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Spin-Offs Under Code Sec. 355

By Robert W. Wood • Wood LLP and Donald P. Board • Wood LLP

Our corporate tax system imposes two taxes, one at the corporate level and one on the company's shareholders. As a result, if a corporation distributes appreciated property to its shareholders, the corporation is taxed on the appreciation. The shareholders are taxed, too, on the full value of the property they receive.

Shareholders may be entitled to a reduced rate on certain dividends, but that is about the only break they receive. Of course, dividends are not deductible by the corporation, which is why people say there's a "double tax" on corporate earnings. One of the few exceptions to this unhappy symbiosis are distributions of stock to divide a corporation under Code Sec. 355.

Code Sec. 355 is a storied section of the tax code, usually described as the spin-off provision. And since 1986, when the Code was amended so that corporations have to pay tax when they liquidate, it has become even more important. It even features in big news stories, such as the seemingly endless saga of Yahoo and Alibaba.

Spin-offs involve corporate law, securities law and tax considerations. The tax impact of a spin-off gone awry can be catastrophic. For that reason, plus the fact that the tax treatment of many common spin-offs can be hard to assess, spin-offs have traditionally been one of the few transactions for which a ruling from the IRS seemed a virtual necessity.

Of course, many spin-offs have been done without a ruling. Some are done based on the strength of an opinion of counsel. The recent discussions about Yahoo's failure to get a ruling on its Alibaba spin-off might have been different had the size of the transaction not been so enormous. [*See* Wood, *Yahoo's Alibaba Spinoff Revisits Tax Opinion vs. Private Letter Ruling Dynamics*, The M&A Tax Report, Oct. 2015, at 4.]

Indeed, in some cases, the advisers may not worry about a ruling or even a tax opinion. The traditional "let's go our separate ways" transaction, a clean non-*pro rata* spin-off between warring factions, may seem to require neither. The same goes for spin-offs undertaken to comply with a government mandate, *e.g.*, an anti-trust decree requiring a corporation to divest itself of one of its lines of business.

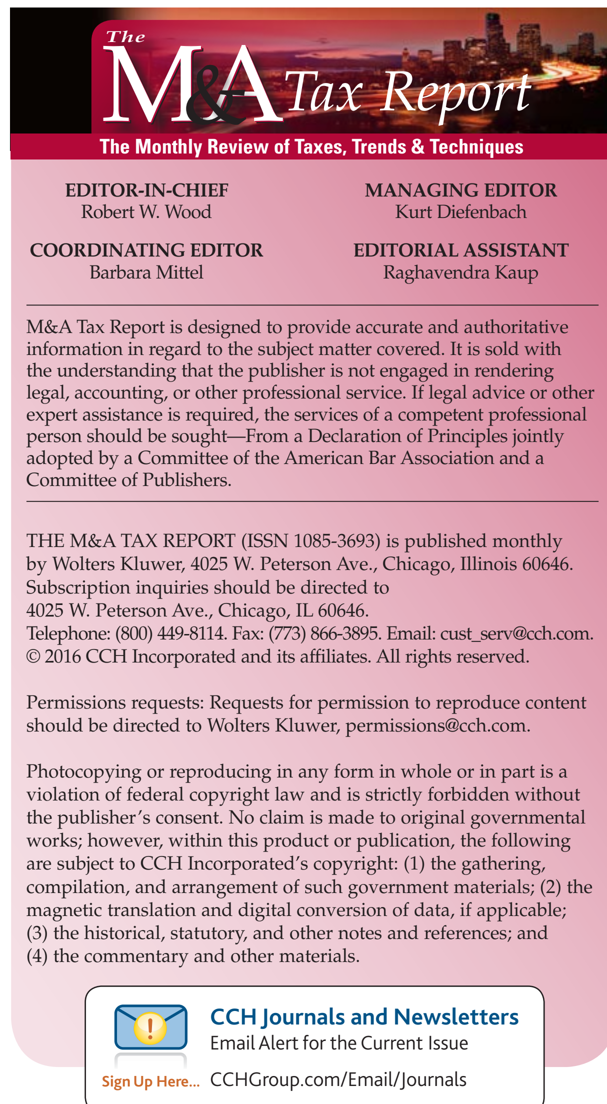
What's in a Name?

