What's an Active Business?

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"Active" means different things to different people. As I become more sedentary, it certainly means something different to me today compared with 25 years ago. Even confined within the halls of the tax world, "active" has various meanings. For example, it is often used as an antonym for "passive," which can have relevance under the passive activity loss rules of Code Sec. 469. Similarly, it is often used to describe a level of business activity denoting a "real" trade or business, as opposed to something (albeit profit motivated) that is more akin to portfolio investing activity.

In the M & A world, which is at least in part a subspecialty of the tax world, "active" is most likely to be referred to in the context of Code Sec. 355. Code Sec. 355 is in some ways the last bastion of the *General Utilities* doctrine, that relic of our corporate tax system that went out (like the bath water) when the whopping 1986 Tax Act and 1986 Code came in. Although Code Sec. 355 has been whittled down in efficacy over the years, it is (thankfully) still with us.

Base Line

As M & A Tax Report readers know, Code Sec. 355 allows a corporation to distribute the stock and securities of another corporation it controls to its shareholders and security holders. Significantly, it facilitates this distribution without causing either the distributing or distributed corporations, or indeed, even the shareholder recipients, to recognize income, gain or loss. That plainly is a mouthful.

The devil is in the details, of course, and beyond this simple statement, there are many requirements that must be navigated in order for this tax Valhalla to be possible. One of them is the active trade or business requirement, designed at least in part to prevent portfolio companies that engage in mere income production to qualify. The active business requirement is generally satisfied if the following conditions apply:

- Both the distributing corporation and the controlled corporation have engaged in the active conduct of a trade or business throughout the pre-distribution period.
- The distributing corporation and the controlled corporation are so engaged immediately after the distribution.
- There have been no acquisitions of control of either the distributing or the controlled corporation during that period.

This is hardly new, of course. Indeed, what constitutes an active business for purposes of Code Sec. 355 has long been one of the key limitations inherent in Code Sec. 355, preventing, for example, the distribution of portfolio companies and investment companies that merely engage in rental real estate operations, *etc.* Of course, just what is "active" is a question of degree.

Fortunately, there are now plenty of situations in which activities that might in other contexts be viewed as not sufficiently active are considered to be active for purposes of Code Sec. 355. Anyone who's ever been involved in a spin-off of real estate operations knows what to look for. This can include making decisions about tenants, and handling directly (or at least making decisions about) custodial services, *etc.* Rental real estate, after all, can be an active business too.

TIPRA Anyone?

In its continuing efforts to tinker with Code Sec. 355, Congress amended Code Sec. 355(b) in 2005, as part of the Tax Increase Prevention and Reconciliation Act of 2005 (a tax bill producing the dubious acronym "TIPRA"). Code Sec. 355(b)(3) was enacted because Congress became concerned that, prior to a distribution under Code Sec. 355, corporate groups conducting business in multiple entities often underwent elaborate restructurings to place one or more active businesses in the proper entities to satisfy the active trade or business requirement. Code Sec. 355(b)(3) therefore treats all members of a corporation's Separate Affiliated Group (SAG) as one corporation.

The idea was to greatly reduce the need for such restructurings. That sounds almost charitable. On the other hand, introducing this kind of rule into the active trade or business requirement could significantly impact the operation of Code Sec. 355. In a way that the Treasury evidently thought would be consistent with Congressional intent, proposed regulations were issued on May 8, 2007 to interpret Code Sec. 355(b)(3). The Treasury says that it hopes these proposed rules integrate the various provisions of Code Sec. 355(b). [*See* Reg-123365-03, FR 26012, 2007 TNT 88-4 (May 8, 2007).]

SAG

When you say "SAG," the LA crowd will think Screen Actors Guild. Not here. All members of the corporation's SAG are treated as one corporation ("SAG rule"). This SAG rule is applied in determining whether the distributing and controlled corporations are engaged in the active conduct of a trade or business immediately after the distribution. Moreover, the SAG rule is applied throughout the pre-distribution period too.

