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Amended Spinoff Law: How Bad Is It?

by Robert W. Wood • San Francisco

There has been discussion over Section 355 and its reach for at least ten years. Ever since the *General Utilities* doctrine was repealed in 1986, Section 355 emerged as one of the few remaining avenues for moving assets outside a corporation without paying tax. While there was never a serious movement to entirely repeal Section 355, it was amended several times, culminating in significant amendments in the Taxpayer Relief Act of 1997.

Deja Vu

Ten years earlier, the Revenue Act of 1987 amended Section 355 so that the nonrecognition rules for distributees do not apply to any distribution by a corporation if control of the distributed corporation was acquired by a corporate distributee within five years prior to the distribution. I.R.C. §355(b)(2)(D). Thus, a full five-year waiting period is required before a distribution can be covered by Section 355.

In 1988, further changes (albeit merely technical ones) were made. Section 355(b) was amended to provide that nonrecognition treatment will not apply if either the distributee corporation or the distributing corporation acquires control, directly or indirectly, over the controlled (distributed) corporation in a taxable transaction within five years before the distribution. Technically, if such a taxable transaction within the preceding five years has occurred, the corporation will not be treated as engaged in the active conduct of a trade or business, thus failing one of the prerequisites of Section 355 treatment.

Annual Changes?

The next round of Section 355 amendments occurred in 1990. Recognition of corporate level gain was then required on a distribution of subsidiary stock or securities qualifying under Section 355 if, immediately after the distribution, a shareholder holds a 50% or greater interest in the distributing corporation or the distributed subsidiary that is attributable to stock or securities that were acquired by purchase within the preceding five-year period. I.R.C. §355(d).

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Consequently, gain recognition will be required by the distributing corporation if a person purchases stock or securities in the distributing corporation and, within five years, 50% or more of the subsidiary stock is distributed to that person in exchange for the purchased stock or securities.

This five-year purchase prohibition of Section 355(d) contains a number of nuances. For example, there is a somewhat counter-intuitive definition of the term "purchase." Plus, calculations of the five-year period can include extra time depending upon positions in which one's risk of loss is altered. And there are additional wrinkles in this 1990 law. Now, though, most attention seems focused on the 1997 round of Section 355 changes.

Here Morris

The focus of the most recent scrutiny was the *Morris Trust* transaction, so called because of the case by that name. *Morris Trust* is reported at 367 F.2d 974 (4th Cir. 1966). *Morris Trust* was a popular acquisition technique in which a target could be acquired on a tax-free basis without acquiring one or more unwanted businesses owned by the target. Put simply, the target spun off the unwanted businesses to its shareholders before the acquisition.

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In the halcyon days prior to the 1997 tax law, both the spinoff and the acquisition were tax-free. As a result of the 1997 scrutiny on Section 355, now a corporate level tax will be imposed on certain of these transactions. For an early warning, see Matthias, "Clinton Administration Proposes *Morris Trust* Ban," Vol. 4, No. 10 (May 1996), p. 1.

The traditional *Morris Trust* transaction was accomplished by distributing one of the corporate businesses into a new corporation via Section 351, spinning off the new corporation, and then having shareholders of the distributing corporation transfer stock in the distributing corporation in exchange for stock in an unrelated corporation. This efficient acquisition mode allowed a corporation to dispose a portion of its business to new shareholders without the recognition of gain. That bothered the IRS and ultimately Congress.

Interestingly, in the actual *Morris Trust* case, after the Section 355 distribution, the distributing corporation merged with an unrelated corporation. However, the shareholders of the distributing corporation controlled more than 50% of the shares of the merged corporation. Consequently, even if the new 1997 rules had applied to the facts, the result in *Morris Trust* would not have been changed.

Such musings aside, let's look at what the new requirements do and how one must comply with them. Under Section 311, a corporation that distributes its property to shareholders is generally required to recognize gain on a distribution as if the property had been sold for its fair market value. A shareholder who receives a distribution generally must treat the receipt of the property as a taxable event.