Spin-off nomenclature can be confusing. "Spin-off," "split-up" and "split-off" are all terms used to describe variations of the fact pattern.

Yet all are spin-offs, and all seek to qualify for the nonrecognition treatment Code Sec. 355 can afford. Code Sec. 355 transactions are often referred to generally as spin-offs, but can also be structured as split-ups or split-offs.

Spin-Off

A spin-off is the *pro rata* distribution of the stock of a corporation that is controlled by the distributing parent. In a spin-off, the distributing parent distributes the stock of the controlled company to the parent's shareholders, and the shareholders do not surrender any stock. Thus, after a spin-off, all of the prior shareholders of the distributing parent now own stock of both the distributing company and the controlled company. And, because the distribution is *pro rata*, they own the two corporations in same proportions as before.



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Split-Off

A split-off is the distribution of the stock of the controlled company to some, but not all, of the shareholders of the distributing parent. The distribution is in exchange for stock of the distributing parent.

In a split-off, the shareholders of the distributing company who receive stock of the controlled company surrender their stock in the distributing company. Thus, after a split-off, some of the old shareholders of the distributing company will continue to hold stock in it. However, the other shareholders will now hold stock of the controlled company instead of stock in the distributing parent.

Split-Up

A split-up is the distribution of the stock of two or more controlled corporations in complete liquidation of the distributing parent. After a split-up, some of the old shareholders of the distributing company hold stock in one controlled corporation. The other old shareholders hold stock in another controlled corporation. But the distributing parent is liquidated.

Divisive D

Finally, there is the divisive D reorganization, another type of Code Sec. 355 transaction. Here, a part of the assets of the distributing company that comprises a trade or business is transferred to the controlled company. This happens before the distribution of the controlled company's stock. The controlled company may even be newly formed. The stock of the controlled company is then distributed to the shareholders of the distributing company under Code Sec. 355.

Tax Goals

Code Sec. 355 allows the players to get an extraordinary package of benefits, which are discussed below.

No Shareholder-Level Gain

A distribution that qualifies under Code Sec. 355 means no tax at the shareholder level. Even if you get handed a share of stock in a new separate company, it is not taxable.

No Corporate-Level Gain

A distribution that qualifies under Code Sec. 355 will also not trigger any corporate-level tax.

There are exceptions to this if Code Sec. 355(d), (e) or (f) applies, and they are discussed below.

Boot Is Taxed

"Boot" is usually defined as assets other than the qualifying stock or securities distributed by the corporation. It might be cash or other property. But whatever it is, if it is distributed as part of a Code Sec. 355 transaction, the boot is subject to both corporate tax and shareholder tax.

Carryover Basis

The basis of the stock and securities in the controlled company that are received by shareholders of the distributing company is a carryover basis. That is, the basis that the distributing company's shareholders held in their stock carries over to the basis they take in the stock of the company they receive in the transaction. The recipient's aggregate basis in the stock and securities of the distributing company is allocated based on relative fair market values between the stock and securities retained in the distributing company and the stock and securities received in the controlled company.

Tax Attributes

In a Code Sec. 355 transaction that is also a divisive D reorganization, the tax attributes of the distributing company will remain with the distributing company, except for its earnings and profits. The E & P must be allocated between the distributing company and the controlled company in proportion to the value of the retained and transferred assets. In some cases, though, E & P allocations can become complex.

In a spin-off or split-off, the E & P of the distributing company is decreased by the lesser of: (i) the amount of the adjustment that would have been made to the E & P of the distributing company if it had transferred the stock of the controlled company to a new subsidiary in a divisive D reorganization; or (ii) the net worth of the controlled company. The remaining tax attributes of the distributing company and the tax attributes of the controlled company are generally unaffected.

However, Code Sec. 382 may limit the carryover of either company's losses after a split-off. If the Code Sec. 355 transaction is a split-up, the tax attributes of distributing company (which liquidates) will disappear. The tax attributes of the controlled company should not be affected.

