business purpose for doing the spin, provided (i) there is an identified business need for the funds to be raised; and (ii) a post-spin offering by Distributing or Controlled on a stand-alone basis is expected to be more attractive to the market and more cost-effective.¹⁸¹

Case 23

Pubco, a publicly traded corporation, has conducted Bus. A and Bus. B directly through divisions for many years. To fund substantial new plant and equipment for its steadily growing Bus. A operations, and based on discussions with its investment banker (“IB”), Pubco decides to transfer Bus. B to a newly formed subsidiary (“Subco”), spin-off the Subco stock to the Pubco shareholders, and then do a 30% public offering of Pubco’s stock. The spin-off is effectuated on 11/1/12; and the offering, which is fully subscribed, occurs on 12/15/12. In the spring of 2013, Pubco’s R&D group scores an important technological break-through, resulting in the need for substantial additional funding to develop and bring associated new products to market. Pubco initially hoped to raise all of the new capital through bank loans but was unable to do so. After discussions with IB, it decides to raise the shortfall through another public stock offering, which is successfully effectuated on 9/15/13 and represents 30% of the then total outstanding Pubco stock.

Like the private placement scenario in Case 22, post-spin public offering scenarios should not pose serious device or COI risks, but may have Section 355(e) implications because all purchasers of the offered stock are considered as having made an “acquisition” of such stock for purposes of that provision. Under the overall facts and circumstances “plan” analysis, if an acquisition of stock occurs via a post-spin public offering, and at any time during the two-year period ending on the date of the spin Distributing or Controlled had discussions with an investment banker regarding such acquisition or a similar acquisition, such circumstances will be considered indicative of a “plan” linking the acquisition to the spin.¹⁸² In this regard, an actual post-spin acquisition involving a public offering may be considered “similar to” a potential acquisition involving a public offering (discussed pre-spin), notwithstanding changes in the terms (including stock price), size, or timing of the offering.¹⁸³ Moreover, an additional post-spin public offering may be considered similar to a potential acquisition if the purpose of the additional public offering is similar to the potential acquisition and it “occurs close in time to the first public offering.”¹⁸⁴

The Case 23 facts involve two post-spin public offerings of Distributing stock. Setting the stage for the first public offering was the avowed business purpose for doing the spin, so that public offering was clearly linked to the spin for Section 355(e) purposes. A linkage of the spin to the second public offering is less

clear but critical to determine; for aggregating the two public offerings would cause the total stock ownership shift to pass the fatal 50% level and thus trigger taxable gain to Pubco on its distribution of the Subco stock, as none of the safe harbors in the “plan” regulations would be available to disassociate the second public offering from the spin.¹⁸⁵

Examples in the regulations address situations involving two post-spin public offerings and focus the analysis on (i) the planned use of the public offering proceeds and (ii) the amount of time elapsing between the two public offerings. In one example, two public offerings are not aggregated where the first public offering (occurring two months after the spin) funded the acquisition of Company X, and the second public offering (first discussed with an investment banker seven months after the spin and occurring one year after the spin) served to fund the acquisition of Company Y.¹⁸⁶ In two other examples, the post-spin public offerings were both done to raise capital for “general corporate purposes” and were separated by six and 12 months, respectively.¹⁸⁷ The public offerings were considered “close in time” and thus aggregated in the six-month scenario, but not in the 12-month scenario.

Considering the Case 23 facts in light of these examples, the two post-spin public offerings do not have similar purposes in terms of Pubco’s intended use of the proceeds of each; so even if they might be considered “close in time” (the nine-month gap is between the six- and 12-month separation periods considered in the regulatory examples), the stock acquisition pursuant to the second public offering should not be considered similar to the first public offering, which was discussed with IB before, and clearly motivated, the spin. This “non-plan” result is certainly buttressed by the unforeseen post-spin circumstances that prompted the second public offering (i.e., the unanticipated financial ramp-up required by the R&D success).¹⁸⁸

VII. Section 355 ruling policy

IRS National Office policies with respect to the issuance of private letter rulings for Section 355 transactions have undergone significant evolution since the mid-1990s. Prior to 2003, rulings were generally available as to all of the statutory and non-statutory qualification requirements of Section 355. Particularly in public company spins, advance rulings were routinely sought even in “plain vanilla” situations where little or no doubt existed as to a favorable outcome. The comfort of an advance ruling was generally deemed essential by corporate management given the usually catastrophic double-tax consequences of a failed Section 355 transaction.

The volume of Section 355 letter ruling requests was no doubt enhanced by the publication of comprehensive guidance in Rev. Proc. 96-30, including (i) specific language for required factual representations; and (ii) a non-exclusive list (and detailed description) of several acceptable non-tax corporate business purposes for doing a spin.¹⁸⁹ Moreover, it was not at all uncommon for taxpayers to seek and receive one or more supplemental rulings after obtaining a favorable Section 355 ruling — again, even though such rulings were non-controversial and sought only as a matter of extreme caution.

In an effort to reduce the demands associated with the high volume of Section 355 letter ruling requests, the Service announced in Rev. Proc. 2003-48 that it would no longer rule on the “business purpose” or “device” requirements for Section 355 qualification or upon the Section 355(e) “plan” requirement.¹⁹⁰ Instead, all Section 355 ruling requests were required to include standard representations with respect to these no-rule areas, leaving to the audit examination process the ultimate determination of whether such areas were problematic.

In addition, Rev. Proc. 2003-48 announced that requests for supplemental rulings in connection with Section 355 transactions would be entertained only if the request presented a “significant issue.” Until recently, the term “significant issue” had been defined with reference to three conditions, namely:

- The issue is not clearly and adequately addressed by a statute, regulation, decision of a court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin.

- Resolution of the issue is not essentially free from doubt.
- The issue is legally significant and germane to determining the major federal tax consequences of the transaction.¹⁹¹

Further, for purposes of applying these definitional criteria, an issue was considered not “clearly and adequately addressed” by the listed authorities and not “essentially free from doubt” when, because of a concern over a legal (as opposed to factual) issue, taxpayer’s counsel was unable to render an unqualified (i.e., “will”) opinion on the federal tax consequences of the transaction.¹⁹²

While the “no rule” areas added by Rev. Proc. 2003-48 do not appear to have significantly dampened the desire of public companies to seek these caveated rulings in connection with spins, corporate management often thought it prudent to obtain as well an outside tax opinion that all of the requirements for Section 355 qualification would be met (including business purpose and device) and, if a post-spin transaction was planned, that Section 355(e) would not be triggered.¹⁹³

The impact of the “significant issue” limitation on post-2003 supplemental rulings has been more pronounced, although the Service has continued to entertain a fair number of supplemental ruling requests under Section 355.¹⁹⁴ Indeed, in 2009, the Service instituted a special pilot program permitting and according expedited processing of ruling requests on only specific aspects or issues arising in the context of a Section 355 transaction.¹⁹⁵

The latest, and clearly most dramatic, change in Section 355 ruling policy was announced in Rev. Proc. 2013-32. Per that revenue procedure, the Service will no longer rule (even on a caveated basis) on whether a transaction *qualifies* under Section 355, regardless of whether the transaction (i) presents a significant issue or (ii) is an integral part of a larger transaction that involves other issues upon which the Service will rule. Section 355-related ruling requests will continue to be considered, however, with respect to “significant issues” (i.e., other than overall qualification under Section 355(a)); and the “significant issue” concept has been re-defined (and potentially broadened) to encompass issues that are “not essentially free from doubt” and are “germane to determining the tax consequences of the transaction.”¹⁹⁶

The Rev. Proc. 2013-32 strictures extend as well to supplemental ruling requests. Since Section 355 ruling requests will now be a rare occurrence and of very limited scope, in most instances there will not be an original letter ruling with respect to which a supplemental ruling on a “significant issue” might be obtained. That being so, it appears that it might be possible to obtain a stand-alone ruling with respect to a post-spin event or development where no initial ruling was received.¹⁹⁷ In any event, as Rev. Proc. 2013-32 makes clear: (i) a post-spin change in circumstances “ordinarily” will not present a significant issue;¹⁹⁸ (ii) an issue of fact (as opposed to law) can never present a significant issue; and (iii) all other pertinent “no rule” policies will continue to apply in supplemental Section 355 ruling contexts.¹⁹⁹

The upshot of all this is that few, if any, of the post-spin scenarios discussed in this article are likely to be eligible for ruling protection. That undoubtedly will place greater pressure on the advisability of seeking at least some degree of comfort through an outside tax opinion.²⁰⁰ Apart from any penalty protection that might be afforded, such opinions will be especially useful where the post-spin transaction has not yet occurred and, depending on the strength of the opinion, can still be abandoned or postponed until a “safer” date further removed from the spin.

VIII. Conclusion

Section 355 transactions are complicated creatures. The coveted tax-free treatment they provide is conditioned upon full compliance with a myriad of statutory and non-statutory requirements. Some of these requirements are not yet fully developed in terms of their legal parameters; some can be difficult to interpret and apply in particular factual circumstances; and Section 355 qualification can be retrospectively jettisoned by a wide range of post-spin transactions or events involving Distributing, Controlled, or their shareholders.

Some of the potential issues raised by these post-spin scenarios could be neutralized by the issuance of clarifying administrative guidance or possibly via statutory amendments — e.g., with respect to the “immediately after” element of the ATB Requirement or application of the 355 COI and 355 COBE Requirements. Even without any such changes, however, the current legal landscape does provide a viable framework for identifying and analyzing the potential risks presented by these situations: post-spin developments should not spawn adverse Section 355 qualification or Section 355(e) effects unless they were in fact planned, intended, or otherwise contemplated at the time of the spin (or even if not actually planned, intended, or contemplated, reasonably should have been).

This analytic framework mirrors the core rationale of Rev. Rul. 2003-55, which, although specifically focused on the “business purpose” requirement, seems justifiably extendable to other Section 355 qualification requirements (i.e., device, ATB, COI, COBE). It also borrows heavily from traditional step-transaction principles, which can properly apply, of course, in virtually any tax context. Admittedly, the suggested approach ultimately turns on factual determinations and proof that may be difficult to make or adduce. But that is the nature of most tax issues and, absent some statutory or administrative edict that requires viewing Section 355 distributions as isolated events for tax purposes, likely would be inherent in any other analytic approach that might be pursued.

In the final analysis, before engaging in any Section 355 transaction, taxpayers and their advisors must identify and carefully assess the potential tax risks associated with any post-spin transactions or events that might be on the drawing board, no matter how preliminary, tentative, or speculative such transactions or events may be. With respect to post-spin developments that truly were unforeseen at the time of the spin (and that fact can be amply demonstrated), it normally should be possible to preserve Section 355 treatment even where such developments occur relatively soon after the spin. However, where post-spin developments may have been foreseeable at the time of the spin, serious consideration should be given, if feasible, to postponing their occurrence. In all events, the need to engage in prudent planning and self-help measures along these lines has become even more critical in light of the stringent “no-rule” policy now generally in effect with respect to Section 355 transactions.

