

Spin-off Regulations Proposed: Part II

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Part I of this article [13 M&A TAX REPORT 5, at 8] covered basic rules of the new proposed Code Sec. 355(e) regulations [REG-145535-02]. Apart from this simple basis rule, a predecessor will also include a corporation that, before the distribution, transfers property to the distributing corporation in a Code Sec. 381 transaction if some (but not all) of the property transferred to the distributing corporation includes controlled corporation stock, and if after the combining transaction, the distributing corporation transfers less than all of the property acquired (other than the controlled corporation stock) to the controlled corporation.

Interestingly, the proposed regulations recognize that the definition of a predecessor of a distributing corporation can actually result in a corporation being treated as a predecessor of the distributing corporation even if the distribution and the combination of the predecessor and the distributing entities are *not* part of a plan. Once the predecessor is identified, of course, one must determine whether the distribution and any acquisitions (and this would include deemed acquisitions as well as actual ones) of the stock of the predecessor might be part of a plan.

Predecessors of Controlled

The definition of a predecessor of a controlled corporation is convoluted. Looking at the objectives of the definition might be helpful. The proposed regulations' definition of a predecessor of the controlled corporation is meant to ensure that a corporation is treated as a predecessor of the *distributing* corporation in the following case, plus similar ones:

Example. Distributing acquires all of the assets of X (including all of the outstanding stock of a subsidiary of X, X1), in a transaction to which Code Sec. 381 applies. After the acquisition, Distributing causes X1 to merge into Controlled (a wholly owned subsidiary of Distributing) in a reorganization under Code Sec. 368(a)(1)(B). Distributing then distributes the stock of Controlled to its shareholders, *pro rata*, in a Code Sec. 355 transaction. Here, there is a separation of the X assets in a distribution to which Code Sec. 355(a) applies. Accordingly, X1 will be

treated as a predecessor of Controlled. Plus, because Distributing acquires (in a transaction to which Code Sec. 381 applies) stock of a predecessor of Controlled from X, X will be treated as a predecessor of Distributing.

Interestingly, the proposed regulations recognize that the considerations applying to the identification of predecessors of a *controlled* entity versus the predecessors of a *distributing* one are different. Generally speaking, property transferred to a controlled corporation cannot be divided tax-free between Distributing and Controlled in the same way that property transferred to Distributing can be divided tax-free. Nonetheless, there are certain reasons why a definition of a predecessor of the controlled corporation is needed.

Solely for purposes of determining whether a corporation is a predecessor of the distributing corporation, calculating certain limitations on gain recognition and applying an affiliated group rule, these proposed regulations define a "predecessor of the controlled corporation" as a corporation that (before the distribution) transfers property to the controlled corporation in a transaction to which Code Sec. 381 applies. For no other purpose can a corporation be a predecessor of Controlled.

Thus, acquisitions of stock that are part of a plan that includes a distribution and that in the aggregate represent a 50 percent or greater interest in a predecessor of Controlled will not cause Distributing to recognize gain. Interestingly, though, the preamble to the proposed regulations indicates that the IRS and the Treasury are continuing to study whether there may be other situations in which a corporation should be treated as a predecessor of the controlled corporation.

The definition of a predecessor of the controlled corporation ensures that a corporation will be treated as a predecessor of the distributing corporation in the following situation:

Example. Distributing acquires all of the assets of Target (which includes the outstanding stock of Affiliate) in a transaction to which Code Sec. 381 applies. Afterwards, Distributing causes Affiliate to merge into Controlled, a wholly owned subsidiary of Distributing, in a D reorganization. Distributing then distributes

the stock of Controlled to its shareholders *pro rata* in a Code Sec. 355 distribution. Here, there is a separation of the Target assets in a distribution to which Code Sec. 355 applies. Under the definition of a predecessor of Controlled, Affiliate will be treated as a predecessor of Controlled. Plus, because Distributing acquires the stock of a predecessor of Controlled in the transaction from Target, Target will be treated as a predecessor of Distributing.

Multiple Predecessors

These rules get complicated enough that more than one corporation can be treated as a predecessor of Distributing or Controlled. For example, suppose that one corporation transfers property to the distributing entity in a Code Sec. 381 transaction. Each of the transferring corporations may be a predecessor of Distributing. However, a corporation that transfers its assets in a Code Sec. 381 transaction to a predecessor of Distributing will not *also* be treated as a predecessor of Distributing.

