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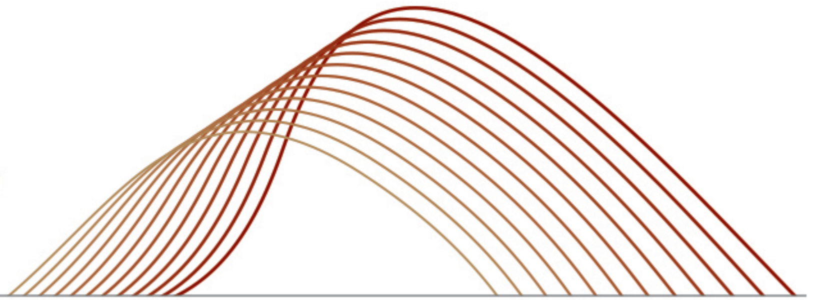

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Section 355 Spin-Off Developments: Clarification of "Predecessors" and "Successors"

By Douglas Schaaf & Erika Mayshar

Despite the numerous and complex requirements associated with a valid Section 355[1] spin-off a qualifying distribution under Section 355 is one of the most valuable tools available to a corporate tax practitioner. Since 1986, it remains as one the few transactions that can successfully sidestep the reach of the repeal of the *General Utilities* doctrine.

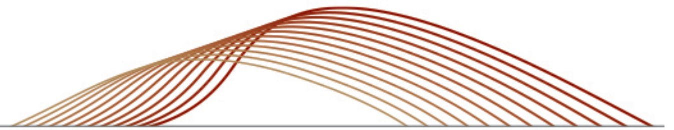
A successful Section 355 spin-off allows a corporation ("Distributing") to distribute to its shareholders the stock of a subsidiary ("Controlled") in a completely tax-free manner, without recognizing any built-in gain at the corporate level and without triggering any dividend income to the shareholders.

A substantial limitation on tax-free Section 355 spin-offs was imposed in 1997 in the form of Section 355(e). This provision was implemented in response to several high-profile transactions that involved spin-offs followed by an acquisition of either Distributing or Controlled.[2] Section 355(e) has come to be known as the "anti-*Morris Trust* provision".[3]

A transaction failing to pass muster under Section 355(e) may still qualify as a tax-free spin-off with respect to the recipient shareholders, but Distributing is required to recognize any inherent gain in the stock of Controlled distributed in the transaction. Generally, Section 355(e) taxes Distributing on the inherent gain if the transaction is part of a "plan" pursuant to which one or more persons acquire (directly or indirectly) stock representing a 50-percent or greater interest in Distributing or Controlled (measured by vote or value).

The "Plan" Regulations

After several versions of regulations attempting to define the "plan" aspect of Section 355(e), the tax community can now rely on nine different safe harbor provisions to provide substantive comfort on the ability of a particular distribution transaction and related acquisition to avoid the clutches of Section 355(e). Most importantly, the first safe harbor provides that a Section 355 distribution will not be disqualified from favorable tax treatment due to a subsequent acquisition of Distributing or Controlled if (i) the distribution was motivated by a qualifying corporate business purpose (other than a purpose to facilitate an acquisition of Distributing or Controlled), and (ii) the acquisition occurred more than six months after the Section 355 distribution and there were no substantial negotiations concerning the acquisition during the period that begins one year before the distribution and ends six months thereafter.[4]



355(e) Applied to Predecessor Corporations

In order to fully implement the Congressional intent associated with the Section 355(e) restrictions, Section 355(d)(4) provides that the same restrictions imposed by Section 355(e) on Distributing and Controlled will apply to a predecessor of Distributing ("POD") or a predecessor of Controlled ("POC").

Proposed regulations defining a POD and POC were issued in 2004.[5] Recent temporary and proposed regulations were issued on December 19, 2016, and reflect a further refinement of the thinking of the Treasury Department with respect to the POD and POC definitions.[6] The newly-issued regulations will generally apply to distributions occurring after January 18, 2017.

On a conceptual level, the temporary regulations state that the POD rules have two primary purposes:

- First, Section 355(e) will apply if, as part of a plan, (i) some of the assets of a POD are transferred to Controlled without full recognition of gain and (ii) the later distribution accomplishes a division of the assets of the predecessor. It should be noted that this statement is a substantial expansion of the POD rules under the earlier proposed regulations, as those rules required that the first transfer at issue be a transfer defined in Section 381.

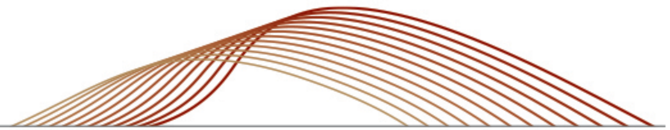
- Second, Section 355(e) will apply if the transaction is a 50-percent acquisition of a Successor of Distributing or a Successor of Controlled that is part of an overall plan.