¹ Under the rationale of *General Utilities & Operating Co.*, 16 AFTR 1126, 296 US 200, 80 L Ed 154, 35-2 USTC ¶9658, 1936-1 CB 214, 36-1 USTC ¶9012 (1935), a corporation could make a liquidating or non-liquidating distribution of appreciated property to shareholders without incurring a corporate-level tax. The Code generally embraced such treatment for non-liquidating distributions until 1984, and for liquidating distributions until 1986. The statutory reversal of the *General Utilities* doctrine in those years (through amendments to Sections 311, 336, and 337) spared only complete liquidations of controlled subsidiaries (under Section 332) and qualifying distributions of the stock of a controlled subsidiary (under Section 355).

² For an earlier treatment of this topic, see Beller and Harwell, “After the Spin: Preserving Tax-Free Treatment Under Section 355,” 2 *Mergers & Acquisitions: The Monthly Tax Journal* (2001), reprinted with minor modifications in 92 *Tax Notes* 1587 (2001).

³ Sections 355(c) and 361(c).

⁴ Sections 355(a) (flush language), 356(a) and (b).

⁵ Section 358(a)-(c); Reg. 1.358-1(a) and -2(a).

⁶ Section 355(a)(1)(A); see also Reg. 1.355-2(a). Under Section 355(a)(1)(A)(ii), holders of D securities may receive either C stock or C securities tax-free under Section 355 only if they surrender D securities in the exchange. Furthermore, holders of D securities may receive C securities tax-free only to the extent that the principal amount of the D securities surrendered equals or exceeds the principal amount of the C securities received. Sections 355(a)(3)(A) and 356(d)(2)(C). Exchanged D or C debt instruments that have sufficiently lengthy maturities (typically at least five to ten years) generally will constitute “securities” for Section 355 and other subchapter C purposes.

⁷ Section 355(a)(1)(B); see also Reg. 1.355-2(d)(1).

⁸ Section 355(a)(1)(C) and (b)(1)(A); see also Reg. 1.355-2(h). In the context of a split-up, Section 355(b)(1)(B) requires that, immediately before the transaction, the distributing corporation have no assets other than stock or securities in Controlled(s) and that, immediately after the transaction, each of the distributed Controlled(s) be engaged in a qualifying active business.

⁹ Section 355(a)(1)(D); see also Reg. 1.355-2(e). Section 368(c) “control” means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. Only *direct* (actual) ownership is taken into account; and 80% of *each class* of non-voting stock must be held. See Rev. Rul. 59-259, 1959-2 CB 115; Rev. Rul. 56-613, 1956-2 CB 212. In limited circumstances, Distributing may be able to retain a relatively minor portion of the Controlled stock for good business reasons, but not indefinitely. See Section 355(a)(1)(D)(ii) (D must demonstrate that retention of C stock not in pursuance of a plan having avoidance of federal income tax as one of its principal purposes); Rev. Proc. 96-30, App. B, §1.01, 1996-1 CB 696 (advance ruling requirements where D retains C stock; retained stock generally must be disposed of by D not later than five years after spin); see also Rev. Rul. 75-321, 1975-2 CB 123 (D’s distribution of 95% of C stock to comply with federal banking laws and retention of 5% of C stock to meet collateral requirements for short-term financing did not jeopardize Section 355 qualification); Ltr. Rul. 200534006 (5/24/05) (post-spin retention of C stock by “rabbi trust” established by D prior to spin to hold D stock and other assets did not constitute a proscribed tax avoidance retention by D), supplementing Ltr. Rul. 200403060 (9/30/03).

¹⁰ Section 355(g)(1) and (4). A corporation will constitute a “disqualified investment corporation” if the fair market value of its “investment assets” is equal to two-thirds or more of the fair market value of all of its assets. Section 355(g)(2)(A)(i). For this purpose, the term “investment assets” generally means (i) cash, (ii) any stock or securities in a corporation, (iii) any interest in a partnership, (iv) any debt instrument or other evidence of indebtedness, (v) any option, forward contract, futures contract, notional principal

contract, or derivative, (vi) foreign currency, or (vii) any “similar asset.” Section 355(g)(2)(B)(i). For purposes of Section 355(g), the term “50% or greater interest” means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock. Section 355(g)(3)(A) (cross-referencing Section 355(d)(4)).

¹¹ Reg. 1.355-2(b). A non-exclusive list of acceptable business purposes is set forth in Appendix A to Rev. Proc. 96-30. See generally Beller, “Rev. Proc. 96-30: A New Business Purpose Roadmap for Section 355 Transactions,” 50 Tax Lawyer 1 (1996). Although the Service stopped ruling on the Business Purpose Requirement in 2003, see Rev. Proc. 2003-48, §2, 2003-2 CB 86, the particular business purposes described in Appendix A generally continue to be considered “acceptable” by both practitioners and the Service; and the administrative criteria set forth in Rev. Proc. 96-30 with respect to such purposes continue to guide practitioners in the planning of Section 355 transactions.

¹² Reg. 1.355-2(c)(1). Examples in the regulations indicate that 50% continuing stock ownership is an acceptable COI threshold for Section 355 purposes, but that 20% is too low. Reg. 1.355-2(c)(2), Examples 2 and 4. Indirect COI can exist, for example, where an internal spin of a lower-tier subsidiary is followed by another spin of that subsidiary to the distributee corporation’s shareholders. See, e.g., Rev. Rul. 62-138, 1962-2 CB 95.

¹³ Reg. 1.355-1(b). But see McLaulin, 88 AFTR 2d 2001-7324, 276 F3d 1269, 2002-1 USTC ¶150156 88 AFTR 2d 2001-7324, 276 F3d 1269, 2002-1 USTC ¶150156 (CA-11, 2001) (listing the statutory and non-statutory requirements for Section 355 qualification without any reference to COBE).

¹⁴ In contrast to an “acquisitive” type-“D” reorganization, there is no requirement that Distributing transfer “substantially all” of its assets to Controlled. See Section 354(b)(1)(A).

¹⁵ See Section 368(a)(2)(H)(ii). A similar relaxation of the “control immediately after” requirement applies where the pre-distribution asset transfer by Distributing to Controlled is governed by Section 351 (as opposed to being part of a “D” reorganization). See Section 351(c)(1) and (2).

¹⁶ See Reg. 1.355-2(b)(3) (“For rules with respect to the requirement of a business purpose for a transfer of assets to a controlled corporation in connection with a reorganization described in section 368(a)(1)(D), see §1.368-1(b).”). In many instances, the corporate business purpose(s) for the reorganization and the spin-off will coincide.

¹⁷ See Reg. 1.368-1(b) (“Requisite to a reorganization under the Internal Revenue Code are a continuity of the business enterprise . . . and (except as provided in section 368(a)(1)(D)) a continuity of interest as described in paragraph (e) of this section. (For rules regarding the continuity of interest requirement under section 355, see §1.355-2(c).”) (Emphasis added)); TD 8760, *Continuity of Interest and Continuity of Business Enterprise*, 63 Fed. Reg. 4174, 4176 (1/28/98) (“The IRS and Treasury Department continue to study the role of the COI requirement in section 368(a)(1)(D) reorganizations and section 355 transactions. Therefore, these final COI regulations do not apply to section 368(a)(1)(D) reorganizations and section 355 transactions. See §1.355-2(c).”) (Emphasis added)).

¹⁸ Important amendments to the Section 368 COI regulations in 1998 eliminated the requirement of “post-acquisition continuity,” i.e., the target company shareholders are generally free to dispose of their acquiring company shares at any time. See Reg. 1.368-1(e)(1)(i). As will be seen, however, post-spin stock dispositions can jeopardize satisfaction of the Non-Device Requirement and, even absent device or COI concerns, may risk corporate-level taxation under Section 355(e).

¹⁹ The preamble to the 1998 amendments to the Section 368 COBE regulations states that the 368 COBE Requirement applies to any reorganization “for which COBE is relevant,” and is not necessarily limited to type-A, B, C, or G reorganizations under Section 368. TD 8760, *Continuity of Interest and Continuity of Business Enterprise*, 63 Fed. Reg. 4174, 4178 (1/28/98). Reg. 1.355-1(b) literally requires the “continued operation of the business(es)” (not “continuity of business enterprise”), and pre-dates the

“historic business”/“historic business assets” concept that was added to the Section 368 COBE regulations in 1980. See TD 7745, *Continuity of Business Enterprise Requirement for Corporate Reorganizations*, 1981-1 CB 134. For a discussion of earlier COBE case law and the events leading to this then controversial regulatory change, see Beller and Brown, “IRS Mounts Double-Barreled Attack on ‘Cash Reorganizations’ with Mutual Funds,” 53 J. Tax’n 76 (1980).

²⁰ Section 355(e)(1) and (2)(A); Reg. 1.355-7(a). For purposes of Section 355(e), the term “50% or greater interest” means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock. Section 355(e)(4)(A). Gain is recognized by Distributing on the distribution because the stock of Controlled is not treated as “qualified property” for purposes of Section 355(c)(2) or Section 361(c)(2).

²¹ Section 355(e)(2)(B). Corporate-level gain can also be triggered under Section 355(d) in connection with qualifying Section 355 distributions, where substantial purchases of Distributing or Controlled stock occur during the five-year pre-distribution period (whether or not linked to the distribution by any plan). Where both Section 355(d) and (e) could apply (i.e., in cases involving stock purchases during the two-year period preceding the distribution), Section 355(d) trumps. Section 355(e)(2)(D).

²² See Rev. Proc. 2003-48, *supra* note 11, at §2; see also Rev. Proc. 2013-3, 2013-1 IRB 113, §3.01(43). Although audit challenges to Section 355 transactions are apparently quite rare, the authors understand that IRS attorneys sometimes do receive inquiries from the field regarding Section 355 ruling letters on which they had worked.

²³ See Rev. Proc. 2013-32, 2013-28 IRB 1 (discussed *infra* in Section VII, “Section 355 ruling policy”).

²⁴ Post-spin reductions in the voting power attached to the Controlled shares also may be problematic where the spin was preceded by a recapitalization designed to give Distributing the requisite 80% “control” (within the meaning of Section 368(c)) of Controlled at the time of the spin. See *infra* note 199.

²⁵ Reg. 1.355-2(b).

²⁶ 2003-1 CB 961.

²⁷ See, e.g., Ltr. Rul. 200129032 (4/24/01) (cancellation of planned public offering of Controlled following spin-off undertaken to allow Controlled to raise more capital), supplementing Ltr. Rul. 200017019 (1/27/00); Ltr. Rul. 200103054 (10/23/00) (due to unexpected business difficulties and unfavorable market conditions, public offering of Controlled could not be completed within one year of spin-off transaction; later date set), supplementing Ltr. Rul. 199950032 (9/13/99).

²⁸ See, e.g., Ltr. Rul. 200104025 (10/26/00), supplementing Ltr. Rul. 200011017 (12/14/99).

²⁹ See, e.g., Ltr. Rul. 200036023 (6/7/00), supplementing Ltr. Rul. 9821052 (2/24/98).