There are nonrecognition provisions that allow property to be distributed without incurring gain at the corporate level, or even by the shareholders who receive the property. The most significant of these exceptions involves spinoffs—distributions of stock of controlled corporations provided detailed requirements are met. If they are, then property can be transferred to a new entity and stock can be distributed without the recognition of gain by either the corporation or the shareholder.

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With the 1997 law change, new restrictions apply on the acquisition or disposition of the stock of a distributing or controlled corporation. If either the controlled corporation or the distributing corporation is acquired pursuant to a plan or arrangement in existence on the date of the distribution, gain will generally be recognized by the distributing corporation as of the date of the distribution.

In the case of an acquisition of a controlled or distributing corporation, the amount of gain recognized by the distributing entity will be the amount of gain that the distributing corporation would have recognized had stock of the controlled corporation been sold for fair market value on the date of distribution. Although this gain is treated as long-term capital gain, no adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of this gain.

Acquisition of Controlled Corporations

Whether a corporation is considered to be acquired under these rules is basically determined in the manner prescribed by Section 355(d), except that acquisitions are not restricted to so-called "purchase" transactions. Thus, an acquisition occurs if one or more persons acquire, directly or indirectly, 50% or more of the vote or value of the stock of the controlled or distributing corporation pursuant to a "plan or arrangement." I.R.C. §355(e)(2)(A). Acquisitions occurring within the four-year period beginning two years before the date of distribution (and continuing two years after) are presumed to have occurred pursuant to a plan or arrangement. Taxpayers can avoid gain recognition by showing that an acquisition occurring during this four-year period was unrelated to the distribution. I.R.C. §355(e)(2)(B). Thus, the four-year presumption is rebuttable.

If the assets of the distributing or controlled corporation are acquired by a successor in an A, C or D reorganization, or in any other transaction specified in regulations, the shareholders immediately before the acquisition of the corporation acquiring those assets will be treated as acquiring stock in the corporation from which the assets were acquired. I.R.C. §355(e)(3)(B). If the former shareholders of the distributing or controlled corporation receive stock in a successor or in a new controlling corporation, though, then the stock is apparently not treated as acquired stock if it is attributable to the shareholder's stock in the distributing or controlled corporation, and if it was not acquired as part of a plan or arrangement to acquire 50% or more of the successor or other corporation. I.R.C. §355(e)(3)(A).

The following example demonstrates the trap that can exist in this kind of situation:

> ***Example:*** Parent distributes 100% of the stock of its subsidiary, Smallco, to its shareholders. Parent has a $100,000 basis in Smallco, and Smallco's market value is $10,000. One year later, an unrelated corporation purchases 1% of Smallco's stock. A 50% or greater interest in the controlled corporation has been acquired in the four year measuring period (beginning two years before the distribution date). Consequently, it is presumed (unless you can establish otherwise) that the acquisition and distribution are pursuant to a "plan or arrangement." The parent corporation must therefore recognize gain of $90,000, the amount of net gain which would have been recognized if all of the assets of Smallco were sold at their fair market value.

A plan or series of related transactions will not cause the recognition of gain if, immediately after the completion of the plan or transaction, the distributing corporation and all of the controlled corporations are members of a single affiliated group. For this purpose, however, a rather curious version of Section 1504 applies. The Code's definition of an affiliated group in Section 1504 is modified for this purpose to exclude various exceptions, such as tax-exempt organizations, life insurance companies, foreign corporations, real estate investment trusts, or regulated investment companies. Thus, these entities could be considered a member of an affiliated group in determining whether the distributing and controlled corporations are in the same affiliated group.

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Interaction with §355(d), etc.

There is a rather significant interaction between the new restriction (now contained in Section 355(e)), and the prior one contained in Section 355(d). The new rules do not apply to a distribution that would otherwise be subject to Section 355(d), which imposes corporate level tax on certain disqualified distributions. Likewise, the new provisions do not apply to a distribution pursuant to a Title XI bankruptcy or similar case.