What a Spin-off Does *Not* Do

A spin-off is a great way to divide a corporation and get stock of the spun-off corporation into the hands of shareholders without triggering either corporate-level or shareholder-level tax. Notice, however, that even after a successful spin-off, none of the real-world assets of the distributing company has actually "left corporate solution" without being subjected to the double tax.

Suppose that a corporation owns a gold mine and a silver mine. The corporation can't literally spin off the silver mine to its shareholders without triggering tax at both the corporate and shareholder levels. Under Code Sec. 355, it has to spin off shares of a corporation (whether existing or newly formed). The spun-off corporation can own the silver mine, effectively splitting the original corporation in two. But, despite the successful division, shareholders who receive shares of the silver-mine corporation are no closer to getting their hands on the mine than they were before. If they want to own the mine *directly, i.e.,* at the shareholder level, the silver-mine corporation will have to distribute the mine to them in a transaction that is *not* covered by Code Sec. 355. That means the distribution of the mine will be taxable, as usual, to both the silver-mine corporation and its shareholders.

Overview of Requirements

To do a spin-off, here are the basic requirements:

- Immediately before the distribution, the distributing corporation must control the corporation being distributed. This is tested under a typical reorganization 80-percent control standard. The subsidiary may be newly created right before the distribution or may be one of long standing.
- There must be two separate active businesses, one retained by the distributing corporation and one that will be continued by the spun-off corporation. Classically, this is done with two distinct and quite separate businesses. But there have been many successful divisions of what seems really to be one business, such as a separation

of Northern California from Southern California operations. Moreover, it may be possible to separate a business along functional lines, such as separating sales from manufacturing.

- The two businesses each must satisfy a five-year active trade or business requirement (that is, the businesses must have been operated for five years prior to distribution).
- Immediately after the distribution, each entity must be engaged in the active conduct of a trade or business.
- There must be a business purpose for the transaction. This requirement is narrowly interpreted by the IRS and is one reason a non-*pro rata* transaction is much easier, since by its very nature, it suggests shareholders want to go their separate ways with their respective businesses.
- The transaction must not be used primarily as a "device" to distribute E & P. As in so many other parts of Subchapter C, the device concept is amorphous. The fear that the IRS may decide, after the fact, that a transaction was a proscribed device to distribute E & P is the primary reason companies traditionally ask for the IRS for advance rulings on spin-offs.
- The shareholders of the distributing corporation must retain a continuing proprietary interest in each of the two corporations after the spin-off. Put bluntly, the spin-off cannot be immediately followed by a sale of the stock of either of the two corporations.
- Controls should be in place to ensure there is no acquisition of either the distributing or the controlled corporation for two years after the spin-off, even on a tax-free basis. Any acquisition within two years before or after the spin-off is presumed part of a bad plan, although this presumption can be rebutted.

Non-*Pro Rata* Transactions

If businesses are divided in a non-*pro rata* fashion, is there a possibility for abuse? Very little, it would seem. Suppose two sides of a family run a family company. One side wants the manufacturing business, while the other side wants the construction business.

Alternatively, one side wants the Northern California real estate sales business. The other side wants the Southern California real estate sales business. Dropping one business into a subsidiary and distributing the stock of the subsidiary to one shareholder group in exchange for their parent stock can be simple.

And assuming one can navigate the list of Code Sec. 355 requirements, it can be relatively foolproof. In this post-*General Utilities* Repeal generation, the *pro rata* spin-off seems somehow suspect. After all, in a *pro rata* spin-off, a shareholder who was previously holding a share of one company may end up holding two separate shares of constituent companies.

Done correctly, there is no corporate tax and no individual shareholder tax. Yet obviously, with a *pro rata* spin-off, a person who had shares in one company pre-transaction ends up with shares in two different companies post transaction. That means the shareholder is in a far more flexible position.

Of course, the two companies are also better positioned for the future as well. The contrast to a non-*pro rata* transaction could not be sharper. A non-*pro rata* transaction seems so sensible on the surface. Whether or not the shareholders are feuding, the division is complete.