³⁰ The “fit and focus” purpose contemplates a spin undertaken 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. See Rev. Proc. 96-30, *supra* note 9, at §4.04(4) and App. A, §2.05(1). In such situations, the spin is expected to eliminate internal competition or conflict between the separated businesses. See, e.g., Ltr. Rul. 200944026 (6/29/09) (the separation will (i) reduce the competition for capital that currently exists between Business A and Business B and (ii) improve management “fit and focus,” including sharpening management focus and strategic vision, providing the flexibility needed to respond more effectively to customer needs and a changing economic environment and enhancing the success of the businesses by enabling them to resolve management, systemic or other problems that arise or are exacerbated by Distributing’s operation of Business A and Business B within a single affiliated group); Ltr. Rul. 200932018 (4/14/09) (corporate business purposes include (i) resolving concerns regarding allocation of scarce resources; (ii) allowing Distributing’s management to

focus solely on the performance and profitability of Business A; and (iii) allowing Controlled's management to focus solely on the performance and profitability of Business B).

³¹ 2003-2 CB 79.

³² See, e.g., Ltr. Rul. 200420015 (2/2/04) (extension of Controlled's lease of building from Distributing due to unexpected circumstances), supplementing Ltr. Rul. 200107008 (11/9/00); Ltr. Rul. 200130003 (4/3/01) (Section 355 ruling still valid where, shortly after "fit and focus" spin, chairman of Controlled's board of directors (i) resigned as chairman but remained a Controlled director; (ii) was appointed chairman and CEO of Distributing on a temporary basis; and (iii) was likely to remain on Distributing's board of directors after replacement found), supplementing Ltr. Rul. 200044019 (8/3/00).

³³ See, e.g., Ltr. Rul. 200823004 (3/3/08) (in exchange for arm's-length consideration, Distributing 1, Distributing 2, and Controlled will continue certain business relationships, including sharing of employees, accounting functions, continuance of the currently existing benefits plan for Controlled's employees, and Controlled's receipt of services from Distributing 1 with respect to Business B; regulatory, risk, and acquisition business purposes); Ltr. Rul. 200704018 (10/12/06) (third-party lenders required cross-guarantees by D and C of each other's indebtedness; most of the loans were to mature in "a year or two" following spin, but three loans had longer terms; key employee business purpose (among others)), supplementing Ltr. Rul. 200603016 (10/14/05); Ltr. Rul. 200214025 (1/4/02) (post-spin administrative management services provided by Distributing to subsidiaries of Controlled without time limitation; regulatory business purpose).

³⁴ Cf. *Atlas Tool Co.*, 70 TC 86, 103-104 (1978) ("It is well established that the same business need not be conducted by the transferee as was conducted by the transferor. In several cases in which reorganizations were found, the transferor's assets have been taken by a newly formed, related corporation and employed in a different business."), *aff'd* 45 AFTR 2d 80-645, 614 F.2d 860, 80-1 USTC ¶9177 (CA-3, 1980).

³⁵ Section 355(b)(1)(A) and (2)(A). In the context of a split-up, where Distributing goes out of existence, each Controlled must conduct a qualifying ATB immediately after the distribution.

³⁶ Section 355(b)(2)(B), (C), and (D).

³⁷ See Prop. Reg. 1.355-3(b)(1)(ii) (2007). The composition of a SAG is determined under the Section 1504(a) "affiliation" rules (i.e., chain of corporations linked by 80% or more direct/indirect stock ownership), but including corporations normally excluded under Section 1504(b) (e.g., foreign corporations and life insurance companies).

³⁸ See Reg. 1.355-3(b)(3)(ii) ("[I]f a corporation engaged in the active conduct of one trade or business during . . . [the 5-year pre-distribution period] purchased, created or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business."); Reg. 1.355-3(c), *Example 8* (expansion of existing hardware store business via purchase of assets of hardware store in another state).

³⁹ See Notice of Proposed Rulemaking, *Guidance Regarding the Active Trade or Business Requirement Under Section 355(b)*, 72 Fed. Reg. 26012, 26022 (5/8/07) (noting that no authorities have limited the application of the business expansion exception to asset acquisitions).

⁴⁰ The effect of such treatment is to disable the restriction of Section 355(b)(2)(D). See, e.g., Prop. Reg. 1.355-3(d)(2), *Example 20* (2007).

⁴¹ Accordingly, if the business expansion exception does not apply to the acquisition of the stock of S1, Bus. 3 may run afoul of Section 355(b)(2)(D), or, if the acquisition were instead tested as an asset acquisition under the SAG rules, Section 355(b)(2)(C). While the relatively minor size of Bus. 3 (12.5% of Distributing's post-spin value) might also be problematic from an ATB perspective, the Service has historically been comfortable with otherwise active businesses representing 5% of total asset value. For example, in Rev. Proc. 96-43, 1996-2 CB 330, the Service announced that it generally would not rule on whether a distribution of stock or securities is described in Section 355(a)(1) when the gross assets of the trade or business relied on to satisfy the ATB Requirement have a fair market value that is less than 5% of the total fair market value of the gross assets of the corporation conducting the trade or business. This position was incorporated into the annual "no-rule" list beginning with Rev. Proc. 97-3, 1997-1 CB 507, but ultimately was deleted from that list. See Rev. Proc. 2003-48, *supra* note 11, at §4.07.

⁴² *Cf.* Intermountain Lumber Co., 65 TC 1025 (1976) (Section 351 "control immediately after" requirement breached by pre-existing legal obligation to sell to unrelated party 50% of stock received in exchange for incorporation transfer).

⁴³ See, e.g., Ltr. Rul. 199922036 (3/3/99) (sale of active business due to industry consolidation), supplementing Ltr. Rul. 9651045 (9/23/96); see also Ltr. Rul. 200109045 (12/6/00) (transfer of Distributing's active business to new subsidiary more than three years after spin, preparatory to sale in response to changed market conditions), supplementing Ltr. Rul. 9649040 (9/10/96); Ltr. Rul. 200019013 (2/10/00) (despite dedicating additional resources to growth of active business's employees, offices, and assets, unforeseen circumstances caused significant decline in rate of return resulting in discontinuance of business), supplementing Ltr. Rul. 9821052 (2/24/98).

⁴⁴ See, e.g., Murray, *The Gregory Rules of Section 355-Business Purpose, Active Trade or Business, Device (With Additional Thoughts on Control, Continuity, and Other Section 355 Miscellany)* 568-569 (Practising Law Institute 2012); Wessel et al., *Corporate Distributions Under Section 355* at 31-32 (Practising Law Institute 2009); Ridgway, *Tax Management Portfolio 772-4th: Corporate Acquisitions-D Reorganizations*, at pt. VII.B.

⁴⁵ The representation that had been required in Section 355 letter ruling requests did not include a temporal or quantitative benchmark, stating merely that "each of Distributing and Controlled will continue the conduct of its active trade or business." Rev. Proc. 96-30, *supra* note 9, at §4.03(8).

⁴⁶ See Reg. 1.368-1(d)(2)(ii) ("significant line of business"), (d)(3)(i) ("significant portion of T's historic business assets") and (d)(5), *Example 1* (Target conducts three businesses of roughly equal value; six months before being acquired, Target sells two of the three businesses; 368 COBE Requirement satisfied).

⁴⁷ See, e.g., Rev. Rul. 2002-85, 2002-2 CB 986.

⁴⁸ The appropriate percentage comparison presumably should not include Bus. 2, which was spun-off with and continued by Controlled. As to the remaining post-spin businesses of Distributing (Bus. 1 and Bus. 3), Bus. 3 represents approximately 12.5% on a relative value basis, still well below the one-third "significance" benchmark blessed in the Section 368 COBE regulations.

⁴⁹ See commentary cited *supra* note 44.

⁵⁰ Reg. 1.355-3(b)(2)(iv)(B).

⁵¹ Reg. 1.355-3(b)(2)(iii) instructs that "the determination whether a trade or business is actively conducted will be made from all of the facts and circumstances." In Rev. Rul. 82-219, 1982-2 CB 82 a one-year pre-spin interruption due to loss of the business's only customer did not prevent that business from satisfying the ATB Requirement because the loss was unforeseen, outside of the taxpayer's control, and all reasonable steps were taken to restore income flow by redesigning products and looking for new

customers in that year). See also Rev. Rul. 57-126, 1957-1 CB 723 (pre-spin dormancy of a citrus business for five years due to series of disastrous freezes did not prevent satisfaction of the ATB Requirement; separate identity of citrus division maintained and full operations resumed); Ltr. Rul. 201102046 (9/28/10) (pre-spin business activity temporarily suspended due to increase in raw material price; history of slowdowns and accelerations in the business); Ltr. Rul. 9809051 (12/2/97) (four months of reduced activity pre-spin during relocation and size reduction not inconsistent with active business). But see *Spheeris*, 29 AFTR 2d 72-1057, 461 F2d 271, 72-1 USTC ¶9395 (CA-7, 1972) (pre-spin four-year interruption of business on account of fire violated ATB Requirement).

⁵² Cf. Ltr. Rul. 200323041 (3/11/03) (due to business differences between son and daughter, Distributing leased farm property on cash rent basis to third party for crop year, pending (i) probate of father's estate, (ii) distribution of father's Distributing shares equally to son and daughter, and (iii) separation of Distributing's assets equally between son and daughter; viewed as temporary cessation of business activities that did not violate ATB Requirement).

⁵³ See Reg. 1.355-3(b)(3)(iv)(A).

⁵⁴ Ltr. Rul. 199914003 (12/15/98) (U.S. subsidiaries of Controlled sold after unexpected drop in stock value), supplementing Ltr. Rul. 9730024 (4/28/97); Ltr. Rul. 9630033 (4/30/96) (several unforeseen changes in Controlled's industry rendered Controlled no longer able to compete; Controlled sold following receipt of unsolicited offer), supplementing Ltr. Rul. 9427010 (4/6/94); Ltr. Rul. 9136012 (6/6/91) (post-spin sale of Distributing stock due to unanticipated legal restrictions), supplementing Ltr. Rul. 8812067 (12/29/87).

⁵⁵ Section 355(g)(1), (2)(A), and (2)(B)(i)(II).

⁵⁶ Reg. 1.355-3(b)(3)(ii) embellishes on this concept as follows: "[T]he fact that a trade or business underwent change during the five-year period preceding the distribution (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded, provided that the changes are not of such a character as to constitute the acquisition of a new or different business. In particular, if a corporation engaged in the active conduct of one trade or business during that five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such a character as to constitute the acquisition of a new or different business."

⁵⁷ Rev. Rul. 2003-18, 2003-1 CB 467; cf. Reg. 1.355-3(c), *Examples 7 and 8* (expansion via construction of suburban retail store and acquisition of out-of-state store).

⁵⁸ As explained in the preamble to the proposed ATB regulations with respect to the SAG rules: "The SAG rule alters the application of section 355(b)(2)(C) and (D) with respect to the acquisition of stock of a corporation that is or becomes a subsidiary SAG member. Section 355(b)(3) treats SAG members as one corporation for purposes of . . . section 355(b). Consequently, a transaction that results in a corporation-including controlled-becoming a subsidiary SAG member is treated as a direct acquisition of all the assets (and activities) owned (and performed) by the acquired corporation at the time of the acquisition. . . . In addition, an acquisition that results in a corporation becoming a subsidiary SAG member in a transaction in which gain or loss is recognized might . . . [qualify] as an expansion of one of the acquiring SAG's existing businesses, as discussed in section E. of this preamble." Notice of Proposed Rulemaking, *Guidance Regarding the Active Trade or Business Requirement Under Section 355(b)*, 72 Fed. Reg. 26012, 26015-26016 (5/8/07) (citations omitted).

