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THE M&A Tax Report

VOLUME 14, NUMBER 12
JULY 2006

THE MONTHLY REVIEW OF
TAXES, TRENDS & TECHNIQUES

Latest Tax Act Impacts Spin-offs

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It wasn't too many years ago that tax laws bore unimaginative names such as The Tax Reform Act of 1969, 1976 and so on. Tax reform seemed a laudable goal. One could debate whether there was a lot or a little reform, but the names were descriptive and predictable.

Then came the Economic Recovery Tax Act of 1981, President Reagan's brainchild. From then on, tax laws have acquired increasingly imaginative—and sometimes downright bizarre—titles. Whether we are promoting deficit reduction (1984), community renewal (2000), no child left behind (2000), victims of terrorist relief (2001) or "tax increase prevention" (the most recent iteration of this phenomenon), we like to give our tax laws pithy handles. All too often, these omnibus tax bills are chock full of all sorts of pluses and minuses, whatever the moniker might be that sometimes seems merely the result of a popular name contest.

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) [P.L. 109-222] carries on this cute tradition, but like so many of its predecessors, contains a lot that isn't obvious from the name. One such set of provisions impacts Code Sec. 355, long a favorite of readers of the M&A TAX REPORT.

Active Business Hurdle

Code Sec. 355 contains a number of critical lynchpins, including the sometimes Kafka-esque determination of what constitutes a good business purpose, and the related (but distinct) question of just what constitutes a device to distribute earnings and profits. Yet, among the seemingly more pedestrian and mechanical requirements lies the active business requirement. Sometimes this particular issue requires one to focus on just what is active and what is passive in nature. Take managing and operating real estate (or just passively renting it out), for example.

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The active business requirement actually dictates either that, immediately after the distribution:

- both the distributing and the controlled corporation must be engaged in the active conduct of a trade or business; or
- the distributing corporation has no assets other than stock or securities of controlled corporations and, immediately after the distribution, each of those controlled corporations is itself engaged in the active conduct of a trade or business.

Of course, yet another requirement is that this trade or business must have been actively conducted for five years and must not have been acquired within that period of time in a transaction in which gain or loss was recognized. A big question, though, often arises when holding companies hold subsidiaries that are engaged in the active conduct of a trade or business. In the context of tiered structures, the IRS has long taken the position that, in evaluating the active trade or business test, the fair market value of the gross assets of the trade or business being relied upon must equal at least five percent of the total fair market value of the corporation's gross assets.

Furthermore, the IRS has said that at least 90 percent of the corporation's gross assets must consist of stock and securities of controlled corporations engaged in the active conduct of a trade or business. If you add these thoughts together, the rule for holding companies was tougher than stand-alone operations, and that has caused considerable gyrations in the board room. Maybe restructurings to take advantage of Code Sec. 355 have been good for tax lawyers, but they sometimes don't make a lot of sense.

An Ounce of Prevention

Under TIPRA, a corporation is treated as satisfying the active conduct of a trade or business test if (and only if) it is engaged in the active conduct of a trade or business. Yet, all members of the corporation's "separate affiliated group" are treated as one corporation. [*See* Code Sec. 355(b)(3)(B).]

A "separate affiliated group" is the affiliated group that would be described in Code Sec. 1504(a) were the corporation the common parent, and the exclusions provided by Code Sec. 1504(b) did not apply. [*See* Code Sec. 355(b)(3)(B).] Code Sec. 1504(a), of course, contains the age-old 80-percent vote and value requirements, and disregards certain preferred stock, as long as it is nonvoting and nonconvertible into another class of stock, is limited and preferred as to dividends, and does not participate in corporate growth to any significant extent. Plus, if the preferred has redemption and liquidation rights, they must not exceed the issue price of the stock, excepting reasonable premiums.

Notably, the exclusions of Code Sec. 1504(b) do not apply, meaning that the special types of companies, insurance companies, foreign corporations, *etc.*, can benefit from the new Code Sec. 355 rule too. The short version is simply that Congress has made it easier—for a while

THE M&A Tax Report
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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646.
Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

at least—for corporate groups that use a holding company structure to do spin-offs. I say "for a while" because, in something that is becoming annoyingly familiar, this provision applies *only* to distributions made after May 17, 2006, and *before* January 1, 2011. As if tax professionals don't have enough to worry about, we need now to worry about sunsets in the law and the inevitable discussions about extenders.

Of course, there are transition rules that may help some, and there is even an election that can be made. [*See* Code Sec. 355(b)(3)(C).] Although there are some details and qualifiers here, aficionados of Code Sec. 355 will recognize this as a positive (if temporary) change.

Second Code Sec. 355 Fix

True to its appealing moniker, TIPRA may provide some tax benefits, but like all things coming out of Congress with clever and appealing names, it also takes benefits away. TIPRA amends Code Sec. 355(g) to disallow Code Sec. 355 treatment if, immediately after the distribution:

- either the distributing corporation or the controlled corporation is a "disqualified investment corporation"; and
- any person holds a 50-percent or greater interest in any disqualified investment corporation, but only if
- the person did not hold that interest immediately before the transaction. [*See* Code Sec. 355(g)(1).]

This provision is all about cash and liquidity. Plus, it harkens back to that almost McCarthy-esque inquiry of just what constitutes a device to distribute earnings and profits. The presence of substantial nonbusiness assets has always been a factor suggesting that the distribution might be used principally as a device to distribute E & P. Yet, one could overcome this taint by showing a sufficiently strong business purpose.