Unless the stock held before an acquisition was acquired pursuant to a plan to transfer 50% control of either the controlled or distributing corporation, the following acquisitions are not considered acquisitions of a controlled corporation for purposes of these rules:

- The acquisition of stock in any controlled corporation by the distributing corporation (such as a drop down of property by the distributing corporation to the controlled corporation in exchange for its stock);
- The acquisition by a person of stock in any controlled corporation by reason of holding stock or securities in the distributing corporation;
- The acquisition by a person of stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock or securities in the distributing or controlled corporation (such as the receipt by a distributing corporation shareholder of controlled corporation stock in a split-off distribution in which the shareholder did not own 50% of the distributing corporation, but does own 50% of the controlled corporation; and
- The acquisition of stock in a corporation if shareholders, who own directly or indirectly stock possessing more than 50% of the total combined voting power and total value of all classes of stock in either the distributing corporation or any controlled corporation before the acquisition, owned directly or indirectly stock possessing such vote and value in that distributing or controlled corporation after the acquisition. This would cover the receipt by the former shareholders of the distributing or controlled corporation of 50% or more of a successor corporation in a merger of the distributing or controlled corporations. I.R.C. §355(e)(3).

Interestingly, in applying all of these rules, the attribution rules of Section 318(a)(2) kick in for purposes of determining whether a person holds stock or securities in a corporation. However, Section 318(a)(2)(C) is applied without regard to the phrase "50% or more" in value, so that attribution from corporations is applied regardless of the amount of stock ownership. The aggregation rules of Section 355(d)(7)(A) also apply. The result is that all related persons (within the meaning of Section 267(b)) are treated as one person. I.R.C. §355(e)(4)(C)(i).

Regulations Coming

Although it will doubtless be some time before they are released, the IRS is specifically authorized (and really needs to) prescribe regulations to carry out the purposes of these provisions. One of the intended topics of the regulations is to provide for the application of these provisions in the case of multiple

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transactions, and to more than one controlled corporation. In determining whether a 50% interest has been acquired, regulations may also be provided for applying rules similar to Section 355(d)(6), thus suspending the holding period for any stock or security for which a taxpayer's risk of loss is substantially diminished through devices such as options and short sales. See I.R.C. §355(e)(5).

Intragroup Distributions

The law and its legislative history spend a fair amount of time dealing with intragroup distributions. Except as provided in regulations, where distributions of stock occur within an affiliated group of corporations, the nonrecognition rules of Section 355 do not apply to any distribution of the stock of one member of the group to another member, if one or more persons acquire directly or indirectly 50% or more of the vote or value of the stock of the controlled or distributing corporation pursuant to a plan or arrangement. I.R.C. §355(f).

Interestingly, the Conference Committee Report to the provision suggests that the IRS might consider issuing regulations under which gain would not have to be recognized when an intragroup distribution fails to qualify under Section 355. For example, instead of recognizing gain, perhaps adjustments could be made to the basis of stock in the constituent companies.

As if the consolidated return rules were not complex enough already, injecting a whole new level of complexity into the mix via Section 355 seems unfortunate. Various determinations may now need to be made with respect to so-called intragroup spinoffs, and such intragroup spinoffs may be qualified under Section 355. However, the Conference Committee Report expresses concerns that excess loss accounts may not be recaptured when there is an internal spinoff followed by a subsidiary leaving the group. The Conference Committee Report suggests that the IRS may provide rules that require a carryover basis within the group for the stock of the distributing corporation, including a carryover of an excess loss account. They also suggest that the change in the value and basis of the distributing corporation's assets should be reflected in basis reduction to the stock of the distributing corporation.

Even a relatively simple matter like allocating a shareholder's basis between shares of stock after a distribution can be complicated. The Conference Committee Report suggests that with an affiliated group having a high inside basis in one corporation, increasing depreciation deductions, and a high outside basis in the other corporation, it could reduce gain if that corporation was sold!