⁵⁹ Dealerco became a SAG member because Carco acquired Section 1504(a)(2) "affiliation" ownership of Dealerco, i.e., stock representing at least 80% of vote and value. See, e.g., Ltr. Rul. 201133003 (5/18/11) (Distributing acquired Controlled stock via taxable inversion transaction and distributed such stock to Parent; Distributing and Controlled in same business, so business expansion doctrine applied.)

⁶⁰ See Rev. Rul. 2003-38, 2003-1 CB 811.

⁶¹ Note that, because the expansion occurred through internal growth, as opposed to via an acquisition of an existing on-line business from unrelated owners, Section 355(b)(2)(C) should not apply. Furthermore, because Clickco acquired its assets from Stepco in a wholly non-taxable Section 351 transaction, Clickco will have the requisite five-year ATB history for purposes of Section 355(b)(2)(B).

⁶² If the shoe store conversion was not planned or contemplated at the time of the spin, any risk of violating the ATB and 355 COBE Requirements would appear substantially lower (as in Cases 4, 5, and 6).

⁶³ 18 AFTR 2d 5843, 367 F2d 794, 66-2 USTC ¶9718 (CA-4, 1966).

⁶⁴ See Rev. Rul. 68-603, 1968-2 CB 148; Rev. Proc. 96-30, *supra* note 9, at App. A, §§2.07-2.08 (business purpose requirement generally satisfied where spin facilitates an acquisition of D or an acquisition by D or C); see also Rev. Rul. 2003-79, 2003-2 CB 80 (involving post-spin acquisition of C).

⁶⁵ The term “50% or greater interest” means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock. See Sections 355(e)(4)(A) and 355(d)(4). For purposes of determining whether a 50% or greater interest has been acquired:

- A person and all persons related to such person (within the meaning of Section 267(b) or Section 707(b)(1)) are treated as one person. See Sections 355(e)(4)(C)(i) and 355(d)(7)(A).
- The attribution rules of Section 318(a)(2) are applied when determining whether a person holds stock of a corporation, but Section 318(a)(2)(C) (concerning attribution from corporations) generally is applied without regard to the “50% or more in value” threshold. See Section 355(e)(4)(C)(ii).
- All acquisitions of the stock of Distributing or Controlled that are considered to be part of a Proscribed Plan must be aggregated. See Reg. 1.355-7(c)(5).
- Any reference to Distributing or Controlled includes a reference to any predecessor or successor of such corporation. Section 355(e)(4)(D). Proposed Treasury regulations issued in 2004 define the terms “predecessor” and “successor” primarily by reference to transactions described in Section 381. See Prop. Regs. 1.355-8(b) and (c) (2004).

⁶⁶ See Section 355(e)(3)(B) (specifying reorganizations under Section 368(a)(1)(A), (C), or (D) or any other transaction specified in regulations). *Morris Trust* transactions may also involve type-“B” reorganizations (stock for solely voting stock) under Section 368(a)(1)(B), where the acquired corporation survives as a controlled subsidiary of the acquiring corporation. See Rev. Rul. 78-251, 1978-1 CB 89 (acquisition of Distributing stock by unrelated corporation).

⁶⁷ Mechanically, the Safeco shareholders are treated under Section 355(e)(3)(B) as having acquired 40% of the Foodco stock. While that alone is not enough to trigger Section 355(e), additional tainted acquisitions of at least 10% of the Foodco stock during the four-year statutory period (i.e., two years before and after the spin) could bring Section 355(e) into play.

⁶⁸ Nor should satisfaction of the Non-Device or 355 COI Requirements be jeopardized. See discussion of Case 19 *infra*.

⁶⁹ The Fourth Circuit essentially concluded that Distributing had met the “immediately after” requirement simply by completing the spin, no matter how quickly its ATB was taken over by the acquiring bank in the merger. The court reasoned as follows:

Section 355(b)(1)(A) requires that both the distributing corporation and the controlled corporation be “engaged immediately after the distribution in the active conduct of a trade or business.” There was literal compliance with that requirement, for the spin-off, including the distribution of Agency’s stock to American’s stockholders, preceded the merger. . . . It is in marked contrast to § 355(b)’s highly particularized requirements respecting the duration of the active business prior to the reorganization and the methods by which it was acquired. These contrasts suggest a literal reading of the post-reorganization requirement and a holding that the Congress intended to restrict it to the situation existing “immediately after the distribution.”

Such a reading is quite consistent with the prior history. . . . It sufficiently serves the requirements of permanence and of continuity, for as long as an active business is being conducted immediately after the distribution, there is no substantial opportunity for the stockholders to sever their interest in the business except through a separable, taxable transaction. If the corporation proceeds to withdraw assets from the conduct of the active business and to abandon it, the Commissioner has recourse to the back-up provisions of § 355(a)(1)(B) and to the limitations of the underlying principles. At the same time, the limitation, so construed, will not inhibit continued stockholder conduct of the active business through altered corporate form and with further changes in corporate structure, the very thing the reorganization sections were intended to facilitate.

Morris Trust, *supra* note 63, at 796, 798-799.

⁷⁰ Rev. Proc. 96-30, *supra* note 9, at App. A, §2.07.

⁷¹ No matter what percentage of the acquiring corporation’s stock is owned by the Distributing shareholders, the Distributing ATB will be “inherited” in the merger by the acquiring corporation; and the value of the Distributing shareholders’ shares in the acquiring corporation will be the same regardless of what percentage of the acquiring corporation’s total shares they represent.

⁷² See Regs. 1.355-7(d) (safe harbors), 1.355-7(b)(3) (plan factors) and 1.355-7(b)(4) (non-plan factors). The Section 355(e) plan regulations evolved out of various earlier proposed versions that generally were less “taxpayer friendly” and generated substantial comment and other input from the tax community. For a comprehensive review of the history of these proposals and the provisions of the final version, see Silverman, “Final Section 355(e) Plan Regulations-The Final Chapter in the Saga,” (Practising Law Institute 2012).

⁷³ Reg. 1.355-7(b)(2).

⁷⁴ The potential Natco acquisition and the actual Safeco acquisition likely are not “similar acquisitions” for Section 355(e) purposes because the “ultimate owners” of the combined business operations in these alternative scenarios would be “substantially different.” See Regs. 1.355-7(h)(12) and 1.355-7(j), *Example 6*.

⁷⁵ These include, for example, the facts that (i) the Healthco Spin was motivated by a corporate business purpose other than to facilitate an acquisition of Foodco (i.e., to make Foodco more attractive to lenders); and (ii) the Healthco Spin would have occurred at the same time and in the same form notwithstanding the acquisition (which was not contemplated or expected at the time of the spin). See Reg. 1.355-7(b)(4)(ii), (v), and (vi). Consistent with Rev. Rul. 2003-55, the fact that no new debt financing had yet been obtained by Foodco prior to the Safeco acquisition ought not be considered a fatal deviation from the asserted business purpose for the spin, so long as the seeking of such borrowings was in fact intended at the time of the spin.

⁷⁶ 20 AFTR 1301, 95 F2d 732, 37-2 USTC ¶9501, 1939-1 CB 248, 38-1 USTC ¶9238 (CA-4, 1937).

⁷⁷ For ruling purposes, “substantially all” is defined to mean assets representing at least 90% of total net asset value and 70% of total gross asset value. See Rev. Proc. 77-37, 1977-2 CB 568, §3.01, as amplified by Rev. Proc. 86-42, 1986-2 CB 722, §§7.05-7.06. Published rulings and case law, however, embrace a more flexible “facts and circumstances” approach, considering, for example, the types of assets involved (i.e., cash v. non-cash; operating v. non-operating). See, e.g., Rev. Rul. 70-240, 1970-1 CB 81 (involving a “D” reorganization); Rev. Rul. 57-518, 1957-2 CB 253 (involving a “C” reorganization); see also Moffatt, 42 TC 558, 578 (1964) (“[The] term ‘substantially all’ is a relative term, dependent on the facts of any given situation.”), *aff’d* 17 AFTR 2d 1290, 363 F.2d 262, 66-2 USTC ¶9498 (CA-9, 1966).

⁷⁸ In addition to Section 368(a)(2)(D) mergers, these include reorganizations described in Sections 368(a)(1)(C) (stock for assets), (a)(1)(D) (acquisitive variety), (a)(2)(E) (reverse triangular mergers), and (a)(1)(G) (bankruptcy reorganizations).

⁷⁹ Rev. Rul. 2003-79, *supra* note 64. This ruling indicates that the Service will continue to apply the *Elkhorn Coal* rationale to post-spin acquisitions of *Distributing* via reorganizations involving a “substantially all” requirement. Respecting post-spin acquisitions of *Controlled* as separate transactions is consistent with Rev. Rul. 98-27, 1998-1 CB 1159, where the Service announced that, in light of (i) the legislative policy behind the enactment of Section 355(e), and (ii) the effective elimination of the “control immediately after” requirement for “D” reorganization and Section 351 transfers followed by Section 355 distributions (see Sections 368(a)(2)(H)(ii) and 351(c)(2)), it would no longer apply step transaction principles to treat pre-arranged post-spin acquisitions or restructurings of *Controlled* as violating the “distribution of control” requirement under Section 355. Prior to Rev. Rul. 98-27, the Service was willing to bless such transactions only where the post-spin acquisition was subject to shareholder approval or otherwise not a foregone conclusion at the time of the spin. See Rev. Rul. 75-406, 1975-2 CB 125, modified by Rev. Rul. 96-30, 1996-1 CB 36. (Rev. Ruls. 75-406 and 96-30 were both obsoleted by Rev. Rul. 98-27.)

⁸⁰ Bailine, “A Partial Epitaph for Born-To-Die Spin-Offs?” 32 Corp. Tax’n 25, 26 (2005) (Rev. Rul. 2003-79 represents “a complete acceptance by the IRS of the born-to-die spin-off.”)

⁸¹ See, e.g., Ltr. Rul. 201032017 (2/5/10) (upstream reorganization of newly organized *Controlled* following D/355 transaction).

⁸² See, e.g., Ltr. Rul. 200812017 (12/14/07) (lateral merger of newly organized *Controlled* into sister corporation following D/355 transaction); Ltr. Rul. 200113019 (12/27/00) (same); Ltr. Rul. 200104001 (3/16/00) (same).

⁸³ See, e.g., Ltr. Rul. 201312020 (12/20/12) (Section 332 liquidation of “old and cold” *Controlled* following spin); Ltr. Rul. 200912008 (12/10/08) (lateral merger of “old and cold” *Controlled* into sister corporation following D/355 transaction); Ltr. Rul. 200811012 (11/30/07) (Section 332 liquidation of “old and cold” *Controlled* following D/355 transaction); Ltr. Rul. 9445015 (8/11/94) (downstream merger of *Controlled*).