Ruling Policy

Sensibly, the IRS seems to like such transactions. Thus, in LTR 201113003 [Nov. 1, 2010], the IRS considered the division of a corporation's business among its feuding shareholders. Interestingly, the IRS seemed to have no problem with the need for the transaction or its mechanics.

But in accordance with its then ruling policy, the IRS expressed no opinion on a number of issues. These included whether the distributions satisfied Reg. §1.355-2(b)'s business-purpose requirement. Arguably, of course, the whole point of the distributions was to separate the feuding shareholders, which is normally a fine business purpose.

The IRS also did not consider or rule on whether the transaction was being used principally as a device for distributing the earnings and profits of the distributing or controlled corporations. The facts involved an active business with two activities in two distinct locations.

Shareholder 1 and Shareholder 1's children beneficially owned an undisclosed

percentage of both the total value and total number of shares of the distributing corporation's outstanding stock. Shareholder 2 and Shareholder 2's lineal descendants owned LLC 1 and beneficially owned an undisclosed percentage of both the total value and total number of shares of the distributing corporation's outstanding stock.

Due to continuing disagreements among the shareholders and their descendants, the distributing corporation dropped one set of business activities into subsidiaries, and then distributed shares to one shareholder group in exchange for that group's stock in the distributing corporation. When the smoke cleared, the result was corporate separation and perhaps even family harmony.

Business Purpose

Much has been written about business purpose, something that can also raise the specter of economic substance. In some ways, one of the most difficult criteria to satisfy under Code Sec. 355 has been business purpose. At least a few business purposes have been invoked creatively to justify something that may have been planned for other purposes.

For a business purpose, shareholder hostility is about as good as it gets. Indeed, even without the soap opera of family hostility, there is simply nothing to suggest that a non-*pro rata* transaction involving one group of shareholders going one way and another group going another is *not* a good business purpose.

However, in LTR 201113003, the IRS cautioned that it was expressing no opinion on other aspects of the transaction. Most advisers would probably not worry about the business-purpose element on these facts. That is probably true with the device issue too, something inherently tied in with the business-purpose inquiry.

Statutory Requirements

The statutory requirements in Code Sec. 355 are usually broken into four tests. There must be the requisite control. The transaction must not be a prohibited device to distribute E & P. The distribution must involve an active trade or business. Finally, the distribution must qualify as a complete distribution.

Control

In order for Code Sec. 355 to apply to the distribution of a corporation's stock, the distributing company must be in control of the controlled company immediately before the distribution. If a spin-off involves a divisive D reorganization, it is also necessary that either the distributing company or its shareholders control the controlled company immediately after the transfer.

Control means stock possessing 80 percent of the total combined voting power of all classes of stock entitled to vote, plus at least 80 percent of the total number of shares of each of the other classes of stock. The key factor in determining voting control is generally the ability to elect directors. In certain circumstances, however, the IRS or a court may look beyond the power to elect directors if there are unusual voting rights allocated to different classes of shares.

To be sure, there are sometimes timing issues impacting the control requirement. In some cases, it can be important when and how the control is required. Sometimes, the step-transaction doctrine can even be invoked. And that leads logically to our next requirement, the device rule.

Device

In order for Code Sec. 355 to apply to the distribution of the controlled corporation's stock, the distribution cannot be principally a device for the distribution of earnings and profits of the distributing and/or the controlled corporations. Many a tax adviser has worried over this one, and the higher the E & P, the more likely this bailout specter can seem to loom.

Classically, the device test is a matter of looking at all of the facts and circumstances surrounding the transaction. That, without more, is not very helpful. But a list of indices of a device is considerably more helpful.

Two of the classic factors that are considered to evidence a device are a sale of shares shortly after the distribution and the fact that the distribution is *pro rata*. Warring shareholders of two corporate factions obviously must not be using their non-*pro rata* spilt to bail out E & P! Another possibility is a sale of shares shortly after the distribution.

