More on Active Businesses and Code Sec. 355

By Robert W. Wood • Wood & Porter • San Francisco

Code Sec. 355 is a kind of evergreen provision to M&A TAX REPORT subscribers. Although it is considerably more narrow today than it was 30 years ago, it is still viable, still popular and still represents one of the only holes in the dyke of *General Utilities* repeal. (Or in case you don't like that metaphor, maybe Code Sec. 355 is the finger that goes in the hole in the dyke).

In any event, although the IRS and Congress both continue to chip away at this nearly hallowed provision, there are some good things of late. As we reported in a recent issue (Robert W. Wood, *What's an Active Business?* M&A TAX REP., July 2007), the Tax Increase Prevention and Reconciliation Act of 2005 (odiously initialized as "TIPRA") enacted Code Sec. 355(b)(3). The idea was to treat all members of a separate affiliated group ("SAG") as one corporation. Furthermore, the idea was to obviate the kind of gerrymandering, er I mean restructurings, that occurred.

Although [Code Sec. 355] is considerably more narrow today than it was 30 years ago, it is still viable, still popular and still represents one of the only holes in the dyke of *General Utilities* repeal.

Staying Active

Code Sec. 355(b)(2)(A) deals with a considerably more fundamental issue under Code Sec. 355: the active conduct of a trade or business. It is axiomatic that Code Sec. 355 works only where you have one (or maybe two, since you really need controlled and distributing corporations to conduct them). Portfolio activities are decried.

Fundamentally, the Code requires the trade or business to have been actively conducted throughout the five-year period that ends on the date of the distribution. [*See* Code Sec. 355(b)(2)(B).] Moreover, the trade or business cannot have been acquired in a transaction in which gain or loss was recognized (in whole or in part) within the predistribution period (namely, the five-year period ending on the date of the distribution). [*See* Code Sec. 355(b)(2)(C).] Finally, control cannot have been acquired (directly or indirectly) by any distributee corporation or by the distributing company, during the predistribution period in a transaction in which gain or loss was recognized (in whole or in part).

Intra-Group Transfers

Although there is a general prohibition on transactions in which gain or loss is recognized, Reg. §1.355-3(b)(4)(iii) allows a direct or indirect acquistion of a trade or business by one member of an affiliated group from an another. Sensibly, that kind of transaction is disregarded. Morever, although this rule generally applies to distributions before December 15, 1987, the IRS has applied it after that date too.

As noted, TIPRA amended Code Sec. 355(b) so that all members of the corporation's SAG are treated as one corporation. Recently, this led the IRS and the Treasury to scratch their collective heads over the consistency (or lack thereof) between the rule that acquisitions between members of an affiliated group are disregarded (on the one hand), and the rule that an affiliated group are treated as one (on the other).

Transitional Relief

As a result, in Notice 2007-60, IRB 2007-35, 1, the IRS indicates (consistent with past administrative practice) that it will not challenge the applicability of the rules stated in Reg. §1.355-3(b)(4)(iii) to distributions effected on or before the publication date of temporary or final regulations that ultimately modify that rule.

Additional Stock Acquisitions

Another fillip in Code Sec. 355 is Code Sec. 355(b)(2). One wing of that provision applies to asset acquisitions (Code Sec. 355(b)(2)(C)) and another to stock acquistions (Code Sec. 355(b)(2)(D)). The question is exactly what Code Sec. 355(b)(3) does to this.

That provision essentially treats a stock acquisition (that results in the acquired corporation becoming a subsidiary member of the acquiring corporation's SAG) as an asset acquisition for purposes of Code Sec. 355(b). That means (according to the IRS) that such a stock acquisition is subject to Code Sec. 355(b)(2)(C), regardless of whether it secures control (thus triggering Code Sec. 355(b)(2)(D)).

Example. Assume that corporations C and D have each engaged in the active conduct of a trade or business for more than five years. Also assume that C and D are not in the same line of business. Throughout the previous five years, D has owned stock of C constituting control (368(c) control, but not Code Sec. 1504 control). In year 6, D purchases (for cash) the remainder of the C stock from an unrelated party. Here, the purchase of the additional C stock does not violate Code Sec. 355(b)(2)(D) because D *already* owned stock of C constituting control as defined in Code Sec. 368(c). However, after the stock purchase, D owns stock that meets the requirements of Code Sec. 1504(a)(2), namely, 100 percent. Because of that, after this purchase, C becomes a member of D's SAG.

Thus, D and C are thereafter treated as one corporation for purposes of the active trade or business requirement. That means that, for purposes of Code Sec. 355(b), D has acquired the assets of C in a transaction in which gain or loss was recognized. That means you violated Code Sec. 355(b)(2)(C).

Yikes!

One of the statements in Notice 2007-60 is a cute understatement: "Taxpayers may not have anticipated that such acquisitions of additional stock of the controlled corporation would adversely impact the controlled corporation's ability to satisfy the active trade or business requirement." Yes, that's true.

The notice helpfully goes on to state that the IRS will not challenge the distributing corporation's (or its SAG's) acquisition of additional stock of the controlled corporation as violating Code Sec. 355(b)(2)(C) with respect to the controlled corporation, in the case of distributions affected on or before the date the proposed regulations (that were published in May, and which we covered in Wood, *supra)*, are published as temporary or final regulations.

Of course, the IRS notes that all of this is subject to the proviso that the transaction needs to satisfy the requirements of Code Sec. 355(b)(2)(D) as in effect before the enactment of Code Sec. 355(b)(3).