⁸⁴ Transfers to a single-member LLC that is treated as a “disregarded entity” for tax purposes will be treated as if the transferor entity transferred the assets to itself and, as such, will likewise have no impact on the Section 355 qualification (whether or not pre-planned). See generally Reg. 301.7701-2(c)(2) (describing business entities disregarded as separate from their owners for federal tax purposes).

⁸⁵ Section 351 treatment requires that the transferor(s) hold transferee corporation stock representing Section 368(c) “control” immediately after the transfer, i.e., at least 80% of voting power and at least 80% of the number of shares of any class of non-voting stock. Section 721 treatment applies for any type or class of partnership/LLC interest received, without regard to any “control” or percentage requirement.

⁸⁶ As such, any unrealized gain inherent in the transferred intangible assets would not be recognized by reason of Section 361(a). The actual issuance of additional Healthco stock to Foodco in exchange for the

transferred property would be a meaningless gesture and therefore unnecessary given Foodco's 100% ownership of Healthco.

⁸⁷ In that event, the pre-spin dropdown into Healthco should still be protected by Section 351(a) (instead of Section 361(a)); and under Section 351(c), the immediate distribution of the Healthco stock by Foodco to its shareholders should not violate the Section 351 "control" requirement. That distribution, however, would be taxable to the shareholders as a dividend and will also trigger Section 311 gain to Distributing.

⁸⁸ Rev. Rul. 2002-85, *supra* note 47. This ruling was motivated by the fact that Section 368(a)(2)(C), which protects asset or stock transfers to 80% or more controlled subsidiaries following type-"A", "B", "C", or "G" reorganizations, does not explicitly protect such transfers following "D" reorganizations (whether of the acquisitive or divisive variety). See generally Beller, "D' Reorganizations and Dropdowns: An Uneasy Match," 26 J. Corp. Tax'n 177 (1999).

⁸⁹ See discussion of Case 18 *infra*.

⁹⁰ Rev. Rul. 92-17, 1992-2 CB 142.

⁹¹ See Rev. Rul. 2002-49, 2002-2 CB 288.

⁹² See Rev. Rul. 2007-42, 2007-28 IRB 44 (Situation 1). Neither Distributing nor any other LLC member performed services with respect to the LLC business.

⁹³ See *id.* (Situation 2).

⁹⁴ See Prop. Regs. 1.355-3(b)(2)(v) (2007), 1.355-3(d)(2), *Examples* 22 and 23 (2007); see also Section 355(g)(2)(B)(v) (providing a similar partnership "look-thru" rule for purposes of determining whether Distributing or Controlled is a "disqualified investment corporation").

⁹⁵ See Prop. Reg. 1.355-3(d)(2), *Example* 22 (2007).

⁹⁶ Reg. 1.368-1(d)(4)(iii)(B)(1).

⁹⁷ Reg. 1.368-1(d)(4)(iii)(B)(2).

⁹⁸ See Reg. 1.368-1(d)(5), *Examples* 7, 8, 10, and 11.

⁹⁹ See Rev. Rul. 71-383, 1971-2 CB 180 ("the transaction is not a device to distribute earnings and profits (that is, to convert dividend income into capital gains)"). While the equivalency since 2003 of tax rates for capital gains and "qualified dividends" largely neutralizes the "bailout" concern, the ability to recover stock basis via a post-spin sale also has device potential.

¹⁰⁰ See Regs. 1.355-2(d)(2) (device factors) and (d)(3) (non-device factors). In addition, certain "safe harbor" rules set forth in Reg. 1.355-2(d)(5) may eliminate the need for a device/non-device factor evaluation. See discussion of Case 15 *infra*.

¹⁰¹ See Regs. 1.355-2(d)(2)(iii)(A) through (D). Section 355(a)(1)(B) states that "the mere fact" that Distributing or Controlled stock is sold or exchanged by some or all of the distributee shareholders subsequent to the spin "other than pursuant to an arrangement negotiated or agreed upon prior to the . . . [spin] shall not be construed to mean that the transaction was used principally as a . . . device." However, other than this passage, the statute says nothing about the device potential, if any, of post-spin sales that were not negotiated, agreed to, or otherwise on the radar screen prior to the spin.

¹⁰² In 1977, Treasury and the Service published proposed amendments to the Section 355 regulations. See Notice of Proposed Rulemaking, *Corporate Separations*, 42 Fed. Reg. 3866 (1/21/77). These

amendments suggested a 20% “per se” rule, under which a post-distribution sale of 20% of the stock of Distributing or Controlled, pursuant to a plan negotiated or agreed upon before the distribution, was “conclusive” evidence of device, while a post-distribution sale of less than 20% was “substantial” evidence. See Prop. Reg. 1.355-2(c)(2), (4) (1977). Although the “per se” rule of the 1977 proposed regulations was not included in the comprehensive Section 355 regulations issued in January 1989, the Service did include a 20% threshold in an administrative safe harbor established in 1996 for post-spin redemptions by public companies. See Rev. Proc. 96-30, *supra* note 9, at §4.05(1)(b).

¹⁰³ Reg. 1.355-2(b)(4) and (d)(3)(ii).

¹⁰⁴ See Pulliam, 73 TC Memo 1997-274 . The post-spin stock sale in *Pulliam* was to a former key employee of Distributing’s funeral home business who had left the company and threatened to go to work for a competitor. The spin and subsequent stock sale were designed to enable him to return to Distributing’s employ and satisfy Illinois law regarding permitted ownership of funeral homes. *Cf.* S. Tulsa Pathology Lab., Inc., 118 TC 84 (2002) (pre-arranged post-spin sale of all Controlled shares was a prohibited device).

¹⁰⁵ This corporate business purpose should be acceptable because K will acquire a significant percentage interest in Homeco (20%) and be able to break a deadlock between the other equal shareholders. See Rev. Rul. 69-460, 1969-2 CB 51 (Situation 2); Rev. Proc. 96-30, *supra* note 9, at App. A, §2.01(1)(c); see also Rev. Rul. 85-127, 1985-2 CB 119 (business purpose requirement met where corporation transferred one of its businesses to a new corporation and distributed stock of new corporation to its shareholders to retain services of a key employee and permit that employee to obtain a majority of the stock of the new corporation); Ltr. Rul. 9202009 (10/7/91) (following distribution of Controlled, key employees had voting control over 47.8% of the Controlled stock); *cf.* Rev. Rul. 88-34, 1988-1 CB 115 (pro rata distribution of the stock of Y by X to the X shareholders to enable Y to hire A as its new president was a valid corporate business purpose).

¹⁰⁶ Regs. 1.355-2(c)(1) and (2), *Examples 2 and 4*. Note that in these examples the stock sales occurred prior to (but in contemplation of) the spin. There are no examples involving post-spin stock sales.

¹⁰⁷ Reg. 1.368-1(e)(1)(i). Prior to this change, a number of court cases addressed the “post-acquisition” 368 COI requirement. See, e.g., Penrod, 88 TC 1415 (1987) (stock sale nine months after reorganization did not break continuity; no intent to sell at time of reorganization); *Est. of Christian*, TC Memo 1989-413, PH TCM ¶89413, 57 CCH TCM 1231 (stock sale seven months after reorganization). The principles of these cases would appear to retain vitality in connection with application of the 355 COI Requirement.

¹⁰⁸ Reg. 1.368-1(e)(2)(v), *Example 1*. Older case law blessed lower percentages. See, e.g., John A. Nelson Co., 16 AFTR 1262, 296 US 374, 80 L Ed 281, 35-2 USTC ¶9680, 1936-1 CB 274, 36-1 USTC ¶9019 (1935) (38%); Miller, 17 AFTR 1308, 84 F2d 415, 36-2 USTC ¶9324 (CA-6, 1936) (25%). Historically, a 50% threshold had been applied for letter ruling purposes. See Rev. Proc. 77-37, §3.02, 1977-2 CB 568. However, consistent with the example in the current regulations, recent private letter rulings indicate that 40% has become the threshold for such purposes. See, e.g., Ltr. Rul. 201109001 (3/2/10) (Representation (b) - “At least 40 percent of the proprietary interest in Target will be exchanged for Acquiring common stock and that proprietary interest will be preserved (within the meaning of §1.368-1(e)).”).

¹⁰⁹ See authorities cited *supra* note 17.

¹¹⁰ See, e.g., Kahn, Kahn, Perris, and Lehman, *Corporate Income Taxation* 374-379 (West, 6th ed. 2009) (urging that the 355 COI Requirement, as articulated in the regulations, is outmoded in light of certain statutory amendments (Sections 368(a)(2)(H)(i) and 351(c)(2)) rendering post-spin sales of Controlled shares, even if pre-planned, harmless for purposes of the Section 368(a)(1)(D) or Section 351 “control” requirements).

¹¹¹ In the case of a publicly traded Distributing or Controlled, this restriction is difficult, if not impossible, to police. Historically, in the context of a letter ruling request for a spin involving a public company, the Service required a taxpayer's representation that "[t]here is no plan or intention by any shareholder who owns 5 percent or more of the stock of the distributing corporation, and the management of the distributing corporation, to its best knowledge, is not aware of any plan or intention on the part of any particular remaining shareholder or security holder of the distributing corporation to sell, exchange, transfer by gift, or otherwise dispose of any stock in, or securities of, either the distributing or controlled corporation after the transaction." Rev. Proc. 96-30, *supra* note 9, at §4.05(1)(a). Although this representation was made with respect to the Non-Device Requirement, it presumably applies as well for purposes of the 355 COI Requirement. Thus, public trading in the shares of Distributing or Controlled would appear to be disregarded in this calculus, at least to the extent that the trading occurs with respect to "small" (i.e., less than 5%) shareholders.

¹¹² While the four-year statutory period sets the parameters for triggering the rebuttable Proscribed Plan presumption, acquisitions outside such period apparently could also be tainted for Section 355(e) purposes if factually linked to the spin.

¹¹³ For example, Distributing's acquisition of Controlled stock in connection with the first leg of a D/355 transaction is not taken into account; nor is an acquisition of Controlled stock by reason of holding stock or securities in Distributing (i.e., the receipt of Controlled stock by the Distributing shareholders in the Section 355 distribution itself). See Section 355(e)(3)(A).

¹¹⁴ See Reg. 1.355-7(c)(5) (providing that "[a]ll acquisitions of stock of Distributing or Controlled that are considered to be part of a plan with a distribution" will be aggregated for purposes of the 50% test).

¹¹⁵ Definitional elements of the AUASN and "similar acquisition" concepts are described, respectively, at Regs. 1.355-7(h)(1) and (12).

¹¹⁶ For example, if the sales to U were instead made a year after the spin and there was no AUASN during the 18-month period starting 12 months before and ending six months after the spin (Safe Harbor I); or if there was no AUASN in effect at the time of the spin or at any time during the 12-month period thereafter (Safe Harbor III). See Regs. 1.355-7(d)(1) and (3).

¹¹⁷ See Reg. 1.355-7(b). This analysis entails more than a mere "counting" exercise. See Rev. Rul. 2005-65, 2005-2 CB 684 ("The weight to be given each of the facts and circumstances depends on the particular case. The determination does not depend on the relative number of plan factors compared to the number of non-plan factors that are present."); see, e.g., Ltr. Rul. 200133035 (5/17/01) (Service reached pro-taxpayer result notwithstanding a number of seemingly adverse facts), supplementing Ltr. Rul. 200125011 (3/14/01).