Of course, that can tie into business purpose too. Even the type and volume of assets involved can be scrutinized. Business assets

that are used and useful in the requisite trade or business tend to be above reproach. But a pile of valuable investment assets not used or useful in any business may raise eyebrows.

There is a symbiosis between the device and business-purpose tests. A good business purpose can constitute evidence that the transaction is not a device. The stronger the business purposes, the less device risk. And the more factors suggesting a device, the more the business purpose is likely to be scrutinized.

Widely held stock is certainly a good fact. With a public company that is trying to divide in two, the fact that no one owns more than 5 percent of any class of stock is evidence the transaction is not a device. The recipients can matter too in this probe for what is a device.

For example, if stock in a controlled company is to be distributed to a domestic corporation that would normally (outside the context of Code Sec. 355) be entitled to an 80- or 100-percent dividends-received-deduction, that suggests there is no device. A lack of E & P is another good factor because you cannot be guilty of using a device to distribute something you do not have!

Active Trade or Business

Both the distributing and the controlled corporations must pass muster on the active trade or business requirement. A passive investment will not do the trick. And timing matters too, with the active business test applied immediately after the distribution.

The active business test is sometimes divided into time periods. It is not only a current test. The business must have been actively conducted throughout the five-year period ending on the date of the distribution. Moreover, the trade or business must not have been acquired during the prior five years.

What is active? As one might suspect, most of the discussion is about the contrast between the management of assets and an actual active business. Not surprisingly, one of the main areas of concern is real estate. One clearly can be in an active real estate business, but one cannot merely receive rent and contract out the management and qualify.

The regulations are helpful on this topic. The regulations say that the activities must include all steps in the process of earning income. Ordinarily, that means collecting income and paying expenses. The corporation itself must perform active and substantial management and operational functions. Independent contractors are generally not enough.

Concerning the five-year history, that too must be active. Product lines can be changed or even dropped, as long as the changes are not of such a character as to constitute the acquisition of a new or different business. The expansion of an existing business is generally viewed as a continuation, not as a new business.

Distribution

In general, in order for Code Sec. 355 to apply, the distribution must be complete. That is, the distributing company must generally distribute all of the stock and securities it holds in the controlled corporation immediately before the distribution. The recipient shareholders may or may not have to exchange something for it.

Judicial Requirements

In addition to the statutory requirements listed in Code Sec. 355, there are nonstatutory requirements as well. These requirements include business purpose, continuity of interest and continuity of business enterprise.

Business Purpose

Having a good business purpose is a plus in virtually any transaction, but it is an essential for a spin-off. The regulations expressly state that the transaction must be carried out for one or more corporate business purposes in order to qualify under Code Sec. 355. In the past, the IRS would grant rulings on valid business purposes, but today no longer grants private letter rulings confirming that specific business purposes are sufficient for purposes of Code Sec. 355.

Some of the classic business purposes that seem evergreen include:

- separating one business from the risks and vicissitudes of another;
- fit and focus;
- facilitating an acquisition by separating wanted and unwanted assets;
- raising capital;
- cost savings; and
- compensating employees with stock tied to specific businesses.

Note, however, that the IRS will also ask whether there was a tax-free way to achieve these purposes without actually distributing stock in a spin-off. For example, the IRS would say that a chemical company that is worried about liability exposure from its nitroglycerin division can protect itself by simply dropping the risky division (very carefully, one hopes) into a subsidiary in a tax-free transaction under Code Sec. 351. There is no need for the chemical company to actually distribute the subsidiary's stock to its shareholders. A spin-off would therefore lack a valid business purpose.

Continuity of Interest

Continuity of interest requires that one or more persons who were the owners of the company before the distribution must continue to own an interest after the transaction. Continuity is satisfied if the shareholders of the distributing company maintain some minimum level of continuity in both companies after the distribution. Exactly how much continuity is needed is not always clear. However, 50-percent continuity is enough, while 20 percent is not.

Once the requisite continuity is present post transaction, a related question is how long it must last. After all, the shareholder should be able at some point to dispose of shares in the distributing or controlled companies (or both) without a risk to the transaction. How long one must wait is subjective, although a five-year holding period is often mentioned as a good idea.