The Conference Committee Report therefore suggests that the IRS may want to determine that the aggregate stock basis of the distributing and controlled corporations *after* the distribution should be adjusted to an amount that is less than the aggregate basis of the stock of the distributing corporation *before* the distribution. This would prevent the inappropriate potential for artificial losses or diminishment of gain on disposition of any of the corporations involved in the spinoff. The topic, frankly, makes my head spin.

What is Control?

There is even a new issue about how one measures control. Under Section 351, of course, there must be control immediately after the transaction. The fact that a corporate transferor distributes part or all of the stock it receives in the exchange to its shareholders will be disregarded. In a transaction that otherwise meets the requirements of Section 355, shareholders who receive stock in a distributed corporation are treated as in control of the distributing corporation immediately after the distribution if they hold stock representing greater than 50% of the total combined voting power and 50% of the value of all classes of stock of the distributing corporation. I.R.C. §351(c).

For certain divisive transactions, the control test of Section 304(c) will apply. This requires that at least 50% of the total combined voting power and 50% of the value of all classes of stock are owned, including stock that is "owned" based on the attribution rules of Section 318(a). However, in a transaction that otherwise meets the requirements of Section 355, shareholders receiving stock in a distributing corporation are treated as in control of the distributed corporation immediately after the distribution if they

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hold stock representing greater than 50% of the total combined voting power and 50% of the value of all classes of stock of the distributed corporation (with no stock attribution).

Thus, this is actually a positive change, a liberalized definition of control for certain transactions. Under prior law, where the distributing corporation transferred assets to a controlled corporation before distributing the controlled corporation stock to its shareholders, the shareholders had to meet a strict 80% ownership test of the stock in the controlled corporation immediately after the distribution. The 1997 law reduces this percentage control requirement from 80% to 50%, so shareholders only need own 50% of the stock (by vote or value) after the distribution. Of course, the distributing corporation must still distribute an 80% controlling ownership interest in the corporation that is being spun off.

This liberalized control requirement should provide greater flexibility in the restructuring of ownership of a controlled corporation in connection with spinoffs. It may now be more possible to have a pre-arranged investment in the controlled company following a spinoff that is greater than 20%, but still less than 50%.

Effective Dates and Transition Rules

The new anti-*Morris Trust* regime is generally effective for distributions after April 16, 1997, pursuant to a plan that involves an acquisition described in Section 355(e)(2)(A)(ii) occurring after that date. However, the greater than 50% control requirement that applies immediately after certain Section 351 transactions and that applies immediately after certain Section 368(a)(1)(B) distributions will be effective for transfers after August 5, 1997.

Transitional rules provide that these provisions that would otherwise require gain to be recognized do not apply for any distribution pursuant to a plan (or series of related transactions) occurring after April 16, 1997, if such acquisition (or transfer) is:

- made pursuant to an agreement that was binding on April 16, 1997 and at all times thereafter;
- described in a ruling request submitted to the IRS on or before that date;
- described on or before that date in a public announcement or in a filing with the SEC required solely by reason of the acquisition or transfer.

Unfortunately, the transitional rules do not apply to any agreement, ruling request, public announcement or SEC filing unless it identifies the acquirer of the distributing corporation or any controlled corporation, or the transferee, whichever applies. The Conference Committee Report states that the transitional rules apply to any contract, even if not written, that is binding under state law as of April 16, 1997. However, so far it seems unlikely someone would rely on purely oral communications!

As Bad As It Wants To Be

It seems safe to assume that the changes wrought by the amendments to Section 355 will have significant effect. Not only do they arguably target a class of transactions that is much broader than they could have done, the determinations that are required can be unduly complex. If either party is acquired pursuant to a plan or arrangement in existence on the date of the distribution, a gain will generally be recognized by the other corporation as of that date.

The idea, of course, is to limit a company's ability to dispose of a portion of its business to new shareholders without recognizing gain. This gain recognition provision kicks in when one or more persons acquire a 50% or greater interest in either the distributing or controlled corporations pursuant to a plan or series of related transactions. Time will tell whether Congress and the IRS really get what it wanted. ■