There's quite a lot to understand about this new provision. Perhaps one should start with just what an investment asset might be. It includes any of the following:

- Cash
- Any stock or securities in a corporation
- Any interest in a partnership
- Any debt instrument or other evidence of indebtedness
- Any option, forward or futures contract, notional principle contract or derivative
- Foreign currency
- Any similar asset

Although this seems comprehensive, note that real estate held for investment is not among the list. Furthermore, there are four categories of assets that are not investment assets if they satisfy particular requirements. These include the following:

- Assets used in the active and regular conduct of certain financial trades or businesses (lending, finance, banking, *etc.*)
- Securities marked to market
- Stock or securities in a 20-percent controlled entity
- Partnership interests or partnership debt, if a partnership trade or business would be taken into account in determining if the active trade or business requirement is met [*see* Code Sec. 355(g)(2)(B)(v)]

Devil in the Details

Volumes probably could, and probably will, be written about the exception for financial trades or businesses. There's quite a lot in this new Code Sec. 355(g) provision, and I'm only scratching the surface. Being classified as a "disqualified investment corporation" is going to turn out to be a big deal. Standing back and looking at the forest, though, remember that all of this hubbub is a problem *only* where any person holds a 50-percent or greater interest in the disqualified investment corporation, and *only* where that person did hold the interest immediately before the transaction. [*See* Code Sec. 355(g)(1)(B).]

Public companies may not have to worry about this situation too frequently, but those of us engaged in a more entrepreneurial practice will much more frequently run into this. In the halcyon days before "tax increase prevention" took effect, the idea targeted in new Code Sec. 355(g) was this: A big (but not controlling) shareholder would agree to create a subsidiary. Into the subsidiary the company would drop cash as well as the assets of a small active trade or business (that it had conducted for at least five years). The idea was for the big (but not controlling) shareholder to exchange his stock in the company for stock in the new sub.

This was a non–*pro rata* spin-off, of course, so it often looked relatively safe from device concerns. Yet, this big (but not controlling) shareholder could go into the sunset with all of the stock of a new subsidiary that happened to have lots of cash and a relatively small active business. Pretty cute.

Now, a bunch of testing will be ferreting out investment assets and status as a disqualified investment corporation. There could be some gyrations involving real estate (I'm guessing). Also, the whole 50-percent-or-greater shareholder interest threshold might be explored. There's also interaction here with the partnership rules (never a model of clarity). An interest in a partnership (or any debt instrument issued by a partnership) is exempt from the investment asset taint if one or more of the partnership's trades or businesses is taken into account in determining whether the active business test is met (by either the distributing or controlled corporation). [*See* Code Sec. 355(g)(2)(B)(v)(I).]

All of this sounds pretty dizzying. Clearly, there will be regulations, and I'm guessing they will be complex and voluminous. Even if the statute hadn't mandated this, there will need to be rules implementing these complex partnership interactions.

Plus, the statute as amended says that there should be regulations to prevent the avoidance of the new rules through the use of related persons, intermediaries, pass-through entities, options or other arrangements. Moreover, the regulations are to address a type of recharacterization under which assets that are unrelated to a corporation's trade or business can be treated as investment assets if, before the distribution, investment assets were used to acquire those unrelated assets. [*See* Code Sec. 355(g)(5)(A)(ii).]

All of this sounds pretty complex, involving multiple lines of tracing and characterization. Lots more work for tax advisors, I suppose. Regulations are also to identify appropriate cases to exclude from the application of the disqualified investment corporation regime if the distribution does not have the character of a redemption that would be treated as a sale or exchange under Code Sec. 302. [Code Sec. 355(g)(5)(B).]

If you go back to the model of a former minority shareholder walking away with a controlling interest in an investment-rich subsidiary with a small active trade or business inside it, this may sound easy to do on a macro level. I predict it will not be easy when it comes to identifying exactly what does (and does not) belong within this proscribed transaction or its kin. Again, more work for tax advisors.

One more thing: This new morass is effective for distributions after May 17, 2006, but (unlike the controlled group change under Code Sec. 355), this investment corporation rule contains no sunset.

Conclusion

TIPRA gives a plus and a minus to Code Sec. 355. As M&A Tax Report readers should all be aware, Code Sec. 355 has long offered a bastion of planning potential. That doesn't mean it is easy. Yet, since the death of the now long dead (but still lamented) *General Utilities* doctrine (which lived from 1935 to 1986), Code Sec. 355 continues to allow (in appropriate circumstances and with appropriate qualifiers) enormous tax (and structural) advantages.

With the enactment of Code Sec. 355(e) and with the IRS and the Treasury continually giving Code Sec. 355 close scrutiny, this is hardly a free-for-all. Still, for those adept at maneuvering, Code Sec. 355 is one of those provisions every tax lawyer should know and of which virtually every corporate lawyer should have a basic understanding. That continues to be true.

The group-wide notion of an active trade or business is certainly a positive change. There are some nuances, but it's a pretty straightforward rule. Not so with the new "disqualified investment corporation" rules. Understanding the reason that Congress took action does not make this complicated and byzantine mess any clearer.

Maybe I'm overreacting, but I think there will be lots of confusion and a fair number of missteps with this one. Stay tuned.