Yet a number of cases can be cited for the proposition that one need not wait that long. In this context, the related-step transaction doctrine can be expected to surface too. A binding contract to make the disposition put in place before the Code Sec. 355 transaction will look bad. If a disposition is being scrutinized, one might look to how close in proximity the disposition occurs to the distribution. It will also be relevant whether the disposition occurs by sale or by reorganization.

Morris Trust and More

Reviewing this long list of rules, one might be forgiven for thinking that the road to a tax-qualified spin-off is littered with high hurdles. And yet there are still additional ones designed as specific limitations to prevent some transactions from qualifying that otherwise might. Code Sec. 355(d), for example, lists limitations to deny the section's benefits for certain distributions of companies and business that would otherwise be tax-free to the distributing corporation.

Code Sec. 355(d)

Code Sec. 355(d) requires the distributing company to recognize gain on a disqualified distribution of subsidiary stock or securities. A disqualified distribution means any distribution to which Code Sec. 355 applies if, immediately after the distribution, a shareholder holds stock that represents a 50-percent or greater interest in either the distributing company or a controlled subsidiary that is attributable to stock or securities acquired by purchase during the five-year period ending on the distribution date.

This can be a more serious rule than might at first be apparent. If a disqualified distribution is made, then all gain in respect of the distributed shares is taxed, not just the portion relating to disqualified stock. There are, however, some exceptions that can apply to exempt certain transactions from disqualified treatment.

The next two subsections, Code Sec. 355(e) and Code Sec. 355(f), specifically target the so-called Morris Trust transaction. Such transactions take their name from a famous tax case. For decades, it was considered perfectly fine for a target company to spin off its unwanted assets to its shareholders as a prelude to an acquisition. Then, in 1997, Congress enacted Code Sec. 355(e).

Code Sec. 355(e)

Code Sec. 355(e) may be thought of as a bad intent provision. Under it, if there is a Code Sec. 355 distribution that is part of a plan pursuant to which one or more persons acquire stock representing at least a 50-percent interest in the distributing company or in any controlled corporation, the distributing company must recognize gain.

That is, the distributing company recognizes gain in the amount that it would have recognized had it sold the controlled company stock for its fair market value on the date of the distribution. Any gain recognized is treated as long-term capital gain, although this does not entitle the corporation to a reduced tax rate.

Notably, however, there is no gain recognition at the shareholder level.

There is a rebuttable presumption that any acquisition occurring two years before or after a Code Sec. 355 distribution is part of a plan including such distribution. The IRS has issued several sets of regulations providing guidance on what constitutes a plan or series of related transactions. The IRS also covers how to rebut this presumption.

Just what constitutes a plan (or series of related transactions) for purposes of this rule? The regulations say that a post-distribution acquisition can be part of a plan only if there was an agreement, understanding, arrangement or substantial negotiations regarding the acquisition or a similar acquisition at some time during the two-year period ending on the date of the distribution. In the absence of such an agreement, understanding, arrangement or negotiations, there should be no need to fret over the overall facts and circumstances.

Code Sec. 355(f)

Under Code Sec. 355(f), intragroup spin-offs are generally not taxed. However, Code Sec. 355(f) provides that the tax-free benefits of Code Sec. 355 will not apply to distributions of stock from one member of an affiliated group to another member if the distribution is part of a Morris Trust transaction covered by Code Sec. 355(e). In effect, Code Sec. 355 will simply not apply to the intragroup spin-off. That means both the distributing company and the shareholder will face tax consequences.

Conclusion

If this summary has not made it obvious, Code Sec. 355 is a complex provision filled with traps. A number of its nuances are omitted here, and there are many contexts in which these nuances matter a great deal. Yet there can be no doubt that this corner of the tax law is rewarding.

With our two-tier system of taxing corporations and their shareholders, a transaction in which neither is taxed remains a notable exception. True, the requirements and details can be burdensome. But the upside of dividing a corporation without triggering the double tax can be remarkable. Until Congress changes it again, try to enjoy it.

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