

# Hot Stock Is Taxable

By Patrick Hoehne • Wood & Porter • San Francisco

Tax professionals like to imbue their language with a kind of verve and sophistication that is arguably unrealistic in light of the nitty gritty of reading regulations and other tax drudgery. Still, perhaps we all benefit from our own *lingua franca*, even if it sometimes seems overly exotic. First we had hot assets. Now we have hot stock.

In LTR 200649016 (Aug. 30, 2006), the IRS ruled that a parent corporation's spin-off of one of its businesses was tax-free, except for the distribution of certain hot stock previously acquired by the parent. Generally, hot stock is acquired in taxable transactions within five years of the spin, and is treated as boot. [Code Sec. 355(a)(3)(B).] Although the parent corporation and its shareholders must recognize gain related to the hot stock, the IRS ruled that the hot stock did not disqualify the company's tax-free spin-off.

In the ruling, Distributing ("D") is the common parent of an affiliated group of corporations that files a consolidated return. D owns stock in Controlled ("C") and other corporations (including Sub 1 and Sub 2). D has two classes of stock outstanding, Class A and Class B. The Class A stock tracks Business 1, and Class B stock tracks Business 2. Business 2 is conducted by C.

D purchased the C stock in two tranches. The first purchase of C's shares was minimal,

presumably not more than 20 percent (referred to as the "hot stock"). In the second purchase, D acquired control of C in a tax-free merger. Prior to the spin-off, D wholly owned C.

D proposed the following steps:

1. D would contribute Sub 1 and Sub 2 stock to C in exchange for additional shares of C stock.
2. D would distribute all of the C stock to the Class B shareholders in exchange for all of their Class B stock.
3. Each holder of an option to purchase shares of Class B stock would receive an option to purchase shares of C common stock.

## Spin Tax-Free, but Hot Stock Taxable

Based on numerous representations made by D (to meet the extensive Code Sec. 355 requirements) and the facts presented, the IRS ruled that the contribution of the Sub 1 and Sub 2 stock, followed by the distribution of all the C stock, qualified as a D reorganization. However, the IRS ruled that D must recognize gain on distributing the hot stock to the extent its fair market value exceeds its adjusted basis in D's hands. Moreover, the IRS ruled that D shareholders who receive hot stock have to recognize any gain they have in the distribution.

## T H E M & A T A X R E P O R T

The basis of the hot stock held by the Class B shareholders immediately after the distribution equals the fair market value of the hot stock.

Saying "hot stock" may be fun, but paying tax on it is not. Hot stock may not disqualify a spin-off, but corporations and shareholders should be prepared to pay tax on it.

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