Because the SAG rule treats all members as one company, the separate existence of subsidiaries is disregarded. That means all assets (and therefore all activities) owned and performed by members of the SAG are treated as owned and performed by the distributing or controlled corporations, as the case may be. Where one member satisfies the active trade or business requirement, the distributing or controlled corporation (as the case may be) will satisfy the active trade or business requirement.

On the flip side, though, the SAG rule also applies in determining whether there has been an impermissible acquisition during the pre-distribution period under Code Sec. 355(b)(2)(C) or (d). Because the SAG rule disregards the separate existence of the subsidiary SAG members, stock acquisitions that result in a corporation becoming a subsidiary SAG member will be treated as a direct acquisition of the subject assets or activities by the acquired corporation.

In essence, the rules clarify a look-through concept. All members of the SAG are treated as one corporation, both during the five-year period preceding the spin, and immediately after it.

Acquisitions

Code Sec. 355 generally says that a trade or business directly or indirectly acquired during the pre-distribution period will not satisfy the active trade or business test, unless it was acquired in a transaction in which no gain or loss was recognized. One of the reasons for this, of course, is to limit the potential for the conversion of dividend income into capital gain through a Code Sec. 355 distribution. Now, the Treasury has suggested that the common purpose of Code Sec. 355(b)(2)(C) and (d) is to prevent the distributing entity from using assets (instead of its stock, or stock of a corporation in control of the distributing corporation) to acquire a new trade or business in anticipation of distributing it to its shareholders tax free.

Acquiring a new trade or business using assets that would be used to affect a purchase, and distributing the new business (or distributing an existing trade or business) would effectively accomplish a separation. In the IRS's view, that should not qualify under Code Sec. 355. Think disguised dividend (if that helps).

In other words, Congress (with Treasury support) is preventing a distributing entity from using its assets (instead of its stock) to acquire a new trade or business. Referring to the historic relationship between the entities, the preamble to the proposed regulations states flatly that "Section 355, like the reorganization provisions, involves the maintenance by the shareholders of a continuing interest in their business or businesses in modified corporate forms." [*See* FR 72, 88, at 26015 (May 8, 2007).]

If your eyes are starting to glaze over, you're not alone. Already, the recent law and lore of Code Sec. 355 is becoming a little muddled. Some transactions that seem to violate one of its provisions seem to be blessed as perfectly valid Code Sec. 355 transactions, and presumably some go the other direction. As the preamble to these proposed regulations notes in *I. Gordon,* CA-2, 67-2 USTC ¶9592, 382 F2d 499 (1967), *rev'd on other grounds,* SCt, 68-1 USTC ¶9383, 391 US 83 (1968), the Second Circuit concluded that even though gain was recognized, Code Sec. 355(b)(2)(C) was not violated, because new assets were not brought within the combined corporate shells of the distributing and controlled corporations.

Therefore, the court found that the common purpose of Code Sec. 355(b)(2)(C) was not violated. The preamble also notes Rev. Rul. 69-461, 1969-2 CB 52, which held that a first tier subsidiary's taxable distribution of stock of a second tier subsidiary to its parent did not violate Code Sec. 355(b)(2)(d). Another ruling, Rev. Rul. 78-442, 1968-2 CB 143, held that Code Sec. 357(c) gain on the transfer from the distributing to the controlled entity also does not violate Code Sec. 355(b)(2)(C).

Proposed Regulations

Given the complexity of the proposed regulations, it is easy to lose sight of their general thrust in the minutiae. The proposed regulations basically interpret Code Sec. 355(b)(2)(C) and (D) to say that a corporation is generally not allowed to use its assets to acquire a trade or business for purposes of facilitating a Code Sec. 355 distribution. As a result, the proposed regulations generally prohibit acquisitions made in exchange for distributing assets, even if no gain or loss is recognized in connection with the acquisition.

Since there is already case law as well as revenue rulings which provide exceptions to the literal application of Code Sec. 355(b)(2)(C) and (D), the proposed regulations also provide some exceptions for some acquisitions in which gain or loss is in fact recognized. Note, however, that the recognition of gain or loss is not disregarded in transactions between affiliates, unless the affiliates are members of the same SAG.