The following example illustrates the primary concern associated with the identification of a POD:

> Example: X owns 100% of the stock of P, which holds multiple assets. Y owns 100% of the stock of Distributing. The following steps then occur: P merges into Distributing in an A reorganization. Immediately thereafter, X and Y own 10% and 90%, respectively, of the stock of Distributing. Distributing then contributes to Controlled one of the assets ("Asset 1") acquired from P in the merger. Asset 1 has a basis of $40 and a fair market value of $110. Upon the contribution of Asset 1 to Controlled, Distributing receives additional Controlled stock and $10 of cash. Distributing then distributes the stock of Controlled (but not the cash) to X and Y, pro rata. At this point, Distributing has an adjusted basis in the stock of Controlled of $100 and the fair market value of the Controlled stock is $200.[7]

The contribution of Asset 1 to Controlled and distribution of the stock of Controlled to X and Y are part of a divisive D reorganization. Distributing recognizes $10 of gain under Section 361(b) on the contribution. Immediately before the distribution, taking into account the $10 of gain recognized, Controlled has an adjusted basis of $50 in Asset 1 and Asset 1 has a fair market value of $110.

If P had distributed Asset 1 to X prior to the merger and then pursuant to a plan was merged into Distributing, the distribution would be subject to Section 355(e) and P would be required to recognize the $70 of built-in gain in Asset 1. The new regulations result in the same outcome where P has transferred Asset 1 to Distributing in a tax-free transaction. In the example above, P is a predecessor of Distributing. This is because immediately before the distribution Controlled holds property received from P on which gain was not fully recognized as part of the overall plan. Most importantly, Distributing continues to hold some of the property acquired in the A reorganization from P ***and*** some of the property acquired in the A reorganization comes to rest in Controlled. It is this movement of property in a non-recognition transaction as part of the overall Section 355 transaction that offends the fundamental policy concerns of the Treasury Department.



Gain Limitation

In the example, if one were to conclude that Section 355(e) should be applied with full impact, Distributing would recognize gain of $100 (because the fair market value of Controlled stock is $200 and the tax basis of the Controlled stock in Distributing's hands is $100). In this case, however, the goal of the POD rule is to compute the amount of the gain that Distributing would recognize solely with respect to the offending Asset 1 acquired from P. The inherent gain in Asset 1 was $70 (fair market value of $110, less the tax basis of $40). Of the total gain of $70, $10 was recognized as part of the contribution transaction. This leaves a remaining unrecognized gain of $60 with respect to Asset 1. It is this reduced amount of gain that Distributing will recognize to appropriately account for the inclusion of the asset from a POD under the modified Section 355(e) rules.

Predecessor of Controlled

Like the proposed regulations, the temporary regulations define a POC as a corporation that transferred assets in a transaction described in Section 381. This categorization is of very limited relevance as it only applies to determine whether the transferor of assets continues to survive for purposes of applying the consolidated return rules.[8]

355(e) Applied to Successor Corporations

A successor of Distributing or of Controlled will exist if there are transfers of property by Distributing or Controlled to a corporation in a transaction governed by Section 381. In each Section 381 transaction, stock will be deemed to have been issued to the relevant transferor, whether or not actually issued. If a successor of Distributing or Controlled is acquired subsequent to a Section 355 transaction in a manner that satisfies the "plan" requirement of Section 355(e), the transaction will come within the restrictions of Section 355(e) and gain will be recognized by Distributing.[9]

Summary

The primary concern of the proposed regulations relates to identification of a POD. It is this category of transactions that will cause most of the practical problems associated with identifying successors and predecessors in connection with Section 355(e). The temporary regulations provide much needed guidance in this complex area of transactional tax law.

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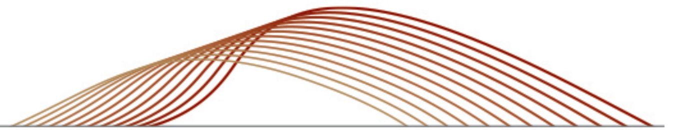

[1] This and all further section references are to the Internal Revenue Code of 1986, as amended.

[2] *See, e.g.*, the sale by Viacom of Tele-Communications, Inc. in 1995.

[3] *See*, Comm'r v. Mary Archer W. Morris Trust, 367 F.2d 794 (4th Cir. 1966).

[4] Treas. Reg. § 1.355-7(d)(1) (2005).

[5] Prop. Treas. Reg. § 1.355-8, 69 Fed. Reg. 67,873 (Nov. 22, 2004).

[6] Temp. Treas. Reg. § 1.355-8T (2016).

[7] Temp. Treas. Reg. § 1.355-8T(h), Ex. (1) (2016).

[8] *See* Temp. Treas. Reg. § 1.355-8T(f) (2016).

[9] *See* Temp. Treas. Reg. § 1.355-8T(h), Ex. (10) (2016).