¹¹⁸ The redemption would be so treated under Section 302(b)(3) as a "complete termination of interest." Because X and Y are unrelated, X would not be deemed to continue to own Realco stock under the Section 318 attribution rules.

¹¹⁹ *South Tulsa Pathology Lab., Inc.*, 118 TC 84 (2002), in which all of the Controlled stock was immediately sold pursuant to a pre-arranged plan, is plainly distinguishable from Case 15, because there was no non-tax corporate business purpose that warranted a separation of Distributing and Controlled in that situation. Moreover, because the transaction in *South Tulsa* was a spin-off that otherwise would have been taxable as a Section 301 dividend distribution, the Section 302 device safe harbor was unavailable. Cf.. Reg. 1.355-2(d)(5)(i)(last sentence; Reg. 1.355-2(d)(5)(v), Example 2.

¹²⁰ The split-off of Shopco was technically part of a D/355 transaction because of the initial transfer of cash by Realco to Shopco. The Section 368(a)(1)(D) "control" requirement would not be jeopardized by Y's sale of the Realco stock to Trumpco because X (a former Realco shareholder) would continue to own

100% of the Shopco stock. Thus, had appreciated assets been transferred by Realco to Shopco, Section 361(a) would have protected Realco against recognizing gain on such transfer.

¹²¹ See Reg. 1.355-2(d)(2)(ii) (“A distribution that is *pro rata* or substantially *pro rata* among the shareholders of the distributing corporation presents the greatest potential for the avoidance of the dividend provisions of the Code and, in contrast to other types of distributions, is more likely to be used principally as a device.”).

¹²² Cf. Reg. 1.355-2(d)(2)(iii)(D) (“[A] sale of exchange is always pursuant to an arrangement negotiated or agreed upon before the distribution if enforceable rights to buy or sell existed before the distribution. If a sale or exchange was discussed by the buyer and the seller before the distribution and was reasonably anticipated by both parties, then the sale or exchange will ordinarily be considered to be pursuant to an arrangement negotiated or agreed upon before the distribution.”).

¹²³ See Reg. 1.355-2(d)(3)(iii).

¹²⁴ See Reg. 1.355-2(d)(3)(ii) (“The assessment of the strength of a corporate business purpose will be based on all of the facts and circumstances, including, but not limited to, the following factors: (A) [t]he importance of achieving the purpose to the success of the business; (B) [t]he extent to which the transaction is prompted by a person not having a proprietary interest in either corporation, or by other outside factors beyond the control of the distributing corporation; and (C) [t]he immediacy of the conditions prompting the transaction.”). Here, the fact that at least Foodco obtained new borrowing relatively soon after the Healthco Spin is indicative of the importance and immediacy of the business purpose, but the reason why stand-alone financing had not yet been acquired by Healthco would have to be closely examined.

¹²⁵ Section 355 letter ruling requests historically included a representation from Distributing that its management was not aware of any plan or intention on the part of the shareholders of Distributing (or any 5% shareholder of Distributing if Distributing is a public company) to dispose of their stock in Distributing or Controlled after the spin. This representation is relevant to both the Non-Device and 355 COI Requirements. See *supra* note 111.

¹²⁶ See, e.g., Ltr. Rul. 9620033 (4/30/96) (several unforeseen changes in Controlled’s industry rendered Controlled no longer able to compete; Controlled sold following receipt of unsolicited offer), supplementing Ltr. Rul. 9427010 (4/6/94); cf. Penrod, 88 TC 1415 (1987) (stock sale nine months after reorganization did not break continuity; no intent to sell at time of reorganization); Est. of Christian, TC Memo 1989-413, PH TCM ¶89413, 57 CCH TCM 1231 (stock sale seven months after reorganization).

¹²⁷ See Reg. 1.355-7(e)(4)(iv). Such discussions would have to involve one or more officers, directors, or other authorized representatives of the acquiring corporation. See Reg. 1.355-7(e)(6).

¹²⁸ Reg. 1.355-7(h)(12).

¹²⁹ Reg. 1.355-7(d)(1).

¹³⁰ Safe Harbor II might also apply. Its temporal requirements are the same as Safe Harbor I (i.e., 18-month window without AUASN), but (i) the business purpose(s) for the spin must be exclusively non-acquisition related purposes; and (ii) no more than 25% of the stock of the acquired corporation can be acquired or the subject of an AUASN during the 18-month period ending six months after the spin (disregarding market trading stock acquisitions that are protected under the “public trading” rules of Safe Harbor VII). See Regs. 1.355-7(d)(2)(i) and (ii), and (d)(7). Safe Harbor III would not apply since, even though the Healthco acquisition occurred more than a year after the spin, there was an AUASN in existence during that 12-month period (i.e., the definitive agreement between Healthco and Safeco was announced 1/31/13, ten months after the spin). See Reg. 1.355-7(d)(3).

¹³¹ Reg. 1.355-7(j), *Example 3*. In this example, (i) the business purpose for the spin was, as here, to enhance stand-alone financing opportunities; (ii) neither Distributing nor Controlled had been approached by any potential post-spin acquirer of Controlled; and (iii) the acquisition of Controlled occurred within six months of the spin pursuant to a tax-free reorganization in which the Controlled shareholders received less than 50% of the acquiring corporation's stock.

¹³² See Reg. 1.355-7(j) (fifth sentence).

¹³³ 63 AFTR 2d 89-860, 489 US 726, 103 L Ed 2d 753, 89-1 USTC ¶9230, 1989-2 CB 68 (1989). Under *Clark*, the exchanging shareholder is treated as if he or she had received solely acquiring corporation stock in the reorganization and then exchanged part of those shares for an amount equal to the value of the boot received. The Section 302(b) tests are applied by comparing the percentage of acquiring corporation stock that would have been owned by the shareholder if all stock had been received against the percentage owned by the shareholder after the hypothetical redemption. If a percentage interest reduction sufficient to meet the "substantially disproportionate redemption" test of Section 302(b)(2) or the "meaningful reduction in proportionate interest" test of Section 302(b)(1) results, the boot will be taxed as capital gain; otherwise, it is taxed as an ordinary income dividend to the extent of available earnings and profits.

¹³⁴ See Reg. 1.355-2(d)(2)(iii)(E). If the boot is taxed as a dividend, the capital gain "bailout" hallmark of a device is not present.

¹³⁵ If Y received solely Trumpco stock (i.e., 120,000 shares worth \$12 million), and hypothetically redeemed \$2 million worth of such stock (i.e., 20,000 shares), his percentage interest would drop from approximately 3.8% (120,000/3,120,000) to approximately 3.2% (100,000/3,100,000), i.e., a reduction of approximately 16%. Such reduction would likely constitute a "meaningful reduction" for purposes of Section 302(b)(1). *Cf.* Rev. Rul. 76-385, 1976-2 CB 92 (calculations indicated that the redemption reduced Y's percentage ownership of the stock of Z from .0001118% to .0001081%; based on this reduction, the percentage of stock of Z owned by Y after the redemption was 96.7% of the percentage of stock owned by Y before the redemption; redemption was not essentially equivalent to a dividend); Rev. Rul. 75-512, 1975-2 CB 112 (redemption of a minority shareholder's interest in a closely held corporation resulting in a 19% reduction in its interest was not essentially equivalent to a dividend).

¹³⁶ *Cf.* Rev. Rul. 78-251, *supra* note 66 (spin undertaken to facilitate "B" reorganization involving Distributing and an unrelated corporation not considered a device merely because shareholders owning 5% of Distributing stock elect to accept cash for their stock in lieu of acquiring corporation stock); Ltr. Rul. 9433018 (5/18/94) (Distributing expected to merge with unrelated corporation following spin; taxpayer represented that shareholders of not more than 5% of Distributing's stock will exercise dissenters' rights in the potential merger transaction), supplementing Ltr. Rul. 9432004 (2/16/94).

¹³⁷ The safe harbor rule will "ordinarily" apply if, absent Section 355, the distribution would otherwise be taxed as a redemption. Reg. 1.355-2(d)(5)(iv). Apart from the last sentence of Reg. 1.355-2(d)(5)(i) the circumstances that might preclude application of the safe harbor are not addressed in the regulations and do not appear to be addressed in any other published guidance.

¹³⁸ See, e.g., Ltr. Rul. 200109031 (11/30/00) (contribution of Controlled stock following split-off); Ltr. Rul. 9841016 (7/7/98) (contribution of Distributing stock), supplementing Ltr. Rul. 9750059 (9/16/97); Ltr. Rul. 9301007 (10/2/92) (multiple Section 351 dropdowns of Controlled stock following internal spin); see also Rev. Rul. 78-251, *supra* note 66 (spin undertaken to facilitate "B" reorganization involving Distributing and an unrelated corporation not considered a device merely because shareholders owning 5% of Distributing stock elect to accept cash for their stock in lieu of acquiring corporation stock).

¹³⁹ See Reg. 1.355-2(c)(1) ("[S]ection 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation.").

¹⁴⁰ In Rev. Rul. 62-138, 1962-2 CB 95, Distributing distributed the stock of Controlled to the parent corporation of Distributing, which, in turn, distributed the stock of Controlled to its sole shareholder. The Service concluded that, because the subsequent distribution did not alter the aggregate interests of the parent corporation's sole shareholder or add or eliminate any shareholders, COI was satisfied because the shareholders "held the same enterprises in modified corporate form as before the transaction and the corporate enterprises were continued as such." See, e.g., Ltr. Rul. 8734062 (5/29/87) (allowing a fifth-tier subsidiary to be distributed four times to its ultimate parent).

¹⁴¹ See, e.g., Rev. Rul. 78-251, *supra* note 66; Rev. Rul. 70-434, 1970-2 CB 83 (acquisition of Distributing in "B" reorganization); Ltr. Rul. 200310005 (11/21/02) (acquisition of Controlled stock via reverse triangular merger under Section 368(a)(2)(E)); Ltr. Rul. 200109045 (12/6/00) (same), supplementing Ltr. Rul. 9649040 (9/10/96).

¹⁴² See *Morris Trust*, *supra* note 63, at 799, 800 ("American's merger with Security, in no sense, was a discontinuance of American's banking business, which opened the day after the merger with the same employees, the same depositors and customers. There was clearly the requisite continuity of stockholder interest, for American's former stockholders remained in 100% control of the insurance company, while, in the merger, they received 54.385% of the common stock of North Carolina National Bank, the remainder going to Security's former stock-holders. . . . As we have noticed above, the merger cannot by any stretch of imagination be said to have affected the continuity of interest of American's stockholders or to have constituted a violation of the principle underlying the statutory control requirement. The view is the same whether it be directed to each of the successive steps severally or to the whole.").

¹⁴³ The 368 COI Requirement is also satisfied in such situations, as that requirement is focused on the composition of the consideration received by the acquired corporation's shareholders in the reorganization. See Reg. 1.368-1(e)(1)(i).

¹⁴⁴ See, e.g., Ltr. Rul. 200109031 (11/30/00) (contribution of Controlled stock); Ltr. Rul. 9841016 (7/7/98) (contribution of Distributing stock), supplementing Ltr. Rul. 9750059 (9/16/97); Ltr. Rul. 9301007 (10/2/92) (multiple Section 351 dropdowns of Controlled stock following internal spin).