Successors

The proposed regulations also contain successorship definitions. The definition of a successor is intended to identify corporations that are properly viewed as a continuation of either Distributing or Controlled for purposes of Code Sec. 355(e). The proposed regulations therefore define a successor of the distributing corporation as any corporation to which Distributing transfers property after the distribution in a Code Sec. 381 transaction.

Likewise, a successor of controlled is any corporation to which Controlled transfers property after the distribution in a transaction to which Code Sec. 381 applies. More than one corporation can be a successor of Distributing or Controlled.

Example. After a distribution, Distributing transfers property to X Corporation in a Code Sec. 381 transaction. X transfers property to Y in another Code Sec. 381 transaction. Here, both X and Y may be successors of Distributing. Whether Y is a successor of Distributing will be determined after the determining whether X is a successor of Distributing.

Special Rules for Measuring Acquisitions

One of the overarching rules here is what constitutes a “plan” under Code Sec. 355(e). Whether there have been acquisitions of stock that are part of a plan that includes a distribution that in the aggregate represents a 50 percent or greater interest in a predecessor of Distributing is counted separately from whether there have been acquisitions of stock that are part of a plan that includes a distribution that in the aggregate represent a 50 percent or greater interest in Distributing.

Whew! So, Distributing and its predecessors are separately considered. Thus, Distributing may have a Code Sec. 355(e) gain with respect to a predecessor of Distributing, but not Distributing, or *vice versa*.

This separate consideration means we need to examine acquisitions, since Distributing may be combined with one or more predecessors. Special rules determine whether there has been an acquisition of a predecessor in connection with (and after) the combined transaction.

Example. D acquires the assets of a predecessor in a statutory merger. A (an individual) owns stock in D immediately before this merger. A would be treated as acquiring stock of the predecessor.

An acquisition of Distributing (or a successor of Distributing) that occurs after the combination of Distributing with a predecessor will count not only as an acquisition of Distributing, but also as an acquisition of the predecessor. The stock of Distributing (or a successor of Distributing) is treated as the stock of all predecessors of Distributing.

Special Gain Recognition Rules

If the distribution and acquisition that in the aggregate represent a 50 percent or greater interest in a predecessor of Distributing (or Distributing) are part of a plan, Code Sec. 355(e) requires Distributing to recognize the full amount of gain inherent in the controlled stock on the date of the distribution. However, suppose a distribution and acquisition of stock in the aggregate represents a 50 percent or greater interest in a predecessor of Distributing, and this distribution and acquisition are part of a plan, but there are *not* acquisitions of stock in the aggregate representing a 50 percent

or greater interest in Distributing that are part of that plan. Also suppose that the plan inherent in the assets of the predecessor of Distributing that are contributed to Controlled is small relative to the gain inherent in the controlled stock on the date of the distribution.

Here, is it appropriate to require that Distributing recognize the full amount of the gain inherent in the controlled stock? The proposed regulations suggest that it may not be, so there are some rules limiting the amount of gain that Distributing must recognize in such a case.

These rules are enormously complex. One of these rules provides that if a distribution and acquisition of stock that in the aggregate represents a 50 percent or greater interest in a predecessor of Distributing are part of a plan, then the amount of gain that Distributing recognizes by reason of such acquisition will not exceed the amount of the gain (if any) the predecessor of Distributing would have recognized if, immediately before the distribution, the predecessor had transferred

the property that was transferred to Controlled, and the stock of Controlled that it transferred to Distributing, to a newly formed, wholly owned corporation solely for stock of the corporation in a Code Sec. 351 transaction, and then sold the stock of that corporation to an unrelated person in exchange for cash at fair market value.

If your eyes are glazing over, that's no surprise. There are several other special rules on gain recognition in these proposed regulations. I find these some of the most difficult portions of the proposed regulations. There is even a backstop designed to ensure that the limitations do not prevent the recognition of gain in the full amount described in Code Sec. 355(c)(2) or 361 (c)(2).

Conclusion

Code Sec. 355(e) has never been anyone's favorite part of the divisive reorganization provision. I'm afraid the proposed regulations will not change that image. These rules are complicated, both in concept and particularly in execution.