There is also guidance provided in the proposed regulations on determining whether a corporation is engaged in a trade or business through the attribution of trade or business assets and activities from a partnership. The regulations clarify when a partnership's trade or business assets and activities can be attributed to the corporation. The partnership provisions can lead to results similar to the rules on the satisfaction of continuity of business requirements. As a result, partners can be attributed a partnership's trade or business assets and activities when the partner owns a significant interest in the partnership.

Line-Drawing

There are lots of fine lines to be drawn here. One relates to "expansion acquisitions." After all, a trade or business can undergo many changes during its lifetime, and during the pre-distribution period, and still satisfy the Code Sec. 355(b) requirements. [*See T.J. Lockwood Est.*, CA-8, 65-2 USTC ¶9646, 350 F2d 712 (1965).] Even the proposed regulations indicate that where a corporation engaged in a trade or business, which during the five year period purchases, creates or otherwise acquires another trade or business in the same line of business, that acquisition will ordinarily be treated as an expansion of the original business. All of it will be treated as having been actively conducted during the 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. §1.35-3(b)(3)(ii).]

Obviously, this can appear to be a question of degree, and can become circular. The SAG rule, of course, will cause a stock acquisition in which the acquired corporation becomes a subsidiary SAG member to be treated as an asset acquisition. That means a corporation which is engaged in a trade or business should be able to expand its existing trade or business by acquiring stock (including stock of a controlled corporation) that is *also* engaged in a trade or business in the same line of business, provided that the acquisition results in the acquired corporation becoming a subsidiary SAG member.

On the other hand, a corporation is not allowed to rely on the trade or business of a non-SAG subsidiary (even if the corporation controls the subsidiary) to satisfy the active trade or business requirement. This will effectively preclude stock expansions where the acquired corporation does not become a subsidiary SAG member.

For Better, for Worse

If it sometimes seems that the definition of an active trade or business has gotten narrower and narrower, take heart. In some places, there are significant liberalizations. For example, the IRS and the Treasury have extended the principles of Rev. Rul. 79-394, 1979-2 CB 141, and Rev. Rul. 80-181, 1980-2 CB 121. Those rulings had concluded that the controlled corporation will satisfy the active trade or business requirement even if all of the operational activities of the business are conducted by an affiliate's employees for the distribution.

The proposed regulations would expand this notion to the performance of management, in addition to operational functions by employees of an affiliate. Thus, under the proposed regulations, in determining whether a corporation is engaged in the act of conduct of a trade or business, activities (including management and operational functions) that are performed by employees of the corporation that are affiliates (including non-SAG members) are taken into account.

Last Gasp

These proposed regulations are proposed to apply to distributions that occur after the date they are published as final regulations in the federal register. Interested parties are invited to comment, and it seems clear that Code Sec. 355 will continue to evolve.

Interestingly, one significant "hot stock" rule was not addressed in the proposed regulations. If the distributing corporation and the controlled corporation are involved in the same active trade or business, and the distributing corporation makes a cash purchase of 100 percent of the outstanding stock of controlled, what happens? Well, distributing was *already* in the same business as controlled. That should mean this purchase is merely an expansion of the distributing corporation's historic business. Therefore, it should not be in violation of Code Sec. 355(b)(2)(C) or (b)(2)(D).

However, note that the so-called hot stock rule of Code Sec. 355(a)(3)(B) tells you that if the controlled corporation is acquired in a capital transaction in the five-year period before the spin-off, then the distributed stock will be treated as boot. Ouch! The proposed regulations do not deal with this nettlesome topic. There have been some suggestions that the hot stock problem might be dealt with in various ways. It seems unlikely that the proposed regulations are going to deal with this anytime soon.

This latest spate of proposed regulations adds a new vocabulary to the M&A and tax lawyer repertoire, a kind of clever SAG-speak. With it, comes a new set of concerns.