¹⁴⁵ See *supra* notes 129 and 130 and accompanying text.

¹⁴⁶ Reg. 1.355-7(b)(4)(v). The business purpose for the spin was to enable X and Y to go their separate ways with identifiable segments of Realco's overall business assets and operations. See Reg. 1.355-2(b)(5), *Example 2*.

¹⁴⁷ Reg. 1.355-7(b)(4)(vi).

¹⁴⁸ Reg. 1.355-7(b)(4)(ii).

¹⁴⁹ The risk would likely be much lower if, shortly after the spin, but before Trumpco appeared on the scene, Y had suffered a heart attack or other serious medical condition and been advised by his doctor to retire.

¹⁵⁰ See Rev. Proc. 96-30, *supra* note 9, at App. A, §§2.07-2.08 (business purpose requirement generally satisfied where spin facilitates an acquisition of D or an acquisition by D or C); see also Rev. Rul. 2003-79, *supra* note 64 (involving a post-spin acquisition of C).

¹⁵¹ See Rev. Rul. 67-448, 1967-2 CB 144. It also would constitute a Section 368(a)(2)(E) reorganization, unless the prior spin of Healthco must be taken into account under *Elkhorn Coal* in applying the "substantially all" requirement of Section 368(a)(2)(E). See *supra* note 79 and accompanying text; *cf.* Rev. Rul. 2003-79, *supra* note 64 ("[T]he acquisition by A of all the properties held by C immediately after the distribution will satisfy the requirement of § 368(a)(1)(C) that A acquire substantially all the properties of C. This result obtains even though an acquisition by A of the same properties from D would have failed

this requirement if D had retained Business X, contributed Business Y to C, and distributed the stock of C. See *Helvering v. Elkhorn Coal Co.*”).

¹⁵² The merger could be structured as a straight two-party “A” reorganization of Safeco into Foodco; a forward triangular merger under Section 368(a)(2)(D) of Safeco into a Foodco subsidiary; or a reverse triangular merger under Section 368(a)(2)(E) of a transitory Foodco subsidiary into Safeco.

¹⁵³ With respect to the potential impact of public trading in the stock of Foodco on the satisfaction of the 355 COI Requirement, see *supra* note 111.

¹⁵⁴ The fact that the *Safeco* acquisition was discussed and negotiated shortly before the spin should not prevent reliance on the Super Safe Harbor in connection with the *Doughco* acquisition, because neither is a “similar acquisition” relative to the other. See Reg. 1.355-7(h)(12) (defining the term “similar acquisition (not involving a public offering)”; Reg. 1.355-7(j), *Example*. 6; see also *supra* note 74.

¹⁵⁵ Cf. Reg. 1.355-7(j), *Examples* 9 and 10 (plan analysis with respect to post-spin acquisitions via public offerings that are/are not close in time).

¹⁵⁶ Section 302(a) “exchange” treatment would result if the redemption involves a complete termination of interest under Section 302(b)(3); a “substantially disproportionate” redemption under Section 302(b)(2); a reduction in stock ownership interest sufficient to meet the “not essentially equivalent to a dividend” requirement under Section 302(b)(1); or a “partial liquidation” described in Sections 302(b)(4) and (e).

¹⁵⁷ As with third-party sales, redemptions at the 20% or higher level that occur soon after the spin will typically risk IRS challenge, especially if pre-arranged. But see Pulliam, *supra* note 104 (pre-planned post-spin sale of 49% of Controlled stock did not trigger device restriction).

¹⁵⁸ The Section 302 device safe harbor applies only if the spin otherwise would have constituted a redemption to which Section 302(a) applied with respect to each distributee shareholder. Once applicable, the safe harbor should work to preclude a post-spin redemption by either Distributing or Controlled from giving rise to a device concern.

¹⁵⁹ See, e.g., Ltr. Rul. 200327049 (4/3/03) (unanticipated change in circumstances following spin—namely, cash flow and liquidity problems of certain Distributing shareholders—resulted in redemption of Class B Distributing shares held by those shareholders; Distributing was a public company and redemption occurred by way of a public tender offer), supplementing Ltr. Rul. 200125044 (3/22/01); Ltr. Rul. 200149020 (11/15/01) (complete redemption of 11 shareholders’ Controlled stock did not jeopardize prior Section 355 ruling; post-spin redemption occurred for “valid business reasons”), supplementing Ltr. Rul. 200116024 (1/17/01).

¹⁶⁰ Rev. Proc. 96-30, *supra* note 9, at §4.05(1)(b).

¹⁶¹ Rev. Proc. 2003-48, *supra* note 11, at §4.02.

¹⁶² See, e.g., Ltr. Rul. 201250021 (9/6/12) (C’s share repurchases “will be motivated by a business purpose, the stock to be repurchased in the Share Repurchases will be widely held, the Share Repurchases will be made in the open market, and Controlled . . . will have no plan or intention to repurchase directly or through any of its subsidiaries an aggregate amount of its stock that would equal or exceed 20 percent of its outstanding stock before the fifth anniversary of [the] Distribution”), supplementing Ltr. Rul. 201240017 (4/12/12); Ltr. Rul. 201037024 (6/8/10) (describing completed and proposed stock repurchase program by Distributing), supplementing Ltr. Rul. 200851014 (8/26/08); Ltr. Rul. 2007430097 (7/10/07) (“Distributing has no plan or intention, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the External Distribution, other than through stock purchases meeting the requirements of section 4.05(1)(b) of Revenue Procedure 96-30, 1996-1 C.B. 696, with the exception of 4.05(1)(b)(iv)”; Ltr. Rul. 200708064 (10/19/06) (describing proposed stock

repurchase program by Controlled), supplementing Ltr. Rul. 200624001 (7/20/05); Ltr. Rul. 200644012 (7/21/06) (describing proposed stock repurchase program by Distributing), supplementing Ltr. Rul. 200624001 (7/20/05). Other private rulings have blessed open market repurchases pursuant to repurchase programs that exclude institutional and more than 5% shareholders from block purchases and similar transactions. See, e.g., Ltr. Rul. 200741013 (6/22/07); Ltr. Rul. 200710011 (11/15/06), supplementing Ltr. Rul. 200645011 (8/10/06). See generally Elliott, "Practitioners Wary of Transportation Bill's Anti-Reverse Morris Trust Provision," 2012 TNT 44-3 (3/6/12) (quoting unofficial statement made by Steve Fattman, Special Counsel, Office of Associate Chief Counsel (Corporate), Internal Revenue Service: "At some point, the percentage of stock that is taken out of the market is going to attract scrutiny from us, but generally speaking, the fact that the issuer is out in the market buying back its own stock is just one fact out of many that you would look at in applying the device test.").

¹⁶³ See Rev. Proc. 2013-32, *supra* note 23 (discussed *infra*).

¹⁶⁴ Cf. Ltr. Rul. 200327049 (4/3/03) (unanticipated change in circumstances following spin-namely, cash flow and liquidity problems of certain Distributing shareholders-resulted in redemption of Class B Distributing shares held by those shareholders; Distributing was a public company and redemption occurred by way of a public tender offer), supplementing Ltr. Rul. 200125044 (3/22/01); Ltr. Rul. 200017035 (2/1/00) (Distributing intended to make stock repurchases through a combination of open market purchases and a public tender offer; Distributing represented that there was no plan or intention for such combined purchases to equal or exceed 20% of the total outstanding stock of Distributing or for Distributing to purchase shares pursuant to the public tender offer from any of Distributing's officers or directors), supplementing Ltr. Rul. 199943030 (8/2/99); Ltr. Rul. 199941027 (7/15/99) (Controlled intended to make stock repurchases through a combination of open market purchases and a public tender offer; Distributing and Controlled represented that there was no plan or intention for such combined purchases to equal or exceed 20% of the total outstanding stock of Controlled or for Controlled to purchase shares pursuant to the public tender offer from any of Controlled's officers or directors), supplementing Ltr. Rul. 199940003 (4/14/99).

¹⁶⁵ See Regs. 1.368-1(e)(2)(i) and (e)(2)(v), *Example 1*.

¹⁶⁶ In that regard, the same features of public company stock repurchase programs that are designed to neutralize device concerns should also ameliorate COI concerns-e.g., preventing block purchases from institutional investors or more than 5% shareholders. See *supra* note 162 and accompanying text.

¹⁶⁷ See Rev. Proc. 2013-3, *supra* note 22, at §3.01(43). In line with the current ruling position, unless the post-spin redemption would result in there being a direct or indirect acquisition by one or more persons of stock representing a 50% or greater interest in Distributing or Controlled, the Service is unlikely to entertain a letter ruling request on the impact of that post-spin redemption under Section 355(e). See Elliott, "Practitioners Hash Out Nuances of IRS Spinoff Ruling Positions," 2012 TNT 198-5 (10/12/12) (quoting unofficial statements made by Steve Fattman, Special Counsel, Office of Associate Chief Counsel (Corporate), Internal Revenue Service: "We have to draw a line somewhere. . . . In an effort to conserve resources, we are not ruling on section 355(e) unless the facts of a transaction present a colorable case that you would have a violation of the statute in the transaction.").

¹⁶⁸ The fact that the buyer in such market transactions is the corporation is normally unknown to the selling shareholder.

¹⁶⁹ If relatively small stock repurchases are made from numerous public shareholders, pursuant to programs that renew annually and permit aggregate repurchases of up to 20% of the total outstanding stock, such repurchases could account for the lion's share of an overall 50% or greater stock ownership shift.

¹⁷⁰ See, e.g., Ltr. Rul. 201250021 (9/6/12) ("For purposes of testing the effect of the Share Repurchases on Distribution 17 under §355(e), the Share Repurchases will be treated as being made from all holders of Controlled 11 common stock on a pro rata basis. The effect of the Share Repurchases will be taken

into account under §355(e) and this ruling only to the extent such Share Repurchases are otherwise treated, for purposes of §355(e), as part of a plan (or series of related transactions) with Distribution 17.”), supplementing Ltr. Rul. 201240017 (4/12/12); Ltr. Rul. 201047016 (8/19/10) (Controlled repurchase plan with respect to widely held stock to be adopted after the spin; no plan or intention to repurchase 20% or more of outstanding stock before fifth anniversary of spin); Ltr. Rul. 201037024 (6/8/10) (Distributing’s open market repurchases treated as made *pro rata* from public shareholders to the extent Distributing could demonstrate that repurchases not made from its controlling shareholder), supplementing Ltr. Rul. 200851014 (8/26/08).

¹⁷¹ See *supra* note 73 and accompanying text. The definition of “public offering” does not encompass a tender offer by Distributing or Controlled in respect of the stock of such company. See Reg. 1.355-7(h)(11) (“An acquisition involving a public offering means an acquisition of stock for cash where the terms of the acquisition are established by the acquired corporation (Distributing or Controlled) or the seller with the involvement of one or more investment bankers and the potential acquirers have no opportunity to negotiate the terms of the acquisition. For example, a public offering includes an underwritten offering of registered stock for cash.”); TD 9198, *Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition*, 70 Fed. Reg. 20279, 20280-20281 (4/19/05) (discussion of “public offerings”); see, e.g., Reg. 1.355-7(j), *Example 2*.

¹⁷² See Regs. 1.355-7(d)(1) through (3).

¹⁷³ The corporation recognizes no gain or loss on the receipt of cash or other property for the issuance of its own stock. Section 1032(a).

¹⁷⁴ See *supra* note 106 and accompanying text. How much below 50% might be acceptable remains an open question, though some comfort may be drawn from the 40% threshold blessed by the regulations with respect to the 368 COI Requirement. See *supra* notes 108-110 and accompanying text.

¹⁷⁵ See authorities cited *supra* note 165.

¹⁷⁶ Although the Super Safe Harbor does not cover stock acquisitions pursuant to a public offering, it can apply in conjunction with a private placement (as in Case 22). See TD 9198, *Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition*, 70 Fed. Reg. 20279, 20280-20281 (4/19/05) (“[W]hile an initial public offering and a secondary offering will be treated as public offerings, a private placement involving bilateral discussions and a stock issuance for assets or stock in a tax-free reorganization will not be treated as public offerings.”).

¹⁷⁷ Even if such negotiations had occurred and been terminated more than 12 months before the spin, Safe Harbor I could not apply because the Homeco stock issuance to U occurred less than six months after the spin and, further, because the spin was motivated wholly or substantially to facilitate “an acquisition” of Homeco stock by K. See Reg. 1.355-7(d)(1). Safe Harbor II could not apply because, even though the spin may not have been motivated to facilitate “the acquisition” by U, such acquisition occurred less than six months after the spin and involved more than 25% of the total outstanding stock of Homeco. See Reg. 1.355-7(d)(2)(i).

¹⁷⁸ Reg. 1.355-7(b)(2).

¹⁷⁹ See Reg. 1.355-7(b)(4)(ii). This non-plan factor might be relied upon, for example, if an unexpected opportunity for Homeco to acquire prime business expansion sites arose shortly after the spin and such acquisitions could be entirely or substantially funded through an equity investment by U.

¹⁸⁰ Reg. 1.355-7(h)(11); see also *supra* notes 171 and 176.

¹⁸¹ See Rev. Proc. 96-30, *supra* note 9, at App. A, §2.02.

¹⁸² See Reg. 1.355-7(b)(3)(ii). Conversely, the absence of pre-spin discussions with an investment banker is considered a “non-plan” factor. See Reg. 1.355-7(b)(4)(i).

¹⁸³ See Reg. 1.355-7(h)(13)(i). A “potential acquisition involving a public offering” includes a potential acquisition that (i) was discussed with an investment banker, (ii) motivated the spin or (iii) was the subject of an AUASN. See Reg. 1.355-7(h)(13)(iii).

¹⁸⁴ Reg. 1.355-7(h)(13)(ii).

¹⁸⁵ The Super Safe Harbor and the so-called “public trading” exception (Safe Harbor VII) are expressly inapplicable to public offerings. See Regs. 1.355-7(b)(2) and (d)(7)(i). While Safe Harbors I, II, or III can be available in certain public offering scenarios, their respective conditions are not met in Case 23 due to the acquisition purpose of the spin and the timing of the second public offering. See Reg. 1.355-7(d)(1) through (3).

¹⁸⁶ See Reg. 1.355-7(j), *Example 8*.

¹⁸⁷ See Reg. 1.355-7(j), *Examples 9 and 10*.

¹⁸⁸ These circumstances constituted “an identifiable, unexpected change in market or business conditions” occurring after the spin and, as such, could not have impacted either the timing or form of the spin itself. See Reg. 1.355-7(b)(4)(ii) and (vi).

¹⁸⁹ Included in the “Appendix A” list is the so-called “fit and focus” business purpose, often the main or sole driver of many public company spins but previously not considered acceptable for ruling purposes. See *supra* note 30.

¹⁹⁰ See Rev. Proc. 2003-48, *supra* note 11, at §2.

¹⁹¹ See Rev. Proc. 2013-3, *supra* note 22, at §3.01(41).

¹⁹² See *id.*

¹⁹³ Such opinions are normally based upon, and indeed require, the very same factual representations included in letter ruling requests. However, they also provide a full legal analysis based on relevant authorities (including, e.g., published rulings with respect to the business purpose requirement or other “no rule” areas).

¹⁹⁴ Rev. Proc. 2003-48 became effective with respect to Section 355 ruling requests (including supplemental Section 355 ruling requests) received by the IRS after 8/8/03. Since that time, the Service has issued approximately 50 supplemental Section 355 rulings. A significant number of those letter rulings addressed post-spin transactions or developments, while the others focused on changes in the Section 355 transaction itself or related pre-spin facts and/or transactions. With respect to the supplemental Section 355 rulings that addressed post-spin transactions or developments, several dealt with the consequences under Section 355(e) of stock repurchase programs and other transactions involving Distributing or Controlled stock. See, e.g., Ltr. Rul. 201250021 (9/6/12), supplementing Ltr. Rul. 201240017 (4/12/12); Ltr. Rul. 201249011 (9/6/12), supplementing Ltr. Rul. 201240017 (4/12/12); Ltr. Rul. 201037024 (6/8/10), supplementing Ltr. Rul. 200851014 (8/26/08). The other post-spin supplemental rulings have addressed a myriad of issues, including the impact of (i) establishing a post-spin business relationship between Distributing and Controlled, see Ltr. Rul. 200704018 (10/12/06) (third-party lenders required cross-guarantees by D and C of each other’s indebtedness), supplementing Ltr. Rul. 200603016 (10/14/05); (ii) eliminating a dual-class voting structure for Controlled, see Ltr. Rul. 200527004 (3/24/05),

supplementing Ltr. Rul. 200135039 (5/24/01); and (iii) a restructuring of certain Controlled subsidiaries, see Ltr. Rul. 200802016 (10/9/07), supplementing Ltr. Rul. 200624001 (7/20/05).

¹⁹⁵ See Rev. Proc. 2009-25, 2009-24 IRB 1088. This pilot program subsequently was incorporated into the annual letter ruling revenue procedure. See Rev. Proc. 2013-1, §6.03, 2013-1 IRB 1.

¹⁹⁶ The prior requirement that the issue not be “clearly and adequately addressed” by the Code, regulations, or other published authority has been dropped; and the “legally significant” and “major tax consequences” elements have been removed from the earlier “germaneness” requirement. But see Rev. Proc. 2013-3, *supra* note 22, at §4.0219 (modified by Rev. Proc. 2013-32 to provide that “clearly and adequately addressed” standard still relevant to IRS’s no “Comfort Ruling” policy).

¹⁹⁷ For example, suppose that, after a no-ruling spin, Controlled plans to make an asset disposition that might be viewed as violating the ATB Requirement. If the proposed transaction gives rise to a significant issue, it appears that a ruling could be sought solely on the ATB Requirement issue, with a representation that the spin otherwise qualified under Section 355. *Cf.* Ltr. Rul. 201333003 (4/29/13) (providing rulings under the “significant issue” pilot program as to Distributing and Controlled’s satisfaction of the ATB Requirement).

¹⁹⁸ *Cf.* Rev. Rul. 2003-55, *supra* note 26 (generally acknowledging that Section 355 qualification should be determined based on the known and reasonably anticipated facts and circumstances existing at the time of the spin).

¹⁹⁹ Thus, neither an initial nor supplemental ruling can be obtained with respect to business purpose, device, or the Section 355(e) “plan” requirement, see Rev. Proc. 2013-3, *supra* note 22, at §3.01(43), or any other current no-rule area, see *id.* at §§5.01(9), 5.01(10), and 5.02(2) (pending further study, the Service will not rule on the Section 355 implications of “North-South” transactions, recapitalizations into control, or certain stock-for-debt (or securities-for-debt) exchanges).

Prior to the issuance of Rev. Proc. 2013-3, the Service’s ruling policy with respect to a pre-spin recapitalization of Controlled, see generally Rev. Rul. 69-407, 1969-2 CB 50, and a post-spin elimination of the resulting dual-class voting structure generally had favored taxpayers. See, e.g., Ltr. Rul. 200527004 (3/24/05), supplementing Ltr. Rul. 200135039 (5/24/01); Ltr. Rul. 200403041 (10/8/03), supplementing Ltr. Rul. 199935031 (6/2/99); Ltr. Rul. 200347013 (8/19/03), supplementing Ltr. Rul. 200048030 (8/30/00). Moreover, the strictures placed on Controlled’s ability to unwind the dual-class voting structure following the spin had lessened over time. *Compare* Ltr. Rul. 200135039 (5/24/01) (“management of Controlled has no plan or intention to, and for a period of five years beginning on the date of the Distribution will not, propose or support any plan . . . or other action . . . [that would alter the dual-class voting structure]”), Ltr. Rul. 200219025 (2/8/02) (“no plan or intention by the managements of Distributing or Controlled to exchange, redeem, recapitalize, repurchase, or in any other way convert the shares of Controlled’s . . . [high-vote stock]”), Ltr. Rul. 200408009 (11/7/03) (“no plan, intention, or formal or informal understanding to change the capital structure of Controlled to eliminate the two-tiered voting structure”), *and* Ltr. Rul. 200505009 (10/21/04) (“no plan or intention for Controlled to realign its voting structure after the distribution”) *with* Ltr. Rul. 200837027 (3/14/08) (“Controlled presently expects that, following the consummation of . . . [the spin] and in connection with the consideration of resolutions to be submitted to the Controlled shareholders at the next regularly scheduled annual shareholders’ meeting of Controlled or at a special shareholders’ meeting of Controlled, the Controlled Board will consider a proposal to . . . [eliminate the dual-class voting structure], subject to the receipt of Controlled shareholder approval.”), Ltr. Rul. 201007050 (11/13/09) (following an internal spin of Controlled from D1 to D2, D2 “will convert” its high-vote Controlled shares), *and* Ltr. Rul. 201116001 (10/6/10) (“Following the Spin-Offs, it is possible that the board of Controlled may propose a shareholder vote to convert the Class A Stock, Class B Stock and Class C Stock into a single class of common stock, or propose to convert the Class B Stock into Class A Stock.”). Similar sentiments apply to the Service’s pre-Rev. Proc. 2013-3 stance in respect of stock-for-debt (and securities-for-debt) exchange transactions, see, e.g., Ltr. Rul. 201228033 (4/11/12); Ltr. Rul. 201232014 (2/16/12); Ltr. Rul. 201216023 (1/19/12); Ltr. Rul. 201138021 (3/25/11); and “North-South” transactions, see, e.g., Ltr. Rul. 201033007 (5/21/10); Ltr. Rul. 201030005

(4/28/10); Ltr. Rul. 201007050 (11/13/09); see also Elliott, "Alexander Explains Expanding "North-South" Ruling Position," 2012 TNT 35-7 (2/22/12).

²⁰⁰ Such opinions, of course, do not bind the IRS. Moreover, the tax sharing or other agreement entered by Distributing and Controlled in connection with the spin may require unattainable "will"-level opinions from both Distributing and Controlled counsel or may not offer the "opinion" option until after a specified period (e.g., three years) has elapsed.

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